Should State and Local Governments Strengthen Internal Controls by Applying SOX-Like Requirements?

A Study of State and Local Government Internal Controls and Related Management Responsibilities

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EXECUTIVE SUMMARY

This research study explores the current state of internal controls in state and local governmental entities. The project was undertaken because, in the aftermath of the 2002 passage of the Sarbanes-Oxley Act (SOX or the Act), there was considerable concern that its requirements would be extended beyond the private sector. State and local governments were concerned that even though there was nothing to equal the level of scandal that had plagued the private sector, legislators might be tempted to mandate similar requirements for state and local governmental entities. KPMG LLP, an AGA CPAG member, sponsored the research and the National Association of State Auditors, Comptrollers and Treasurers (NASACT) provided assistance with the research. This report details the study, its methodology, the responses and the findings. The recommendations developed are derived from analysis of the survey results and provide some pointers for future research.

The principal findings are that:

- State and local governments are already subject to quite stringent checks and balances (legislative versus executive branches) not found in the private sector. These act as constraints and help to prevent (or detect) misconduct.
- Fifty-seven percent of the respondents thought that the costs of compliance with the Act would outweigh any benefits to be derived from stronger internal controls.
- No more than a third of all respondents said they were required to provide an assessment of the effectiveness of the internal control structure over financial reporting.
- Sixty percent of state and local respondents said they were already obtaining opinions on the effectiveness of their internal control structure over financial reporting from their auditors.
- More effort needs to go into adopting or developing integrated internal control frameworks, such as the frameworks provided by COSO and COBIT (see pages 6 and 38).

One observation to be made is that most of the costs of compliance are in section 404 of the Act and relate to obtaining an audit opinion. There are ways to strengthen internal controls other than by getting an audit opinion. One is by adopting requirements similar to those of Office of Management and Budget Circular A-123, Management’s Responsibility for Internal Controls, Appendix A.

Recommendations for legislators:

1. Prior to proposing any new legislation or amending any existing legislation such as the Single Audit Act, federal legislators should:
   - Evaluate the costs and the benefits of any proposed legislative requirement and obtain an independent cost-benefit analysis that includes a comprehensive assessment of the costs of implementation and an assessment of the benefits directly related to those costs.
   - Contact state and local governments and find out what they are doing at the present time with respect to reporting on the effectiveness of their internal control over financial reporting. This could be done through a survey that builds on the findings of this research study.

2. Prior to enacting any new internal control-related legislation, state and local legislators should:
   - Continue to observe and assess the evolution of the Sarbanes-Oxley requirements as promulgated by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB).
   - Evaluate the costs to be incurred by and the benefits to be derived from implementation of any proposed requirement. If possible, obtain an independent cost-benefit analysis.
Introduction

Is there a need for states to adopt provisions like those in the private sector in order to better protect the public trust, especially for public interest entities that are subject to regulation? Will the federal government move to require it of the executive branch agencies, and then of state and local governmental entities, as it has for private companies registered with the Securities and Exchange Commission?

These questions have been a concern of state governments since the passage of the Sarbanes-Oxley Act in 2002. The concern has been somewhat alleviated now because the Securities and Exchange Commission (SEC) has further delayed the implementation date for smaller companies and is revising its requirements regarding auditors’ reports. Further, the Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act to establish auditing and attestation standards and known as the PCAOB, is going to amend its second auditing standard to reduce both the confusion that has led to unnecessary audit work and the costs of compliance with the Act. The proposed PCAOB revisions to its standard clarify that “an internal control audit is limited to an evaluation of whether, in the auditor’s opinion, the company’s internal control is effective, and does not include an opinion on the adequacy of management’s process to reach its conclusion.”

The report describes the results of a study conducted by AGA to survey the current state of internal controls and related management responsibilities in state and local governments. The questions respondents were asked in our survey were based on requirements that have been imposed on private sector companies by Public Law 107-204, the Sarbanes-Oxley Act of 2002 (SOX or the Act), which became law on July 30, 2002.

The topics covered by the survey questions included, but were not limited to, section 404 of the Act. Appendix I, see page 21, shows representative answers to the open-ended questions in the survey. Appendix II, see page 26, shows all questions and includes numeric answers with percentages. Section 404 is one of the most controversial in the Act because it has a requirement for entities to obtain an external auditor’s opinion on the fairness of management’s assessment of the effectiveness of the internal control structure over financial reporting (including directly evaluating that effectiveness) as well as on the traditional audit of the financial statements. In practice this has been interpreted by some to mean requiring two separate opinions. Other topics derived from the Act and covered in the survey questions run the gamut of corporate governance. They include: whether entities have audit committees; who does the audit; auditor rotation; management certification of financial reports; code of ethics; management and criminal fraud accountability; and whether the entity has an integrated framework for internal controls.

Corporate governance is the system by which companies are directed and controlled. The scope of corporate governance includes the role played by the board of directors, management, stockholders and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set and the means for attaining those objectives and monitoring performances are determined. Although this definition is couched in private sector terms, it is clearly applicable to federal, state and local governmental entities.

Corporate governance is crucial for an effective internal control structure in that it sets the “tone at the top” which influences employee behavior at all levels of the organization. Even the best system of internal controls in any organization, public or private, can be thwarted by management override of those controls. In 2006, there was at least one such case noted in a state organization’s Consolidated Annual Financial Report (CAFR).

The objectives of the research were:

• To get a comprehensive snapshot of what states and local governments are doing with regard to internal controls and related management responsibilities.
• To find out whether they have controls similar to those required by the Act.
• To determine whether stringent requirements (such as in section 404) are perhaps not needed because adequate controls to assure accountability exist and are operating effectively.
• To determine whether improvements are needed and what they might be.
• To determine whether additional research is required.

The AGA Corporate Partner Advisory Group (CPAG) Research Program decided to undertake the research project because of the spotlight that has been focused on accountability controls and good corporate governance since the passage of the Act. CPAG Research is intended to further government accountability, promote ‘thought leadership’ and be helpful to AGA membership as a whole. AGA state and local members are keenly interested in whether they may be required sometime in the future to comply with SOX-type requirements. AGA members come from all levels of government with 49 percent of the membership working for state and local government. KPMG, an AGA CPAG member, sponsored the research and the National Association of State Auditors, Comptrollers and Treasurers (NASACT), a professional organization whose mission is to assist state leaders to enhance and promote effective and efficient management of governmental resources, provided assistance with the research.

Background

The new stringent requirements for effective internal controls over financial reporting for the private sector were born out of a financial crisis, actually a series of crises. In 2001 and 2002, there was a cascade of well publicized results of failures of internal controls in the private sector: Adelphia Communications, Inc., Enron, HealthSouth, Tyco and WorldCom. The fall-out from these failures included...
the demise of Arthur Andersen, Enron’s accounting firm and then one of this nation’s premier public accounting firms. As SEC Commissioner Paul S. Atkins said in a speech on Feb. 4, 2003, “Financial crises have yielded a legislative reaction many times in the past.” This time was no exception. New legislation followed swiftly.

The large corporate failures arising from corporate mismanagement and fraud, coupled with a market decline, caused Congress to react. It rushed to pass the Sarbanes-Oxley Act of 2002, whose full title is an Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes. The Act called for creation of the PCAOB, which now sets auditing standards for public companies, subject to oversight from the SEC. Section 103(a)(1) of the Sarbanes-Oxley Act of 2002 directs the PCAOB to “establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.”

The PCAOB developed guidance for auditors in PCAOB Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (AS2). In June 2004, the SEC approved this standard. AS2 requires the external auditors to audit (based on specified control criteria) management’s assessment that the entity maintained effective internal control over financial reporting, and express an opinion both on management’s assessment and on the effectiveness of the entity’s internal control over financial reporting. This has been interpreted as requiring auditors to opine on management’s assessment of the effectiveness of the internal controls and on the effectiveness of the internal controls directly. Sometimes auditors issued two opinion reports. The proposed PCAOB revisions to AS2 will clarify that only the latter is required.

AS2 provides a definition of internal control and suggests the use of control criteria from Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report or COSO). The COSO framework can be used by management to develop its assessment. The standard also provides detailed guidance for independent auditors on the performance of their audit of internal control, which includes testing and evaluating the design and operating effectiveness of internal control. Because the control criteria the PCAOB recommends and uses in the sample reports in AS2 are the COSO criteria, we included questions in our survey on whether respondents were using COSO or any other integrated internal control framework.

The meaning of the phrase “audit of internal control” is not immediately clear, especially to non-accountants. AS2 does not use the phrase in its sample reports. What section 404 of SOX requires is that an external auditor “that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board.” Prior to issuing AS2, the PCAOB adopted all current AICPA auditing and attestation standards.

Under AICPA attestation standards, the auditor conducts an examination-level engagement under attestation standards to be able to render an opinion on whether management’s assessment of the effectiveness of internal control over financial reporting as of a specified date is fairly stated, in all material respects, based on specified criteria that are suitable and available to users. There are two levels in the attestation standards, review and examination. Only at the higher level, the examination level, can the auditor provide assurance in the form of an opinion as to management’s assessment of the effectiveness of internal control over financial reporting. At the review level, the auditor gives only what is called ‘negative assurance.’

It would appear from the answers in the survey to question 33 on page 29 of Appendix II that some local governments and state organizations are using the attestation standards to issue opinions on internal control for their legislature or other oversight bodies. It would also appear from their Performance and Accountability Reports (PARs) that the federal agencies that (voluntarily) obtain audit opinions are also using attestation standards, although in their opinion paragraphs the auditors refer directly only to FFMA and A-123. An example is the wording used in the GAO FY 2006 Performance and Accountability Report in Appendix IV on page 37 of this report.

Internal control is a concept that extends to all areas of a company’s management, not just over financial reporting. Management controls must provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use and misappropriation. Management controls developed for government programs should be logical, applicable, reasonably complete, and effective and efficient in accomplishing management objectives. Internal control over financial reporting is a subset of management controls. Definitions of internal control differ; some are broader in scope than others. Internal controls are not a single event, but a series of actions and activities that occur throughout an entity’s operations on an ongoing basis. People make internal controls work, and responsibility for good internal control rests with all managers throughout an organization. Simply stated, internal controls are everyone’s business.

AS2 defines internal control over financial reporting as: “A process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
1. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;

2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the company; and

3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company’s assets that could have a material effect on the financial statements."

AS2 also states that management is required to base its assessment of the effectiveness of the company’s internal control over financial reporting on a suitable, recognized control framework developed through due-process procedures, including exposure for public comment. Both the SEC guidance and AS2 cite the principles in the COSO report as providing a suitable framework for section 404 compliance. One of the reasons for this is that it provides an integrated framework in which to evaluate internal control effectiveness. The ideal framework for evaluating internal control is considered to be an integrated framework.

COSO is a comprehensive framework for evaluating internal control, including internal control over financial reporting. It includes a common definition of internal control and criteria against which companies can evaluate the effectiveness of their internal control systems. It comprises five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.

The COSO definition of internal control is “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations.” The COSO perspective on internal control over financial reporting does not normally include the first and third of these categories, and neither does the PCAOB definition above.

As seen from the COSO definition, internal control is a concept that extends to all areas of a company’s management, not just over financial reporting. One of the goals of COSO was to establish a common definition of internal control that serves many different parties. The PCAOB is focusing on protection of the needs of external financial statements users (investors) so it chose a narrower definition, excluding “the effectiveness and efficiency of operations” and focusing on compliance only as it related to financial reporting. Where “internal control” is used in this report it should be understood to mean “internal control(s) over financial reporting” unless otherwise stated.

During early 2006 there was much discussion of the need for better guidance, especially for smaller public companies. Smaller companies do not yet have to comply with the SOX requirements (although some have), but are extremely concerned about the cost of compliance if and when they do have to comply. The SEC is cognizant of the need for additional guidance and has twice extended the date for compliance for smaller public companies, first in September 2005, then in late 2006. Its Final Rule,2 issued on Dec. 15, 2006, extended further the deadline for compliance for these smaller public companies or “non-accelerated filers.” A non-accelerated filer is a public company that has a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter. The SEC plans to issue management guidance designed to improve section 404 procedures to establish a risk-based, top-down approach that is scalable for companies of all sizes by May 2007.

State Government Regulatory Environment Applicable to Internal Control

Two of the major sources of guidance for state and local governmental units on auditing and reporting on internal control are the Single Audit Act, as amended (SAA), and Government Auditing Standards or GAS, also known as generally accepted government auditing standards (GAGAS) and popularly known as the Yellow Book. Entities are required to comply with the Yellow Book when they have a single audit or as required by law, policy or regulation. Some states require compliance with the Yellow Book. The SAA requires entities expending more than $500,000 annually in federal financial assistance to have an auditor opine on the fairness of presentation of the financial statements; the auditor is required to comply with the Yellow Book; and must produce two additional reports, one a report on compliance with applicable laws and regulations, the other a report on internal control. These two reports are not required to contain auditor’s opinions.

The report on internal control gives what is called “negative assurance.” The auditor states that, “In planning and performing our audit, we considered the [name of entity’s] internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the general purpose financial statements and not to provide an opinion on the internal control over financial reporting.” If applicable, they go on, “However, we noted . . .” and describe material weaknesses or reportable conditions. This last wording is taken from single audit reports for the fiscal year ending June 30, 2005. The following section describes current Yellow Book guidance on reporting on internal control (referring to significant deficiencies and not reportable conditions since the terminology has been updated to conform to the terminology now used in PCAOB and AICPA guidance).

“When following Yellow Book standards, auditors may take one of two different approaches to reporting on internal control: (1) auditors may choose a scope of work sufficient to express an opinion on internal control, or (2) auditors may report weaknesses found (significant
deficiencies and material weaknesses) without issuing an opinion on internal control. In the second approach, auditors do not issue an opinion but base their reporting on the scope of work performed to gain an understanding of internal control sufficient to determine the auditing procedures for expressing an opinion on the financial statements. Regardless of whether auditors express an opinion, they are required to report

- a description of the scope of the auditors’ testing of internal control over financial reporting and compliance with laws, regulations, and provisions of contracts or grant agreements, including whether their testing provided sufficient, appropriate evidence to support an opinion of the effectiveness of internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements.
- material weaknesses and significant deficiencies detected during the audit.”

Recent Changes Due to Sarbanes-Oxley and Related Concerns

The passage of Sarbanes-Oxley (SOX) created a ripple effect that has spread to the federal, state and local government communities. At the federal level, the Office of Management and Budget (OMB) swiftly moved to revise its guidance in Circular A-123, Management’s Responsibility for Internal Control, to strengthen requirements for management’s assessment of the effectiveness of the internal control structure over financial reporting. At the state level, several states have required nonprofits to comply with SOX-type requirements and several state legislators, regulators and other elected or appointed officials are seeking to duplicate and or extend provisions of the SOX to private companies and their auditors at the state level. The concern among state and local government officials is that the measures taken to improve internal controls could be an overreaction and that legislation may be passed that goes too far and requires the states to implement costly controls over financial reporting far stricter than the risk environment they operate in would suggest is necessary.

The passage of the Department of Homeland Security (DHS) Financial Accountability Act in 2004 strengthened this concern. This legislation, introduced by U.S. Rep. Todd Platts, R-PA, Chair of the House of Representatives Committee on Government Reform Subcommittee on Government Management, required DHS to obtain an audit of its internal control structure by 2006. It also called for a cost-benefit analysis to be jointly conducted by the Chief Financial Officers (CFO) Council and the President’s Council on Integrity and Efficiency (PCIE),10 which was then to be analyzed by the Government Accountability Office (GAO). The GAO would then review the analysis and submit a report to the congressional oversight committees.11

The joint CFO Council/PCIE study and the analysis by GAO were both published in a letter to the House and Senate oversight committees on Sept. 6, 2006.12 The joint CFO Council/PCIE study is also available separately at www.ignet.gov. In the “Observation” section on page nine of the joint study, the report states:

“Many OFGs and OCFOs commented that the costs associated with obtaining the audit opinion may exceed the benefit that would be derived from the process. . . .the additional work could increase the audit fees by more than 50 percent. Although the costs in the later years may drop, the incremental audit costs are expected to be substantial, costing an estimated average of more than $2.4 million. It is questionable whether the benefits from obtaining an audit opinion are substantial enough, beyond those derived from implementing the revised A-123, to justify the incremental audit cost to support the audit.”

The study concluded that:

- The benefits to be achieved, that is, improved internal control and reduced material weaknesses; reduced errors and improved data integrity; documentation reliability and reporting; improved agency focus and oversight; and identification of new material weaknesses, can largely be achieved by strengthening the requirements for management’s assessment of internal control over financial reporting, as required by the revised OMB Circular A-123 (A-123), and detailed in its Appendix A.
- The incremental benefit of the auditor’s opinion is difficult, if not impossible, to determine without first knowing how well management does in performing its assessment under the revised requirements of A-123.
- Agencies that get qualified opinions or get unqualified opinions, but have many material weaknesses, already know this. They have difficulty seeing that great benefit would be provided by imposing an audit opinion on top of management’s assertion, other than to prove that objectively the entity has problems. However, the entity is already admitting to having problems.
- Based on cost data currently available from the private sector (which is significantly higher than originally projected) and the estimates that are beginning to be developed for the public sector, most industry experts agree that there are significant incremental costs associated with obtaining an opinion on internal control over financial reporting.

The consensus was that it would be prudent to further observe the implementation of the Sarbanes-Oxley Act in the private sector and allow time for auditing standards surrounding rendering an opinion on internal control over financial reporting to stabilize before considering additional requirements, and if there were additional requirements, these should apply only to those agencies with clean opinions and no material weaknesses.

Costs of SOX Compliance

Several recent studies, both private sector and federal, have reported that costs of SOX compliance are high. Available data seem to indicate that smaller public companies face disproportionately higher costs in complying with the Act, and the smaller the company, the more disproportionate the costs appear to be. The majority of these costs are
associated with section 404, especially subsection b, the requirements for management assertions and auditor assertions. Commentators have noted in seminars, agency workshops and other literature that compliance testing, and especially documentation, is very labor intensive, and difficult to sustain after the first year unless the procedures are automated.

Private Sector Experience

A 2005 Financial Executives International\textsuperscript{13} (FEI) study of 217 public companies with average revenues of $5 billion found that large public companies spent in excess of $10 million on SOX 404 compliance for 2004. The mean spent was $4,355,972, which was 39 percent higher than had been expected. FEI found that the total cost of compliance averaged $1.43 million for internal costs, $1.72 million for external costs, and $1.3 million for auditor fees. The auditor fees were in addition to companies’ financial statement fees.

A 2006 U.S. Government Accountability Office (GAO) report included results of a survey it had conducted of companies with market capitalization of $700 million or less and annual revenues of $100 million or less that reported to the SEC that they had complied with SOX requirements related to internal control over financial reporting.\textsuperscript{14} The report states on page 17 that:

“According to executives of smaller public companies that we contacted, smaller companies incurred substantial costs in addition to the fees they paid to their external auditors to comply with section 404 and other provisions of the act. . . These smaller companies reported paying fees to external consultants for the period leading up to their first section 404 report that ranged from $3,000 to more than $1.4 million. Many also reported costs related to training and hiring of new or temporary staff to implement the act’s requirements. Additionally, some of the smaller companies that responded to [the GAO] survey reported that their CFOs and accounting staff spent as much as 90 percent of their time for the period leading up to the first section 404 report working on SOX compliance-related issues.

Finally, many of the smaller public companies incurred missed “opportunity costs” to comply with the act that were significant. For example, nearly half (47 percent) of the companies that responded to [the GAO] survey reported deferring or canceling operational improvements and more than one-third (39 percent) indicated that they deferred or cancelled information technology investments.”

Companies implementing SOX are experiencing a learning curve. A study in April 2006\textsuperscript{15} sponsored by the four large accounting firms found that in years following initial implementation, the cost of audit fees did decline because of increased efficiencies, reduced documentation, and a reduction in the use of outside parties. Material weaknesses and significant deficiencies identified also declined, indicating a strengthening of internal control.

Federal Experience

Congress and the Executive Branch have been attempting to obtain estimates of the costs and the benefits of section 404 compliance.

In February 2005, the U.S. House of Representatives Government Reform Committee, Subcommittee on Government Management, Finance and Accountability, held an oversight hearing on revising A-123, titled, Improving Internal Controls: A Review of Changes to OMB Circular A-123. In the question and answer session of the hearing, there was a discussion of whether an audit opinion on internal control should be required, as had been required for the DHS. Testifiers mentioned that the costs of doing this would probably cost some $4.5 million for an agency like the State Department. Most were of the opinion that no requirement should be imposed without a cost-benefit analysis having first been completed. Legislators will no doubt carefully review the cost-benefit analysis reported in the Joint Study by the Chief Financial Officers’ Council and the President’s Council on Integrity and Efficiency discussed on page 8 and below before making decisions about proposing new legislation.

On page nine of the Joint Study, the cost was estimated by the federal IGs as follows:

“The estimated costs to render an opinion on internal control for all 24 CFO Act agencies [are] more than $140.6 million, of which $56.2 million, or 40 percent, is for the 23 civilian CFO Act agencies. The average estimated incremental audit costs are estimated to be approximately 51 percent of the financial statement audit costs, or more than $5.8 million per reporting entity. Excluding DoD, the cost per reporting entity is $2.4 million. The incremental cost estimates ranged from as low as 6.5 percent to more than 100 percent of the cost of the financial statement audit. In dollar terms, these costs ranged from $38,000 to $84.4 million. The wide range of costs reflects the relative size and complexity of the entity being audited.”

In the Executive Summary on page three of the Joint Study, the writers remind readers that, “These . . . represent only the incremental costs directly attributable to the requirement to render an opinion on internal controls. Several Offices of the Chief Financial Officers (OCFOs) believe they as management also will incur additional costs to support the audit effort.” (The additional costs that management must incur to support such an effort were not included in the Joint Study report.)

Our research presumption was that the costs of compliance would be regarded as a disincentive by survey respondents and this presumption was confirmed by the results, as shown on page 29. From the results of our study, state and local governmental entities would almost certainly meet with similar experiences if they had to implement the requirements of section 404.

Other Problems Arising From Areas of SOX Compliance

Companies reported that the Act’s independence requirements had decreased the amount of advice they had received from their external auditor. They had to hire outside counsel for help with drafting audit committee charters, a code of ethics, establishing whistleblower protection, and reviewing Chief Executive Office and Chief Financial Officer (CEO and CFO) certification requirements. They also
had to delay planned operational improvements and IT spending because of the increased costs for the audit of internal controls. Private sector companies report that the costs affect their dividend payouts.

**Recent SEC and PCAOB Developments**

In a reaction that is reminiscent of the government’s reaction to the many complaints about implementation of the Federal Managers’ Financial Integrity Act in 1976 (see Appendix IV for a discussion of FMFIA), the PCAOB is now developing a plan to improve auditors’ implementation of the internal control requirements of the Sarbanes-Oxley Act.17 There have been many complaints about the costs of compliance, so PCAOB is going to amend AS2 to ensure that auditors focus on areas that pose higher risk of fraud or material error and consider whether to use the work of others. The revisions will try to increase efficiency and decrease costs by allowing more judgment in determining whether deficiencies exist and greater use of risk-based approaches.

The SEC arranged for an Advisory Committee to study the effect of SOX on smaller companies and make recommendations. The Final Report of the Advisory Committee on Smaller Public Companies was issued to the Securities and Exchange Commission on April 23, 2006 and is available at www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf. In the report, the Advisory Committee recommended exempting these entities entirely from the requirements. The SEC did not act on this recommendation, but on August 9, 2006, did propose an extension to the deadlines by which small public companies or “non-accelerated filers” must come into compliance with the internal control reporting requirements of Section 404. Non-accelerated filers would not be required to provide management’s report on internal control over financial reporting with their annual report until the first fiscal year ending on or after Dec. 15, 2007. These entities would not be required to submit an auditor’s report attesting to these internal controls until the next year’s annual report, or the fiscal year ending on or after Dec. 15, 2008. The SEC adopted the proposal to extend the deadline in December 2006, as referenced on page 7 and in Endnote 5.

Who knows what will be the final conclusion of these various initiatives to improve SOX? And if smaller companies were to be exempted, this could well be a precedent that could ensure that state and local entities would also be exempted.

**Key Findings and Recommendations**

The results of the survey are mixed. Some respondents seem to be doing much more than is required. Some appear to be doing much less. Some respondents pointed out that some of the recommendations of the Sarbanes-Oxley Act would be difficult to implement because of state regulations or lack of competition in the marketplace. This applies to performing the audit, establishing audit committees and auditor rotation. In some states, state auditors are not allowed to do financial audits and cannot have an audit committee by law. In these cases, states would have to think of what they could do that would accomplish the same purpose as the audit committee, to comply with the spirit if not the letter of the Act.

Some state legislation requires the audit be done by the state auditor general; some cities are required by law to have their audits done by the city auditor. In cases such as these, auditor rotation would always be impossible. In some states where there is mandated regular auditor rotation between the state auditor and the independent public accountants, the state auditor does the audit every third year or the state auditor does the audit for three years, then the independent auditor does it for three years.

Many respondents thought that auditor rotation was in principle a good idea. One respondent said, “A new fresh perspective is needed after a few years. If an auditor becomes too comfortable with the audit little changes may be missed. Fresh eyes and new perspectives are needed over time.” However, some, particularly local government respondents, said that finding an auditor who could do the audit was difficult and rotation would be almost impossible to implement.

More states and local governments than not have audit committees. In general the audit committees do have authority to review the oversight of the work of the auditor, but not so many are responsible for the selection or compensation. To some extent, that is because the selection is set by law. The policies and procedures used to ensure audit committee independence make use of the balance of powers within state government and having elected officials participate. The reports going to the audit committee deal with management letter and schedule of unadjusted differences type communication between auditor and management, but not often on accounting policies or their application of methods used to account for unusual transactions.

Some states have strengthened their internal controls and are applying COSO Enterprise Resource Management (ERM) Integrated Frameworks and state-of-the-art tools like COBIT.18 But it is somewhat disconcerting to note that comparatively few respondents said that they have an integrated system of internal control. Only 54 (18 percent) quoted COSO standards.

A robust, integrated internal control system brings many advantages. Such a system can make complying with federal agency requests for information much easier. Federal agencies are very interested in making sure they comply with the requirements of the Improper Payments Information Act of 2002 (Public Law 107.300) and in ensuring that the states help them implement that Act’s requirements. States that have strong systems of internal control will find doing this easier than states that do not, since the basic or root causes of improper payments can typically be traced to a lack of or breakdown in internal control. Adopting the provisions of COSO would help an organization strengthen its internal controls, and reduce the work required and audit fees if an audit opinion on internal controls were to be
imposed in the future through some amendment to the SAA.

One of the points made by respondents in the survey was that the control environment within state and local governments is different than in the private sector. In the state environment, the legislative and executive branches form a system of checks and balances that help create an atmosphere that tends to discourage or promptly uncover any malfeasance. Elected officials must return to the electorate at frequent intervals for re-election. If they do not do a good job of protecting the taxpayers’ interests, the taxpayers can vote them out. State auditors are either appointed by the legislature or a branch thereof or elected. Some 17 states have an elected state auditor (usually every four years). If they are appointed, then the legislature, which is elected, is responsible. So the citizen has recourse, albeit somewhat delayed, to express dissatisfaction with the performance of state officials by simply using the democratic process.

Some states are passing laws that require strengthened internal controls for non-profit organizations. None of these require an audit opinion on internal control; one does not even require public disclosure of findings. These are listed in Appendix III.

Some of the answers in the section on Internal Control Evaluation and Reporting were fascinating and suggest a requirement for further study. It would appear from the responses to the survey (see pages 23 and 29) that well over half of the respondents are required to have an audit opinion on internal controls. In answer to question 33, on whether the entity’s auditor was required to attest to and specifically provide an opinion on management’s assertion as to the effectiveness of the internal control structure over financial reporting, 60 percent of total respondents, 181 in all, said yes. However, in answer to a previous question, question 27, about whether the entity has a similar requirement to evaluate and report on internal controls, (that is, was required to develop an assertion), 114 of those had said they had no such requirement. A follow-up e-mail requesting clarification was sent to the 114 respondents.

Auditors can opine directly on the effectiveness of the internal control structure over financial reporting even if management is not required to assess the internal controls and provide an assertion as to the effectiveness of the internal controls. This situation is in fact discussed in AS2. In the public sector, companies are unlikely to want to do it because it would require the auditor to retrace most of the steps already taken by management in developing its assessment and thus increase the cost of the audit. And this seems unlikely to be happening on a grand scale in a state and local governmental environment.

A total of 46 responded to the follow-up e-mail, 30 of those changed their answer to no, 12 continued to say yes, without giving a reason, and four said yes and cited reasons. A few of the responses given indicated that respondents were somewhat confused about the requirement, although two gave what appeared to be valid reasons and appear to be obtaining audit opinion reports on a routine basis. The ones who appeared confused often cited the SAA and GAGAS as reasons for answering yes. Some cited the CAFR or GASB guidance. In part, this confusion may be due to the fact that an audit opinion on the effectiveness of the internal control structure over financial reporting is permitted although not required under current standards, as the quote from the Yellow Book on pages 7 and 8 show.

Questions regarding entities obtaining an audit opinion should probably be examined further. An audit opinion on the effectiveness of internal control over financial reporting is not required by the Yellow Book or GAGAS. Nor is it required by the SAA. It is not required by OMB Circular A-123, which some states have used as a basis for their own requirements. It is also not prohibited. GAO obtains an audit opinion on its internal control structure although it is not required to do so, see page 37.

In the future, if state and local governmental units are required to obtain an auditor’s opinion on internal control, a massive education initiative would be needed to make sure people are not doing more or less than is actually required, and using the appropriate standards.

A majority of survey respondents indicate that the costs of compliance would not offset the benefits to be received from compliance. Most of the costs of compliance arise from implementing the requirements of Section 404 of SOX; management assertions about the effectiveness of internal control and the auditor’s attest opinion as to those management assertions or directly on the internal control structure. Other SOX controls, such as audit committees, code of ethics and whistleblower protection, are relatively easy to implement and in fact are currently used by many respondents. It would be difficult to make a case that having an auditor do parallel work to render an opinion produces benefits that outweigh the incremental costs involved. If the organization gets other than a clean opinion with no material weaknesses noted, it is difficult to see that any additional utility would be gained from an audit of the internal control. The organization already knows that its internal control structure needs to be improved.

The Joint Study by the Chief Financial Officers Council and the President’s Council on Integrity and Efficiency found that the benefits that are used to justify having an auditor opine on internal controls can largely be achieved by strengthening the requirements for management’s assessment of internal control as has been done in the revised OMB Circular A-123.

A concern is always that additional work will be required without any additional funding (creating an unfunded mandate) and in fact, if the section 404 b requirement were to be imposed on the states, there would be claims of unfunded mandates. OMB, when considering strengthening requirements for executive branch agencies, stopped short of requiring audit opinions on internal control. In a recent hearing on whether the federal government agencies should be required to strengthen their internal controls, there was bipartisan support for the concept but the consensus was that nothing should be done immediately.
So, while it is probably neither realistic nor necessary for states and local governments to adopt section 404 requirements regarding obtaining an auditor’s opinion on the effectiveness of the system of internal control right now, they could consider partial adoption. Federal government agencies are not being required by the revised Circular A-123 to do more than develop management’s assessment, albeit with much more stringent testing and evaluation, and having management take responsibility by certifying the results. States and local government could consider adopting these provisions.

Where Do We Go From Here?

The reaction of federal executive branch leadership—OMB, the CFO Council, the PCIE—to SOX has been to increase requirements for documentation, testing, evaluation and reporting, but from agency management, not the auditors. They have specified new requirements for testing and documenting internal controls and require management to assess these, but have stopped short of requiring an external auditor’s opinion on management assessment of the effectiveness of internal controls over financial reporting. There seems to be agreement among the groups cited above that there is little utility in obtaining an audit opinion on internal control effectiveness when it is already clear from the financial audit that there are many material weaknesses.

Congress has tried to go further. When audits revealed serious internal control problems at the Department of Homeland Security (DHS), legislation was enacted (P.L. 108-330, 118 Stat. 1275 Oct 16, 2004) requiring DHS to take responsibility for improving internal controls and to have an auditor attest to those improvements. Included in the legislation was a requirement for a cost-benefit analysis to see whether the requirement should be extended to all CFO Act agencies. The oversight committees are now considering the GAO report on the joint federal CFO Council/PCIE cost-benefit analysis of requiring an audit opinion (discussed on pages 8 and 9). No doubt the oversight committees in the coming Congress will try to evaluate the extent of agency compliance with the revised OMB Circular A-123 and whether internal control within the agencies has improved. The question is whether the executive branch reforms will be enough to satisfy the legislators. However, given the backlash of comments on the cost of SOX compliance from the private sector compared to the perceived benefits, and the reactions of the SEC and the PCAOB, it would appear that no additional requirements will be imposed anytime soon.

State and Other Initiatives

Currently, Sarbanes-Oxley legislation is applicable only to publicly traded companies. However, the impact of its provisions is cascading to public institutions, including not-for-profits. Pressure from bond rating agencies, the federal government and board members at state authorities has prompted some government officials to consider using Sarbanes-Oxley as a model for improving internal controls within public agencies. The intent is that the long-term benefits may outweigh the short-term costs. Many nonprofits are voluntarily adopting some of the less onerous requirements of SOX, such as whistleblower provisions. Their rationale is that Congress passed SOX in response to a lapse in integrity in senior management in publicly held corporations. Implementation of relevant parts of SOX is now viewed as a “best practice” for effective stewardship of funds entrusted to an organization by those outside the organization. Taking such action demonstrates to stakeholders an increased level of accountability for actions and reliability of information.

Many states are considering imposing requirements on component units, especially entities that are reviewed by rating agencies and are run similarly to private sector companies. Some agencies in a handful of states already have used the Sarbanes-Oxley legislation as a basis for bringing more rigor to their agencies’ control environment. Numerous state legislatures have tried to enact some or all of Sarbanes-Oxley’s provisions since they became law in July 2002. Almost a dozen states have introduced or passed legislation within the past two years that applies parts of SOX to the nonprofit sector. Some states have enacted or are considering requiring the application of SOX-like provisions to entities like public authorities.

The AICPA has a Special Commission on State Regulation that works closely with state CPA societies and provides guidance to states that are faced with legislative or regulatory accounting reform proposals as a result of Sarbanes-Oxley.

Many institutions of higher education are taking the initiative and making reforms on their own. The University of Texas system saw the Sarbanes-Oxley Act as a unique opportunity to demonstrate its commitment to integrity in financial operations and the reporting of financial operations. The National Association of Colleges and Universities Business Officers and (NACUBO) issued an Advisory Report titled, The Sarbanes-Oxley Act of 2002: Recommendations for Higher Education. It lists eight areas that have relevance to a university’s system of operations. The references in brackets are to the relevant sections of the Act.

* Relations with External Audit Organizations (Title II, sections 201, 202, 203, 204, 206)
* Confidential Reporting Mechanisms (Title III, section 301 (4))
* Audit Committee Duties, Structure and Composition (Title III, section 301; Title IV, section 407)
* Certification of the Financial Statement by the Chief Executive Officer and the Chief Financial Officer (Title III, section 302)
* Off Balance Sheet Activities (Title IV, section 401)
* Unusual Financial Relationships (Title IV, sections 402, 403)
* Certification of Internal Controls over Financial Activities and Financial Reporting (Title IV, section 404)
* Code of Ethics (Title IV, section 406)
Possibility of Federal Nonprofit Oversight Legislation

In 2004, the U.S. Senate Finance Committee issued a staff discussion draft that outlined dozens of possible new regulations that could be applied to the not-for-profit (NFP) sector. Since then, the U.S. Senate Finance Committee and the U.S. House Ways and Means Committee have held several hearings on NFP oversight issues. New legislation could emerge that represents the most significant change to NFP regulations since 1969. Proposed and passed legislation aimed at improving efficiencies, effectiveness and controls of NFPs has accelerated within various state and local governments.

The Study

The study attempts to evaluate whether applying Sarbanes-Oxley-like provisions to state and local governments would improve the current control environment or whether the current environment in state and local government is one that provides reasonable assurance that errors and irregularities are prevented or detected in a timely fashion. The research assesses the current environment, and provides some conclusions. An Advisory Group was established to guide the research, which was conducted by AGA and NASACT staff. Group members are listed at the beginning of this report. The survey was sent out by NASACT to 574 of its members; (state auditors and comptrollers and their key staff) and to local auditors, with responses received from 63, a response rate of about 11 percent. A reminder and encouragement to fill out the survey was sent out by AGA to 1,305 of its state and local members, to target a group not covered by NASACT, local controllers, but also allow all others to respond. AGA received 369 responses, a response rate of 28 percent. After elimination of duplicate responses, the total of useful responses was 303, representing a wide spectrum of state and local government officials, engaged in finance and controller- or comptroller-type functions or in audit functions.

Respondents classed their entities as cities (64 responses), counties (41 responses), city and county (seven responses), school districts (11 responses), colleges and universities (seven responses), local public authorities (six responses), local public utilities (two responses), and special districts (nine responses). One hundred and forty classed their entities as state organizations, either states or state entities. Seven classed their entities as “other” and nine did not answer that question. Some made multiple classifications. We assigned multiples and no responses to the most relevant category. Responses were received from 39 states and the District of Columbia, and six commonwealths, including Puerto Rico and the Marianas Islands, Guam and Ontario Province.

Responses were further classified into four “type of work” categories: state comptroller/finance manager types (100 responses), state audit types (57 responses), local comptroller/finance manager types (97 responses) and local auditor types (49 responses).

Revenues varied with size and type of reporting entity. Many did not respond or listed “not applicable.” Some stated that they used net assets, not revenues. The highest were states, with just over $80 billion; the lowest was just under $150,000 for a small town, with the next lowest being $1 million. The median for state audit types was $5.7 billion, for state controller types $1.1 billion, for local audit types $335 million and for local controller types it was almost $43 million.

Survey Topics

Audit Committee (see pages 21, 26 and 27)

One hundred and thirty-five respondents have either an audit committee or equivalent body (hereafter simply audit committee), established by law or policy. The audit committee is mainly involved in oversight of the work of the auditor, and in selection of the auditor, but less so for the compensation of the auditor. Almost three-quarters of respondents said that the audit committee included at least one member who was a financial expert either in finance or accounting. Question 9 dealt with reports sent to the audit committee. Most respondents said that, of all reports sent to the audit committee, the one on Other significant written communications between the auditor and management, such as any management letter or schedule of unadjusted differences, was the most frequently used. The other two reports, on initial selection of and changes in significant accounting policies or their application and on the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas, were cited less frequently by respondents.

Public companies and governmental entities differ in this area. Some states have regulations requiring oversight bodies other than audit committees or prohibiting auditors from having audit committees. We therefore asked respondents to indicate first, whether they had an audit committee or anything equivalent and second, what authority it was established under. Figure 1 shows the results for the first question.
We asked about what policies and procedures ensured the independence of the audit committee. The responses referred mainly to the independence provided by the election process and the separation of powers within a state (see Appendix I, page 21). We asked about the reports the audit committee received, providing choices taken from the SOX requirements, see Appendix II, page 27 and Figure 2.

The Audit (see pages 21, 22, 27 and 28)

Respondents were split between those who said that a public accounting firm did the audit and those who mentioned a government auditor (some state auditors use public accounting firms). The five percent who indicated “other” usually stated that the audit was jointly conducted by the government auditor and an independent public accountant (IPA). We also asked who in the entity was responsible for the selection, compensation and oversight of the financial statement auditor, see pages 21 and 26 for representative answers.

Respondents answered “yes” 76 percent of the time to this question: “If the state or local auditor does the entity’s financial statement audit, do they follow Government Auditing Standards (GAS) or the Yellow Book?” One state responded that state rules did not require compliance with GAS, but the GFOA did. One percent said “no” and 23 percent said “N/A.” See Appendix II, page 27 and Figure 3 for the distribution of responses.

Most of those who replied “N/A” did so because their entity used a public accounting firm and the question stated, “If you use a state government auditor, ...” Some did not know about the audit and some said no audit was required for their particular organization (for example, the audit office). The three negative responses came from states that are not required to comply with the Yellow Book (GAGAS), although they may choose to do so for other reasons. One reason could be to comply with GFOA requirements for its certificate of excellence award. In the following question, five said they followed PCAOB standards.

We asked whether they had statutes prohibiting audit firms from doing a variety of non-audit work for their clients: bookkeeping; information systems design; actuarial services; management consulting services; or other. Most respondents indicated that the financial statement auditor is precluded from providing such services as bookkeeping (84 percent); information systems design (82 percent); actuarial services (83 percent) and management consulting services (74 percent). More than half (57 percent) indicated other precluded activities. The most commonly referenced source of the prohibition on providing such services was policy with 49 percent, 24 percent said the contract, 16 percent said regulation, 11 percent said law, and 23 percent cited other sources. Several provided citations, such as the Yellow Book (YB), Government Auditing Standards, local regulations, AICPA standards, standard practice, administrative policy and one sent in a document. Only 13 percent stated that they allowed non-audit/non-attest services to be contracted for with pre-approval. Examples given included agreed-upon procedures, etc. One said they had no authority to preclude non-audit activities. Figure 4 shows the results.

Rotation (see pages 22 and 28)

Most respondents did not require lead audit partner rotation every five years (75 percent) and 79 percent did not require rotation of lead audit partner, director or manager at all.

We asked whether the financial statement auditor was precluded from performing the audit if the chief executive officer, controller, chief accounting officer, or equivalent was employed by the auditor and participated in the audit during the preceding year. Sixty percent of respondents said they had such a rule and only six said they had policies in that area.

The final question in this section asked what respondents thought about the benefit of all these requirements and to give reasons for their opinion if they disagreed. Forty percent agreed, and 28 percent strongly agreed that auditor rotation, auditor communications to audit committees and conflict of interest rules on prior employment by auditor would be beneficial in the public sector. One respondent stated that the policy was to rotate accounting firms every seven years. The initial contract is for five years, with options to renew for two additional years.

Internal Control Evaluation and Reporting (see pages 23, 24, 27, 28 and 29)

The section on Internal Control (I/C) Evaluation and Reporting is the meat of the survey. We asked whether respondents have a reporting requirement to evaluate and report on internal controls similar to that in SOX, and if so, based on what authority? A third of total respondents, 99, responded that they had such a requirement. Of those, 21 were cities or counties, and 20 were state public utilities,
AND RELATED MANAGEMENT RESPONSIBILITIES

public authorities, or departments of Social Services, Transportation, Transit Authorities, Industrial Relations, Technical Colleges, State Boards of Education, etc.

More than half of the states were represented in the affirmative responses, either statewide, or by county, city or other state component unit. State auditors and state controller types were more likely to say they had such a requirement than local auditors or controllers. Sixty-three percent had no requirement to evaluate and report on internal controls. How do respondents report on their internal control environment? Answers were through the CAFR; as part of the SAA reporting; by biennial or annual reporting by head of agency; and done as part of the annual audit. What do they do? Many use an internal control questionnaire.

Almost all (90 percent) of those that responded to the questions on content of the I/C report said that the report stated the responsibility of management for establishing an adequate internal control structure and procedures for financial reporting, with 82 percent reporting that the report contained an assessment of the effectiveness of the internal control structure and procedures of the entity for financial reporting.

The question as to what standards the financial statement audit was required to be conducted under produced the following results: 92 percent of 257 responded GAAS, 95 percent GAS Yellow Book, 85 percent the Single Audit Act, and 21 percent cited other auditing requirements, such as specific state or local regulations, AICPA standards or state CPA standards (Oregon, for example). Several cited A-123. Respondents could answer “yes” to all that applied. See Appendix II, page 45 and Figure 5 for the results.

Fifty-seven percent responded in the affirmative that if a requirement was imposed on their entity to evaluate and certify the internal controls over financial reporting, the additional costs of doing this over and above what they had already to do for the SAA would outweigh the benefits gained.

We asked whether they have a system of internal control similar to that of SOX, and gave them certain choices. The responses were as follows: 54 or 22 percent use COSO standards; 74 or 30 percent follow state law or regulation based on A-123; 97 or 39 percent do not have an integrated internal control framework; 23 or 9 percent indicated “other.” See page 24 for the responses in the “other” category.

When asked whether an auditor opinion was required on management’s assertion as to the effectiveness of the internal control structure over financial reporting, 181 (73 percent of those answering the question and 60 percent of total respondents) said their entity was required to attest to and specifically provide an opinion. However, 114 of those had previously stated that they did not have a requirement for management to assess internal control, so it is difficult (though not impossible) to see how they could be getting the auditor to provide an opinion on management’s assertion. The 67 who answered yes to both questions 27 and 33 broke down as follows: state audit types, local audit types, state comptroller types and state audit types. The 28 percent who did not (67 in number) tended to be state auditors and pointed out that they followed the Yellow Book, Generally Accepted Government Auditing Standards or both, or quoted the wording from the standards.

Very few respondents answered the question (no. 40 on page 45) on whether they were applying SOX provisions to units within their government. The distribution of those within the governmental units is shown in Figure 8.

Answers to the follow-up request to describe the provisions numbered 33. Examples given included: higher education institutions; some department and institutions with the primary government adopting certain provisions; redevelopment agencies, community facilities districts, joint pow- ers agencies; library, alcohol and drug commission, fire commission and recreation commission. One said adoption was agency-wide. The provisions mentioned included: assessment of fraud risks; internal controls and management attestations; requiring attestations from lower level management; requiring agency heads and accounting per-

Figure 2: Auditor Reports To Be Sent to Audit Committee

Figure 3: Following GAS for F/S Audit
sonnel to provide a letter of representation to the CFO; auditor rotation; independent audit committee oversight over management; limiting non-audit work by internal and external auditors; audit committee selection of auditor; and rotation in place due to government auditor rotation schedule. One state is in the process of developing a directive to mandate a level of compliance with COSO ERM. One respondent said they were bound by Sarbanes-Oxley. Another said some of its agencies sell bonds in the public market. Another state said that the audits by the state auditor’s office have historically done significant internal control evaluations of an agency’s systems using the risk approach audit. One state Department of Transportation entity said its auditors have been trained in SOX and compliance with and disclosures similar to SOX are required for audit work. One mentioned maintaining separation of audit and non-attest work/engagements.

Two hundred and twenty-six responded to the question as to whether the entity’s SAA reports on compliance and internal control have the same date as the date on the auditor’s report on the entity’s audited financial statements. Of those, 82 percent said “yes”, 18 percent or 41 said “no” (usually state auditors). Ninety-five percent indicated that they had common financial processes, like procurement, payroll, etc.

Management Certification of Financial Reports (see pages 24 and 29)

SOX requires certification by leadership (the principal executive officer and the principal financial officer) that management accepts its responsibility for financial reports. Some states also require certification. We asked whether this was the case for respondents and then followed with questions as to what was covered. The specific items listed were taken from SOX. Respondents cited controllers, auditors, budget directors, finance directors, board chairman, presiding judge, and city chamberlain as officials who accept responsibility for financial reports. One hundred and seven survey respondents indicated that they did have a requirement that the principal executive officer or the principal financial officer, or someone in a similar role, certify the entity’s annual financial report. This represents 35 percent of total respondents. The breakdown among PEO, PFO and other similar functions is shown on page 30.

The responses to question 44 on compliance with requirements for certification of reports (listed on page 30) ranged from a high of 97 percent to a low of 60 percent. Ninety-seven percent said the signing officer certifies that, based on the officer’s knowledge, the financial statements present fairly, in all material respects, the financial condition and results of operations and that the report did not contain any untrue statements that would render the financial statements misleading (for questions 44 b and c). Only 60 percent certify that the officer has evaluated the effectiveness of the entity’s internal controls as of a date within 90 days prior to the report and that it has presented in the report conclusions about the effectiveness of the internal controls based on management’s evaluation (questions 44 d. 3 and d. 4). Eighty-eight percent answered question 44 d.1 in the affirmative, that the signing officers are responsible for establishing and maintaining internal controls.

Figure 9 shows the raw numbers responding, not the percentages. Only those answering “yes” to question 42 (107) went on to answer questions 43 and 44, so the percentages are not entirely representative of the total population of respondents to the survey (303). That is, less than 20 percent of respondents, 59 out of 303, currently present in their reports conclusions about the effectiveness of their internal controls based on their evaluation and only 34 percent certify as to the fairness of presentation of the financial statements. However, one respondent indicated that they believed that the management representation letter to the independent auditors and the transmittal letter that accompanies the statements meet the management certification requirements in questions 42 through 44.
Code of Ethics for Senior Financial Officers (see pages 24 and 31)

We asked whether the entity had adopted a code of ethics, and whether the entity had ever had to restate its financial statements due to material noncompliance or as a result of misconduct. We also asked what punitive actions were taken if this had occurred. Suspension, termination, prosecution with subsequent conviction and reporting to the Board of Accountancy were all mentioned. Almost half of the total respondents said they did have a code of ethics. Ninety-eight percent of those answering the question about whether they had ever had a restatement replied in the negative. Those whose entities had undergone a restatement said it was not the result of misconduct by the controller or auditor. One respondent indicated that many state agencies have adopted their own code of ethics, in addition to the code of ethics for public officials set forth in state statute. The state statutes deal primarily with ethical behavior and conflicts of interest and do not necessarily address full, fair, accurate and timely disclosure in the financial reports.

Management and Criminal Fraud Accountability (see pages 24 and 31)

We asked whether the entity imposes penalties for the destruction, alteration or falsification of records, and if it has a provision in law or regulation that offers protection for employees who provide evidence of fraud. Slightly more than half said their entity imposed penalties for the destruction, alteration or falsification of records. Most described state rules, EEOC or other HR rules. Slightly less said their entity has a provision in law or regulation that offers protection for employees who provide evidence of fraud, most referred to the Federal Whistleblower Protection Act of 1986.

Lessons Learned, Best Practices and Success Stories (see pages 24, 25 and 31)

Finally, we asked respondents to describe any best practices they had related to the setting up, evaluation of, or reporting on their entity’s internal control system. Some states appear to be leaders in best practices. North Carolina has an Internal Control Compliance Review program. Under this program, all state entities are subject to a review of their internal controls. Florida has its own whistleblower laws and counties like Orange perform regular compliance and internal control audits of county operations (see www.occompt.com for a list of past audit reports issued by Orange County, FL). Several states have a requirement to evaluate internal controls yearly. A Delaware County Office of Finance has instituted Control Self Assessment within the government. One example provided showed the benefits of evaluating internal controls. A county in California instituted fiscal operational audits, of the Agriculture Commission and imprest funds. One state department instituted COBIT to evaluate controls over information technology. One of the lessons learned from that example is that implementing COBIT takes much time and effort.

Analysis of Results

The results of the survey provide support for some conclusions and give rise to new questions.

State and local governments are already subject to quite stringent checks and balances (legislative versus executive branches) not found in the private sector. These act as constraints and help to prevent (or detect) misconduct.

The system of checks and balances provided by the separation of powers (division of state government into legislative and executive branches) is a constraint that provides good control. Another is that when the people responsible for maintaining good controls are elected officials, the voters have the final say, since voters can choose not to re-elect them. Answers to the questions in the Code of Ethics Section show that states do have laws in place to protect whistleblowers and to take punitive action against fraud, although the statute does not address the fairness of the presentation in the financial statements.

Congress intended SOX to protect the stockholder from mismanagement and cover-up by management of issuers (private-sector companies). In a private sector environment,
laws are needed to protect stockholders from having to make decisions based on misleading information. In a government environment, officials serve at the pleasure of the people who can choose whether to re-elect them. Frequent elections, term limits, separation of powers all combine to ensure that misleading information will be detected in due time, and the knowledge of this acts as a deterrent.

Fifty-seven percent of respondents thought that the costs of compliance with the Act would outweigh any benefits to be derived from stronger internal controls.

Most of the costs of compliance arise from the requirements of section 404 of SOX and relate to obtaining an audit opinion. There are ways to strengthen internal controls other than by getting an audit opinion. One way would be to adopt requirements similar to those in the revised OMB Circular A-123. From the answers to questions on what standards are followed it is clear that many states rely on the Yellow Book or GAGAS, OMB Circular A-123 or the SAA requirements to guide their internal control review requirements. That being the case, they may start to utilize the more stringent requirements of the Circular if the underlying guidance is updated.

No more than a third of all respondents (99) said they were required to provide an assessment of the effectiveness of the internal control structure over financial reporting.

Federal IGs and CFOs feel that having to provide an assessment provides the entity and its stakeholders with most of the benefits to be derived from SOX-like requirements. They feel that Appendix A of the revised Circular A-123 provides a framework for such an assessment. One of the benefits they see is the stronger internal control structure that results reduces the likelihood of improper payments. Similar findings are possible from the state and local government community. A follow-on study targeting those states with a requirement to provide an assessment could be conducted.

Sixty percent of state and local respondents said they were already obtaining opinions on the effectiveness of their internal control structure over financial reporting from their auditors.

A follow-up study is necessary to find out what states, cities and counties do obtain an audit opinion on internal control, under what circumstances and under what standards and, finally, whether it is done at the same time as the audit of the financial statements. We would want to ascertain both what standards the auditors are using, the kind of report issued—with an opinion or not—and what standards management of the entities apply to the development of management’s assessment.

More effort needs to go into adopting or developing integrated internal control frameworks, such as the framework provided by COSO and making use of COBIT framework.

Only a few respondents said they used an integrated framework, and they thought it was very helpful. As mentioned previously, a robust integrated internal control system provides many advantages. Adopting the provisions of COSO would help an organization strengthen its internal controls, and reduce the work required and audit fees if an audit opinion on internal controls were to be imposed in the future through some amendment to the SAA.

Recommendations

Recommendations for legislators:

1. Prior to proposing any new legislation or amending any existing legislation such as the Single Audit Act, federal legislators should:
   - Evaluate the costs and the benefits of any proposed legislative requirement and obtain an independent cost-benefit analysis that includes a comprehensive assessment of the costs of implementation and an assessment of the benefits directly related to those costs.
   - Contact state and local governments and find out what they are doing at the present time with respect to reporting on the effectiveness of their entity’s internal control structure over financial reporting. This could be done through a survey that builds on the findings of this research study.

Figure 8: Applying SOX-like Provisions to Component Units

Figure 9: Certification in Annual Financial Report
2. Prior to enacting any new internal control related legislation, state and local legislators should:
   • Continue to observe and assess the evolution of SOX requirements as promulgated by the SEC and the PCAOB.
   • Evaluate the costs to be incurred by and the benefits to be derived from implementation of any proposed requirement. If possible, obtain an independent cost-benefit analysis.

   In any application of SOX-like rules to states and local governments, consideration should be given to differences in the way the separation of powers in some states affect the audit function and those states that already require statewide reporting on internal control. Some of the SOX rules may not be applicable. The state of Michigan requires biennial reporting on evaluation of internal control (Section 485 of Act 431 P.A. 1984). The head of each principal department must establish and maintain an internal accounting and administrative control system and report on it biennially to state leadership. The objective is to ensure effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Also in Michigan, and in numerous other states, the auditor general is created in statute or the constitution and has the authority for determining what audits they will conduct and the manner in which they will be carried out. Management’s ability to direct the actions of the auditors is thus significantly limited, and the portions of the survey related to non-audit service and auditor rotation are not applicable.

   State and local government officials tasked with deciding whether to copy nonprofits and implement some SOX requirements should think what would be appropriate to do and not unduly onerous, and then do it. What state and local government officials can do at little cost to get the “biggest bang for the buck” is to establish an audit committee (or equivalent body) and a code of ethics, and add whistleblower provisions and penalties for destruction or falsification of records if they do not already have them. Many do have them as part of other statutes. State and local government officials should try to introduce good controls and reasonable controls. Applying the stringent provisions of Section 404 b would be a mistake, but much of the rest of SOX would be workable, as nonprofits have found. State and local government officials should look at the types of issues and risks that they face and do what is appropriate in the circumstances.

   What we need to ensure in government is accountability and transparency so that if there are problems, the people become aware of them and can make the necessary decisions about how to resolve them. One way would be to have management make public assertions about the internal controls, and if there are findings of deficiencies, these should become be part of the public record.

Conclusion

Internal control is a concept that extends to all areas of a company’s management, not just over financial reporting. Management controls must provide reasonable assurance that assets are safeguarded against waste, loss, unauthorized use and misappropriation. Management controls developed for government programs should be logical, applicable, reasonably complete, and effective and efficient in accomplishing management objectives. Internal control over financial reporting is a subset of management controls. There are different definitions of internal control, some broader in scope than others. Internal controls are not one event, but a series of actions and activities that occur throughout an entity’s operations and on an ongoing basis. People make internal controls work, and responsibility for good internal control rests with all staff.

Everyone in an organization has responsibility for internal control. This includes management, governing body, internal auditors and other personnel, although the chief executive officer (CEO) is ultimately responsible and should assume ‘ownership’ of the system. Methods to ensure that management is aware of its responsibilities include having: an active audit committee with clearly defined responsibilities, an upward reporting system that reminds everyone of management’s responsibilities for financial reports and penalties for management misconduct including protection for whistleblowers. It is generally recognized that no system of internal control works effectively if it is compromised by poor corporate governance. State and local governments should have measures in place and work to ensure good corporate governance. The results of this survey indicate that the majority thinks that adequate systems to ensure good governance are already in place.
Acronyms

AGA Association of Government Accountants
AICPA American Institute of Certified Public Accountants
CFO Council An organization composed of Chief Financial Officers (CFOs, Deputy CFOs of the 24 CFO Act agencies, senior officials in OMB, and the Department of the Treasury
COBIT Control Objectives for Information and Related Technologies
COSO* Committee of Sponsoring Organizations of the Treadway Commission
CPAG Corporate Partners Advisory Group
EEOC Equal Employment Opportunity Commission
ERM Enterprise Risk Management
FCPA Foreign Corrupt Practices Act
FDIC Federal Deposit Insurance Corporation
FMFIA Federal Managers’ Financial Integrity Act
FFMIA Federal Financial Management Improvement Act
GAGAS Generally Accepted Government Auditing Standards
GAO Government Accountability Office
GAS Government Auditing Standards
GFOA Government Finance Officers Association
HR Human Resources
I/CA Institute of Internal Auditors
I/C Internal Control(s)
IRS Internal Revenue Service
NACUBO National Association of College and University Business Officers
NASACT National Association of State Auditors, Comptrollers and Treasurers
NFP Not-for-Profit
OECD Organization for Economic Cooperation and Development

OMB Office of Management and Budget, Executive Office of the President
PCAOB Public Company Accounting Oversight Board
PCIE President’s Council on Integrity and Efficiency—group of presidentially appointed inspectors general and other government officials
SAA Single Audit Act
SAS Statement of Auditing Standards
SEC Securities and Exchange Commission
SOX Sarbanes-Oxley Act of 2002
YB Yellow Book, or Government Auditing Standards, published by GAO

* COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private sector initiative which studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, for the SEC and other regulators, and for educational institutions. The National Commission was jointly sponsored by five major professional associations in the United States, the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, The Institute of Internal Auditors, and the National Association of Accountants (now the Institute of Management Accountants). The Commission was wholly independent of each of the sponsoring organizations, and contained representatives from industry, public accounting, investment firms and the New York Stock Exchange. The Chairman of the National Commission was James C. Treadway Jr., Executive Vice President and General Counsel, Paine Webber Incorporated and a former Commissioner of the U.S. Securities and Exchange Commission. (Hence, the popular name “Treadway Commission.”) Currently, the COSO Chairman is Larry E. Rittenberg.

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Representative Answers to Survey Open-Ended Questions

The open-ended questions had many responses (see Appendix II). Many were duplicative. This Appendix includes selected answers that are representative of the total population of answers.

Audit Committee

*Equivalent bodies* cited included: Legislative Audit or Fiscal Committee or Joint Legislative Audit and Review or Audit and Fiscal Committee, Legislature’s Joint Finance-Appropriation Committee, State Budget and Control Board, Finance Committee, Board of Directors, Board of Commissioners, Board of Supervisors, School Board, Office of the Auditor General. Several respondents mentioned that the equivalent body was composed of elected officials and emphasized that it was in the legislative branch.

*Authority for establishing the audit committee or equivalent body* ranged from City Commission Minute Order, City Charter, City Ordinance, Mayor’s Executive Order, County Board Resolution and Administration recommendation. One respondent cited JFAC and another Law & Constitution.

*Policies and procedures to ensure independence* responses included: having all or some members elected; that they come from both houses of the legislature or branches of government, that they come from the legislative branch; that they are under a different branch of government or in a separate division from programmatic operations, that they have no staff or executive management functions and no direct responsibility for management or operations, that they are not compensated, that they are not employees, and that there is direct reporting from the auditor to the board.

*Who Does The Audit?* Those who responded to the question with “other” actually reported that the audit is completed jointly by the public accounting firm and the government auditor, or rotates between the two, either every year or on some other basis. One responded with the auditor employed by the Administrative Office of the Courts. None reported anything other than a variation on one of the two given choices.

*Who Selects the Auditor?* There were 286 responses. Representative answers were:

- Selection is made by a committee that includes the independent city auditor, the chair of the audit committee, the city attorney and a representative from the administrative services (finance) department.
- Mayor
- Selection is by the County Executive with the consent of the City Council, compensation and oversight is with the Director of Budget and Finance.
- Council for selection (with staff recommendation) and compensation; financial services for oversight.
- Selection is by the Audit Committee; compensation is negotiated in the contract; and oversight is by the finance department.
- A separate state agency reporting to the state legislature, the Examiners of Public Accounts, does the department’s audit.
- The State Comptroller
- Chief Financial Officer and Controller
- Auditor of Public Accounts
- The General Assembly
- The Code of the State requires the State Auditor to conduct the audit.
- The State Auditor’s Office, a state agency, is the independent auditor, although agencies use public accounting firms as well.
- The Board of County Commissioners in conjunction with the County’s Chief Financial Officer, the Clerk of the Courts.
- Auditor Selection Committee for the selection only, the County Mayor for compensation with oversight shared with elected Comptroller.
- Selection: contracted for by County Board; Compensation: recommended by committee headed by fiscal administrator reviewing the bids received; Oversight: about every three to five years.
- The Secretary of State Audits Division has constitutional authority to audit the public accounts of the state. Audit results are reported to agency management, the Legislature, and the Governor.
- Primarily the State Auditor with input from the County Auditor on selection and oversight.
- The audit committee is responsible for the selection and oversight. Compensation is a budgeted function. Another respondent stated the same for selection and oversight, and “determined through the RFP bidding process” for compensation.
- State Auditor is an elected position and given statutory authority for financial audits of state and local governmental entities.
- The Housing Authority Board with oversight by the Board Chairman and Executive Director.
- Financial managers work with internal audit to select and determine compensation.
- The entire city council, based upon audit committee and staff recommendation.

Prohibition on Financial Statement Auditor doing Non-Attest Services. Respondents reported “other” non-attest services that were prohibited as: performance audits, training; financial statement preparation; agreed-upon procedures/special audits; and compilations.

Explanations given as to why the prohibition on hiring the financial statement auditor to do non-attest services was not necessary encompassed such things as:

- already following Yellow Book guidelines on independence so no need to prohibit the services; disclosure required for all conflicts of interest;
• possible need for such services (such as services related to issuance of bonds for long-term financing of construction projects);
• generally no contracts are requested or awarded for prohibited services although there is no specific prohibition.

Several said that the furnishing of management consulting services would not necessarily impair independence and that they want to be able to engage them to do such work if they see a need for oversight outside the scope of the audit.

The source of the prohibition of services was most often given as: GAO Yellow Book, Government Auditing Standards, GAGAS, AICPA and State CPA codes of ethics and conduct; prudent business practice; and good management judgment. Respondents cited Executive Orders, AICPA Statements of Auditing Standards (SASs), Resolutions and unwritten policy. The non-attest services allowed with pre-approval included:

• special engagements, e.g., independent assessment of an internal issue;
• agreed-upon procedures for the quarterly cash counts for the Treasurer Division;
• minor projects to assist management functions, but no actual management work or decision-making;
• training and advice on conforming to GASB pronouncements, like GASB 34;
• rate reviews;
• benefit program administration services;
• review and attestation of financial information related to bond financing commercial paper; issuance;
• help in auditing for fraud;
• information systems software/hardware replacement.

Most did not specifically preclude the financial statement auditor from performing the audit if the chief executive officer, controller, chief accounting officer or equivalent was employed by the auditor and participated in the audit during the preceding year. Some said they had not had such instances. Others referred again to professional standards, AICPA and state CPA codes of ethics and conduct; to the Yellow Book; or to the IIA Ethics Standards. Several referred to a conflict-of-interest policy. One city had conflict-of-interest language in its 'boilerplate' contracts, other in the RFP and the contract. Some said the town or city or state audit office has a policy or a practice that prevents it from happening. A retirement system did have a year’s cooling-off period before such employment could take place. One city had an ordinance directive preventing it.

**Auditor Rotation.** Those who disagreed with the idea that there could be benefit in having rules on auditor rotation, requiring auditor communications to audit committees, and having conflict of interest rules on prior employment, gave these as reasons.

• Do not believe that mandatory audit firm rotation is necessary; but review and competitive proposals on a cyclical basis such as every five years is beneficial.
• We believe the current independence standards (Government Auditing Standards or GAS) are adequate for government audits.
• AICPA and state CPA codes of ethics and conduct along with city purchasing practices effectively deal with these concerns.
• Not a significant benefit, not nearly as significant as in the public sector.
• We agree that these would be beneficial to the public sector, but doubt that the implementation of these functions would be practical.
• We are getting a decent product for a responsible price.
• Our state auditor is independently appointed by the legislature. The private sector independence measures listed just don’t apply to the situation in the public sector.
• Most agencies already have policies in place; professional judgment should not be dictated by more standards.
• A former auditor has a good base knowledge of the system already going in to employment. Other internal controls should be in place to mitigate. We have policies about rotation and communications.
• I do not believe it is an issue for most places.
• While I strongly agree, it is hard to find firms big enough to do our audit on a rotation basis.
• The CPA audit standards cover employment well enough and it says there is only a problem if one of our staff went to work for them. We have too small a pool of auditors to choose from to rotate.
• I prefer it to be a local matter or best practice. We have enough imposed regulation as it is.
• In the 10 years of my auditing experience this has never been an issue. Most entities have two separate groups compiling financial statements from auditing those statements.
• Our agency is specialized in trust management. It is difficult to find auditors with that expertise.
• Auditor rotation does not apply in this state since audit is required by state law.
• There are situations where a prior auditor is hired by the agency as a benefit and [this] should not be arbitrarily prohibited.
• Political processes are sufficient.
• In an ideal world, maybe, but in the real world, sometimes it is not feasible to restrict auditor selection regarding issue No. 1, especially with the restrictions placed by the accounting establishment.

Some respondents agreed that they were beneficial.
• A perspective is needed after a few years. If an auditor becomes too comfortable with the audit, little changes...
may be missed. Fresh eyes and new perspectives are needed over time.

- Dilutes possible political bias in the public sector.
- I believe we need to have better oversight for the external auditor.

**Internal Control Evaluation and Reporting.** We asked whether the respondents work for an entity that is required to report on internal controls, and if so, to describe the requirement. More than a third of respondents (99) said they had (see page 28) and 91 of those described the requirement. Some respondents said that they reported on internal controls through OMB Circular A-133 and discussion in the CAFR. Some quoted state regulations/legislation, departmental policy/guidelines, board policy, ordinance directives. One had quadrennial reporting, and several had biennial. A representative sample of the 91 responses describing the requirement follows:

- There is an annual certification by managers that internal controls are adequate.
- It is the responsibility of management but there is no requirement re: reporting.
- CAFR
- Management sets up policies and procedures and reports on current practices.
- These are the responsibility of another state agency, the Office of Financial Management.
- The attestation letter from the agency to the State Controller only requires a disclosure that internal controls were evaluated and disclosure of any material weaknesses.
- I don’t know if we really “assess the effectiveness,” unless the lack of material breaches addresses the effectiveness.
- Written procedures are reviewed each year to see if they are adequate and being done.
- No mention of management responsibility.
- The report’s focus isn’t financial. It is in the context of control issues around programs and performance and financial if that is reviewed.
- There are policies and procedures on internal control and our external auditors attest to if the written policies are adhered to.
- Required to report weaknesses.
- We are a small agency and try to have segregation of duties as much as possible.
- Internal agency assessment/internal audit.
- Follow up of recommendations, no assessments.

Eight checked the “other” category of the authority the report was required, and reported the following:

- State Governmental Accountability, Audit and Internal Control Act
- State Controller’s Office directions for purpose of preparing the statewide CAFR
- Executive Order of the Governor
- OMB Circular A-133
- Request of the CPA firm
- State Controller requirements
- Part of Contract Deliverables

**Entity’s Current Practice Regarding Management’s Responsibility and Reporting on Internal Controls.**

Responses to this question included:

- Annual certification by managers that internal controls are adequate
- Follow-up of recommendations, no assessment
- No uniform procedure for updating internal controls
- Management sets up policies and procedures and reports on current practices
- Written procedures are reviewed every year to see if they are adequate and being done
- Internal agency assessment/internal audit
- There are policies and procedures on internal controls and the external auditors attest to whether there is adherence to the written policies
- The responsibility of management but no reporting requirement
- The attestation letter from the agency to the state controller only requires a disclosure that internal controls were evaluated and disclosure of any material weakness.

**Auditor’s Current Reporting on Internal Control Over Financial Reporting.** Respondents who answered the “other” category for this question cited:

- Opinion on the effectiveness of the internal controls over financial reporting (Commonwealth)
- Opinion on management control structure (municipal public school system)
- When applicable (for example, material weakness), the external auditors will provide an opinion on internal controls in their management letter (county)
- Report on internal control required by GAS not an opinion, negative assurance on material weakness
- They note compliance, but do not give an opinion
- Minimum acceptable under GAS
- Requirements of SAS pronouncements/AICPA requirements
- Minimum A-133 requirements/Part of the Single Audit Reporting
- Management Letter
- Part of the State Biennial Single Audit performance audits conducted of each department
- Only report of material weaknesses in internal control, no opinion

**Provisions Entity’s Financial Statement Audit is Conducted Under.** Those answering “other” cited: State or Commonwealth Law Requirements, such as State Audit Law (from a
California educational institution, Florida, Minnesota, New Mexico, Ohio, Oregon, a South Carolina county, Utah, Virginia, and Washington State); the Red Book; municipal requirements such as Audit Guides; GAAP, NACUBO, FASB/GASB; GASB 34; no state requirement but GFOA certification requires it; OMB Circulars A-87, A-102, A-133; agreed-upon procedures; and bond requirements (state water authority).

Integrated Internal Control Framework. Those who answered the “other” category cited: city policies and compliance with state statutes; internal accounting procedures manual developed over time; a system that had evolved over time based on the SASs; State Board of Accounts procedures and OMB [Circular] A-87 guidelines; risk assessment and analysis; COSO ERM; COBIT; auditor suggestions; OMB Circular A-133; GAFR, Miller GAAP Guides and PPC’s; GAAP; and a “conglomerate” of internal controls established over the years.

Provisions of the Sarbanes-Oxley Act Being Applied Within Governments. In addition to the answers listed below, see page 29 in Appendix II. Respondents stated that these are being applied to: higher education institutions; redevelopment agency, community facilities districts and joint powers agencies; library, alcohol and drug commission, fire commission and recreation commission; and agency-wide. One responded that some departments or institutions within the primary government have adopted certain provisions similar to Sarbanes-Oxley. Seven states, four state departments or agencies, six counties or county entities like school boards, and two cities say they have implemented Sarbanes-Oxley provisions, some fully, others at various levels of compliance. Some examples of their answers are:

- Internal controls and management assertions. Require attestation from lower level management.
- Tailored very closely to Section 404, also to GFOA requirements.
- Agency heads and accounting personnel are required to provide a letter of representation to the CFO.
- Auditor rotation, independent audit committee oversight over management, limit non-audit work by internal and external auditors.
- Segregation of duties. Using A-133 to assist.
- The audit committee selects the audit firm; a rotation basis is in place due to government auditor rotation schedule.
- One commonwealth mandates a level of compliance with COSO ERM.
- One state’s Department of Transportation auditors have been trained in Sarbanes-Oxley and compliance with and disclosures similar to SOX are required for audit work.
- Maintaining separation of audit and non-attest work/engagements.

Management Certification of Financial Reports. One respondent states that, “We believe that our management representation letter to our independent auditors and the transmittal letter that accompanies the statements meet these requirements.”

Code of Ethics for Senior Financial Officers. Five respondents said that they had had a restatement of their financial statements due to material misconduct or as a result of misconduct. Explanations were that it was not a result of misconduct, that the Board of Accountancy made the determination and management took immediate corrective action. The most common punitive action cited was suspension or dismissal. In one instance an elected official was engaged in off-balance sheet reverse repurchase agreements that were never disclosed or discovered. Ultimately the statement had to be restated due to materiality. The controller and auditor were not impacted, those responsible were terminated. In another instance the perpetrators ended up in jail: one for two years, the other for 10 years.

Management and Criminal Fraud Accountability. Respondents described the penalties imposed for the destruction, alteration or falsification of records.

- Disciplinary procedures
- Termination of employment
- Prosecution to the fullest extent of the law
- One state law makes it a felony criminal offense to falsify official records
- Prosecution for obstruction of justice possible

The majority of respondents have provisions in law or regulation that offers protection for employees who provide evidence of fraud. Most referred to either the federal or various state whistleblower protection laws. Some had policies protecting employees. Some mentioned EEOC regulations, others the fraud hotline that allows for anonymity in reporting fraud, waste and abuse in government. One state provides that the disclosure of confidential information obtained from third parties shall be a felony of the third degree. One mentioned liability insurance for employees.

Best Practices and Success Stories. There were fourteen responses to the question, “If you have a best practice or success story related to the setting up, evaluation of, or reporting on your entity’s internal control system, please tell us about it here.” Some simply stated none or not applicable. A cross-section of state departments, cities and counties, school districts, responded here. One responded, “The people in my organization do not even talk about internal control. When it is brought up, managers say it is not relevant.” Responses like this suggest more education is needed on the value to managers of internal controls.

Others were more positive.

- The best practice we adopted is to evaluate our internal control yearly.
- The Office of Finance has instituted Control Self-Assessment within the government.
- Evaluating internal controls is a primary focus of our office. One recent example of our work is, I believe, noteworthy. In an audit of the city’s golf courses, we found significant weaknesses in internal controls over cash.
The Auditor-Controller’s Internal Audit staff performs a variety of audits: fiscal operational audits being one type that does address internal control structure/processes. A review of the internal control structure was specifically performed at the county’s Agriculture Commissioner’s (Ag Comm) Department for FYE 2001 and a variety of recommendations were made. Ag Comm management has implemented said recommendations. Internal controls are also reviewed with respect to the county’s various impress funds distributed through county departments.

Lessons Learned

- Once internal controls have been established, one must make sure to communicate them to the staff and from time to time make sure that those controls are being followed by all employees.
- One state department used COBIT to evaluate the internal controls over information technology. A lesson learned was that due to the complexity of their systems and the many parties involved, it is a long process.
- Improvements can be made in the overall process. For example, for most programs administered by the department, the administration and policy setting is located in our central office, yet the local offices carry out the programs so it is important that both parties participate in the evaluation of a program.
Survey on Current Practice in Audit & Internal Controls for State and Local Governments

The Association of Government Accountants is requesting your assistance in an AGA Corporate Partner Advisory Group research project sponsored by Corporate Partner KPMG. The objective of the research is to assess the current state of audit and internal controls in state and local governments and to evaluate whether there is a need for improvement. Your input is invaluable to us: without it, there can be no research results. We would be very grateful if you would complete the survey and submit it to us. Although there are many questions in the survey, it should only take about 30 minutes to complete. You can partially complete the survey and then go back to it if you need to research certain questions. Just do not click the DONE button until you have completed all the questions you can answer. Please complete the survey and submit it to us by June 30, 2005. If you have any difficulty with the survey or need advice as to how to complete, a question, please contact Anna Miller at AGA, at 800-242-7211, x 313.

Demographics
Please provide the following information:
Name of Respondent
Title or Function
Name of Respondent’s Office/Division
Name of Government
Phone
Email
Total Revenues from the entity wide statement (for the most recent fiscal year)
Please indicate the type of government you are employed by:
State
City
County
City and County
School District
College or University
Local Public Authority
Local Public Utility
Special District (please describe)

Responsibility for an Organization's Internal Control over Financial Reporting
Internal control is broadly defined as a process, effected by an entity’s governing body, management and other personnel, designed to provide reasonable (but not absolute) assurance regarding the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations. Everyone in an organization has responsibility for internal control. This includes management, governing body, internal auditors and other personnel, although the chief executive officer (CEO) is ultimately responsible and should assume ‘ownership’ of the system. Methods to ensure that management is aware of its responsibilities include having an active audit committee with clearly defined responsibilities, having an upward reporting system that reminds everyone of management’s responsibilities for financial reports and having penalties for management misconduct including protection for whistleblowers.

Audit Committee
An audit committee of a state or local governmental entity often is directly responsible for the appointment, compensation and oversight of the work of any registered public accounting firm employed by the entity. Audit committees are committees (or equivalent bodies) established by and among the governing body of an entity for the purposes of overseeing the accounting and financial reporting processes of the entity and audits of the financial statements of the entity. Sometimes the governing body assumes the roles and responsibilities of an audit committee.

Qu. 1 Does your entity have an audit committee, or equivalent body? If no, skip to Qu.10.
Yes 104 (36 percent)
No 165 (57 percent)
Have Eq. Body 31 (11 percent)
Percentages calculated based on 287 responding to this question.

Qu. 2 Under what authority is the audit committee (or equivalent body) established?
(Note: Respondents could answer more than one)
Law 49 (40 percent)
Regulation 3 (2.4 percent)
Policy 54 (44 percent)
Other (please specify) 21 (17 percent)
Percentages calculated based on 124 responding to this question.

Qu. 3 Is your entity’s audit committee (or equivalent body) responsible for the following activities? Please check all that apply:
Selection of the auditor 66 (65 percent)
Compensation of the auditor 41 (41 percent)
Oversight of the work of the auditor 89 (88 percent)
Percentages calculated based on 101 responding to this question.
Qu. 4 Describe the composition of the audit committee (or equivalent body). 119 responses

Qu. 5 Who appoints the members of the audit committee (or equivalent body)? 118 responses

Qu. 6 Describe the duties and responsibilities of the audit committee (or equivalent body). 115 responses

Qu. 7 What policies and procedures do you have in place to ensure audit committee (or equivalent body) independence? 101 responses

Qu. 8 Does the audit committee (or equivalent body) include at least one member who is a financial expert, either in finance or accounting?
   Yes 82 (73 percent)
   No 31 (27 percent)

Qu. 9 Does your entity require specific auditor reports to the audit committee (or equivalent body) on the following?
   a The initial selection of and changes in significant accounting policies or their application
      Yes 46 (41 percent)
      No 67 (59 percent)
   b The methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus (revenue recognition, off-balance sheet financing, and accounting for equity instruments)
      Yes 49 (44 percent)
      No 63 (56 percent)
   c Other significant written communications between the auditor and management, such as any management letter or schedule of unadjusted differences
      Yes 81 (72 percent)
      No 31 (28 percent)

Qu. 10 Who does the audit of the entity’s financial report?
   A public accounting firm 154 (52 percent)
   A government auditor 126 (43 percent)
   Other (please specify) 16 (5 percent)

Qu. 11 Who is responsible for the selection, compensation and oversight of the financial statement auditor? 286 responses

Qu. 12 If your state or local auditor does the entity’s financial statement audit, do they follow Government Auditing Standards (the Yellow Book)?
   Yes 216 (76 percent)
   No 3 (1 percent)
   N/A 65 (23 percent)

Qu. 13 If no to Qu. 12, do they follow PCAOB standards?
   Yes* 5 (38 percent)
   No 8 (62 percent)
   * A city, a county, a municipal public utility, a state department trust fund and a county public works department

[If your entity uses a public accounting firm, please answer Qus.14-26 below. If not, skip to Qu. 25.]

Qu. 14 Is the financial statement auditor prohibited from providing the following non-attest services in addition to the audit?

<table>
<thead>
<tr>
<th>Service</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bookkeeping</td>
<td>139</td>
<td>26</td>
</tr>
<tr>
<td>(84 percent)</td>
<td>(16 percent)</td>
<td></td>
</tr>
<tr>
<td>Information</td>
<td>135</td>
<td>31</td>
</tr>
<tr>
<td>(81 percent)</td>
<td>(19 percent)</td>
<td></td>
</tr>
<tr>
<td>Systems Design</td>
<td>136</td>
<td>28</td>
</tr>
<tr>
<td>(83 percent)</td>
<td>(17 percent)</td>
<td></td>
</tr>
<tr>
<td>Actuarial Services</td>
<td>120</td>
<td>42</td>
</tr>
<tr>
<td>(74 percent)</td>
<td>(26 percent)</td>
<td></td>
</tr>
<tr>
<td>Management Consulting Services</td>
<td>21</td>
<td>16</td>
</tr>
<tr>
<td>(please specify)</td>
<td>(57 percent)</td>
<td>(43 percent)</td>
</tr>
</tbody>
</table>

Qu. 15 If no to any of the above in Qu. 14, please explain why this prohibition is not necessary. 43 responses

Qu. 16 If yes to any of the above in Qu. 14, what is the source of the prohibition?

<table>
<thead>
<tr>
<th>Source</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Law</td>
<td>15</td>
<td>11</td>
</tr>
<tr>
<td>(11 percent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulation</td>
<td>22</td>
<td>16</td>
</tr>
<tr>
<td>(16 percent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Policy</td>
<td>68</td>
<td>49</td>
</tr>
<tr>
<td>(49 percent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contract</td>
<td>33</td>
<td>24</td>
</tr>
<tr>
<td>(24 percent)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>32</td>
<td>23</td>
</tr>
<tr>
<td>(please specify)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Qu. 17 Please describe and provide citations if possible. 34 responses

Qu. 18 Are there certain non-audit services allowed with pre-approval by the audit committee?
   Yes 20 (13 percent)
   No 48 (31 percent)
   N/A 87 (56 percent)
Qu. 19 If you answered yes to Qu. 18, please list and describe the services requiring pre-approval. 22 responses

Qu. 20 Does your entity require lead audit partner rotation every five years?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>No Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>39</td>
<td>118</td>
<td>146</td>
</tr>
<tr>
<td>(25 percent)</td>
<td>(74 percent)</td>
<td>(92 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Percentages calculated based on 157 responding to this question.

Qu. 21 If no to Qu. 20, does your entity have any requirements that address lead audit partner, director or manager rotation?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>N/A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>18</td>
<td>95</td>
<td>7</td>
</tr>
<tr>
<td>(15 percent)</td>
<td>(80 percent)</td>
<td>(5 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Percentages calculated based on 120 responding to this question.

Qu. 22 Is your financial statement auditor precluded from performing the audit if the chief executive officer, controller, chief accounting officer, or equivalent was employed by the auditor and participated in the audit during the preceding year?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>60</td>
<td>99</td>
</tr>
<tr>
<td>(38 percent)</td>
<td>(63 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Percentages calculated based on 160 responding to this question.

Qu. 23 If no, do you have any policies in this area?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>6</td>
<td>90</td>
</tr>
<tr>
<td>(6 percent)</td>
<td>(94 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Qu. 24 If yes to Qu. 22, please explain. 48 responses

Qu. 25 Do you think that auditor rotation, auditor communications to audit committees, and conflict of interest rules on prior employment by auditor would be beneficial in the public sector?

<table>
<thead>
<tr>
<th></th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Neutral</th>
<th>Disagree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>75</td>
<td>107</td>
<td>64</td>
<td>20</td>
<td>5</td>
</tr>
<tr>
<td>(27.7 percent)</td>
<td>(39.5 percent)</td>
<td>(23.6 percent)</td>
<td>(7.4 percent)</td>
<td>(1.8 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Percentages calculated based on 273 responding to this question.

Qu. 26 If you answered “disagree” or “strongly disagree” in Qu 25, please give your reasons. 32 responses

Internal Control Evaluation and Reporting

Some states have a requirement that the head of each principal department shall establish and maintain an internal accounting and administrative control system and shall report, annually or biennially, to key stakeholders on his or her evaluation of the internal control system. In the private sector all public companies are now required to include in their annual reports an internal control report which states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

Qu. 27 Does your entity have a similar requirement to evaluate and report on internal controls? If no, skip to Qu 33.

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>99</td>
<td>162</td>
</tr>
<tr>
<td>(38 percent)</td>
<td>(62 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Percentages calculated based on 257 responding to this question.

Qu. 28 If yes to Qu 27, please describe. 91 responses

Qu. 29 If yes to Qu 27, under what authority is this report required?

<table>
<thead>
<tr>
<th>Authority</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Law</td>
<td>26</td>
<td>28</td>
</tr>
<tr>
<td>Reg</td>
<td>27</td>
<td>20</td>
</tr>
<tr>
<td>Policy</td>
<td>28</td>
<td>20</td>
</tr>
<tr>
<td>Mgt Dec</td>
<td>16</td>
<td>12</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
<td>12</td>
</tr>
</tbody>
</table>

Percentages calculated based on 93 responding to this question.

Qu. 30 Does your entity’s internal control report state the responsibility of management for establishing an adequate internal control structure and procedures for financial reporting?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>104</td>
<td>12</td>
</tr>
<tr>
<td>(90 percent)</td>
<td>(10 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Percentages calculated based on 116 responding to this question.

Qu. 31 Does your entity’s internal control report contain an assessment of the effectiveness of the internal control structure and procedures of the entity for financial reporting?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>93</td>
<td>20</td>
</tr>
<tr>
<td>(82 percent)</td>
<td>(18 percent)</td>
<td></td>
</tr>
</tbody>
</table>

Qu. 32 If no to Qu. 31, please describe your entity’s current practice regarding management’s responsibility and reporting on internal controls. 23 responses
Qu. 33 Is your entity’s auditor required to attest to and specifically provide an opinion on management’s assertion as to the effectiveness of the internal control structure over financial reporting?

Yes: 181 (73 percent)
No: 67 (27 percent)

Qu. 34 If no to Qu 33, please describe the auditor’s current reporting on internal control over financial reporting. 59 responses

Qu. 35 Is your entity’s financial statement audit required to be conducted under the provisions of (please answer yes to all that apply)?

- GAAS: 237 (92 percent)
- GAS (Yellow Book): 243 (95 percent)
- SAA, as amended: 219 (85 percent)
- Other auditing requirements (please describe): 53 (21 percent)

Percentages calculated based on 257 responding to this question

Qu. 36 If your entity is required to comply with the Single Audit Act (because of the level of federal financial assistance expended annually), do your entity’s Single Audit Act reports on compliance and internal control have the same date as the date of the auditor’s report on the entity’s audited financial statements?

Yes: 185 (82 percent)
No: 41 (18 percent)

Qu. 37 Does your entity have common financial processes, e.g. procurement, payroll, etc.?

Yes: 242 (95 percent)
No: 12 (5 percent)

Qu. 38 If a requirement was imposed on your entity to evaluate and certify the internal controls over financial reporting, would the additional costs of doing this over and above what you have to do for the Single Audit Act outweigh the benefits gained?

Yes: 133 (57 percent)
No: 106 (45 percent)

Percentages calculated based on 235 responding to this question

Qu. 39 If your entity has established an integrated internal control framework, is it based on guidance like Internal Control: Integrated Framework (the COSO Report of the Treadway Commission) or OMB Circular A-123? Please indicate which guidance your entity uses (please check all that apply).

- COSO standards: 54 (25 percent)
- State Law or Reg based on A-123: 74 (34 percent)
- Do not have an integrated I/C framework: 97 (44 percent)
- Other (please specify): 23 (11 percent)

Percentages calculated based on 219 responding to this question

Qu. 40 Is your entity applying provisions similar to those of Sarbanes-Oxley within your government? Please indicate which it is applied to (please check all that apply).

- Primary Government: 34 (65 percent)
- Nonprimary Government: 3 (6 percent)
- Semi Independent Agencies: 0
- Political Subdivisions: 5 (10 percent)
- Public Authorities: 11 (21 percent)
- Other Component units (please describe): 12 (23 percent)

Percentages calculated based on 52 responding to this question

Qu. 41 If yes to any of the above, please describe the provisions and how they can be applied. 32 responses

Management Certification of Financial Reports

Some states require a certification that management of the entity accepts its corporate responsibility for financial reports. Specifically, some states require that the principal executive officer and the principal financial officer, or persons performing similar functions, certify each annual financial report. This certification covers such items as a statement that the financial statements are presented fairly in all material respects.

Qu. 42 Does your entity have a requirement that the principal executive officer(s) and the principal financial officer(s), or persons performing similar functions, certify the entity’s annual financial report? If no, skip to Qu. 45.

Yes: 107 (46 percent)
No: 128 (55 percent)
**APPENDIX II**

**Qu. 43** If yes to Qu. 42, who certifies the report? Please check all that apply.

<table>
<thead>
<tr>
<th>Type</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principal Executive Officer</td>
<td>59 (55%)</td>
</tr>
<tr>
<td>Principal Financial Officer</td>
<td>82 (76%)</td>
</tr>
<tr>
<td>Other (please specify)</td>
<td>20 (19%)</td>
</tr>
</tbody>
</table>

Percentages calculated out of 108 responding to this question

**Qu. 44** If yes to question 42, does the certification in the annual financial report comply with the following requirements?

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. The signing officer has reviewed the report.</td>
<td>97 (92%)</td>
<td>9 (9%)</td>
</tr>
<tr>
<td>b. Based on the officer’s knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary to the statements not misleading.</td>
<td>101 (97%)</td>
<td>3 (3%)</td>
</tr>
<tr>
<td>c. Based on the officer’s knowledge, the financial statements present fairly, in all material respects, the financial condition and results of operations.</td>
<td>102 (97%)</td>
<td>3 (3%)</td>
</tr>
<tr>
<td>d.1. The signing officers are responsible for establishing and maintaining internal controls.</td>
<td>91 (88%)</td>
<td>13 (13%)</td>
</tr>
<tr>
<td>d.2 The signing officers have designed such internal controls to ensure that material information relating to the entity is made known to others within the entity.</td>
<td>85 (83%)</td>
<td>18 (17%)</td>
</tr>
<tr>
<td>d.3 The signing officers have evaluated the effectiveness of the entity’s internal controls as of a date within 90 days prior to the report.</td>
<td>60 (61%)</td>
<td>39 (40%)</td>
</tr>
<tr>
<td>d.4. The signing officers have presented in their report their conclusions about the effectiveness of their internal controls based on their evaluation.</td>
<td>59 (60%)</td>
<td>40 (40%)</td>
</tr>
<tr>
<td>e.1 The signing officers have disclosed to the entity’s auditors and the audit committee all significant deficiencies in the design or operation of internal controls which could adversely affect the entity’s ability to record, process, summarize, and report financial data and have identifies any material weakness in internal controls.</td>
<td>81 (82%)</td>
<td>19 (19%)</td>
</tr>
<tr>
<td>e.2 The signing officers have disclosed to the entity’s auditors and the audit committee any fraud, whether or not material, that involves management or other employees who have a significant role in the entity’s financial control.</td>
<td>90 (90%)</td>
<td>10 (10%)</td>
</tr>
<tr>
<td>f. The signing officers have indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.</td>
<td>77 (75%)</td>
<td>25 (25%)</td>
</tr>
</tbody>
</table>

Percentages calculated out of 98 responding to this question

Percentages calculated out of 105 responding to this question

Percentages calculated out of 104 responding to this question

Percentages calculated out of 105 responding to this question

Percentages calculated out of 104 responding to this question

Percentages calculated out of 102 responding to this question

Percentages calculated out of 100 responding to this question

Percentages calculated out of 102 responding to this question

Percentages calculated out of 99 responding to this question

Percentages calculated out of 99 responding to this question
Code of Ethics for Senior Financial Officers

Qu. 45 Has your entity adopted a code of ethics for senior financial officers? This would cover honest and ethical conduct, including the handling of actual or apparent conflicts of interest between personal and professional relationships; full, fair accurate, timely and understandable disclosure in the financial reports; and compliance with applicable laws and regulations.

Yes 148 (62 percent)
No 92 (38 percent)

Qu. 46 Has your entity ever had a restatement of its financial statements due to material noncompliance or as a result of misconduct?

Yes 5 (2 percent)
No 235 (98 percent)

Qu. 47 If yes to Qu. 46, what punitive actions were taken relative to the comptroller and/or the auditor? Please describe. 9 responses

Management and Criminal Fraud Accountability

Qu. 48 Does your entity impose penalties for the destruction, alteration or falsification of records?

Yes 142 (62 percent)
No 88 (38 percent)

Qu. 49 If yes to Qu. 48, please describe them. 132 responses

Qu. 50 Does your entity have a provision in law or regulation that offers protection for employees who provide evidence of fraud?

Yes 129 (57 percent)
No 99 (43 percent)

Qu. 51 If yes to Qu. 50, please describe them. 117 responses

Lessons Learned and Best Practices

Qu. 52 If you have a best practice or success story related to the setting up, evaluation of, or reporting on your entity’s internal control system, please tell us about it here. 14 responses
State Nonprofit Oversight Legislation

Several states have proposed or have passed legislation affecting nonprofits deriving from SOX.

Proposed and Passed NFP Legislation

Connecticut (S.B. 946/H.B. 6515) passed June 2005—Requires charities to submit a financial report annually to the Department of Consumer Protection. A nonprofit whose gross revenues exceed $200,000 must also file an audited financial statement.

Kansas (S.B. 121) passed May 2005—All charities must submit a tax return to the secretary of state before soliciting funds, and those whose contributions total $500,000 or more must submit an audited financial statement.

Iowa (S. 2274)—Replaces the current NFP provisions with revised model Nonprofit Corporation Act. Sets out general standards for directors and officers and provisions governing when transactions involving director conflicts of interest may be allowed. Prohibits loans/guarantees to directors/officers.

Maine (L.D. 1691) enacted in 2004—Act to Strengthen the Charitable Solicitations Act: When renewing registration as a charitable organization, the organization must submit an audited financial statement, including federal IRS Form 990.

Massachusetts—(AG)—An Act to Promote the Financial Integrity of Public Charities; (HB 4234)—Changed the requirements for state public charities regarding filing financial statements reviewed or audited by an independent certified public accountant (effective Oct. 13, 2004).

Michigan (S.B. 1115)—Amends the Charitable Organizations and Solicitations Act

New Hampshire (H.B. 1408)—Requires NFPs with revenues of more than $500,000 to file the organization’s most recent audited financial report with the AG. The bill, passed in 2004, also changes the community needs assessment reporting requirement for HC charitable trusts from three to five years.

New Jersey (S. 204)—Revises the Charitable Registration and Investigation Act (P.L. 2005, c. 283 )


Ohio (S.B. 153)—Various legislative considerations surrounding use of public monies

Rhode Island (H.B. 7962)—Any NFP with the exception of hospitals that pays its officers or directors more than $200,000 a year shall not be entitled to NFP status.

Passed State Legislation

California Nonprofit Integrity Act of 2004
(effective Jan. 1, 2005)

S.B. 1262 effects:
• All charitable corporations, charitable trusts and unincorporated associations required to register with/annually report to the Attorney General’s Registry of Charitable Trusts (hospitals, educational institutions, or religious organizations exempt)
• NFPs with gross revenues of more than $2 million, not counting funds for which a governmental entity requires an accounting, must comply with requirements around:
  • Audits, independent auditors, public disclosure, audit committees, CEO/CFP compensation
  • Does not require an internal controls component

All NFPs, registered with the Office of the Attorney General must comply with requirements centered around:

California Public Disclosure
Accelerated registration requirement
Notice of commencement of solicitation
Contracts with commercial fundraisers and fundraising council
Misrepresentation
Control
Registration
Prohibitions

Many nonprofits are voluntarily basing their guidelines on this California legislation. One of the reasons it is being used is that it does not require an audit opinion on internal control over financial reporting.

New Jersey Act—Public Law 2005, c.283 (S204 3R)

Amends the Charitable Registration and Investigative Act (P.L. 1994, c.16) by requiring:
• CEO certification for nonprofit organizations receiving more than $250,000 in gross revenues;
• Nonprofits with gross revenues of $250,000 or more to prepare its financial statements in accordance with GAAP and undergo an audit by an independent certified public accountant in accordance with GAAS; and
• The CPA to provide management letters prepared by the auditor in connection with the audit commenting on the internal accounting controls or management practices of the organization.
• Any written communication prepared by the CPA in connection with the audit commenting on the internal accounting controls or management practices shall not be considered a public record, shall be removed from the record at such time the information is no longer necessary for the enforcement of P.L. 1994, but shall be retained for at least three years after the end of the period to which they relate.
**APPENDIX III**

**State of New Jersey Executive Orders**

Executive Order No. 10 (2002) Mandates that members of certain boards, commissions, independent authorities and public corporations, as well as the executive or administrative heads and assistant heads of such boards, commissions, or independent authorities file annual financial disclosure statements.

Executive Order No. 122 (2004) Directs that all public authorities, agencies and commissions create an audit committee to assist in the oversight of the financial reporting and audit processes of that entity, and that such audit committee follow certain specified procedures in carrying out its duties.

Executive Order No. 134 (2004) Requires that the State of New Jersey and all of its agencies and independent authorities implement procedures designed to limit or ban campaign contributions by vendors doing business with the state or its authorities.

Executive Order No. 41 (2005) Requires the Inspector General to assess the internal controls that are in place at every authority, and make recommendations concerning what uniform practices and procedures should be established for all state authorities.

**New York State—Public Authorities Accountability Act of 2005**

In February 2004, the New York governor issued a directive for the 31 public authorities—Model Governance Principles for Authorities (the Principles). On June 6, 2005, the state, represented in Senate and Assembly, enacted the Public Authorities Accountability Act of 2005 (the Act). The Act was passed by the Senate. The bill enacts the Public Authorities Accountability Act of 2005 (the Act) that would:

- Ensure greater efficiency, openness and accountability for our state’s public authorities by codifying the Model Governance Principles developed in conjunction with corporate governance expert Ira Millstein.
- Remove any legal impediments that prevent full implementation of the Model Governance Principles by public authorities.
- Establish a new public authorities office within the Executive Department to provide additional oversight and ensure full compliance with the principles.
- Allow for the creation of an independent inspector general to ensure greater accountability for authority-related activities and operations.
- Establishes an independent Public Authorities Inspector General.
- Allows certain authorities to have presidents who shall be the CFO.
- Establishes an independent Public Authorities Budget Office.
- Establishes a New York state commission on Public Authority Reform (the Commission), with Ira Millstein as chairman.

The Principles are based upon better practices and Sarbanes-Oxley

They are:

1. Formal training of public authority board members on legal, fiduciary, ethical and personal responsibilities;
2. The separation of oversight/executive functions;
3. Guidelines governing independence of public authority board members;
4. Organization and structure of the public authority board and its committees, including the establishment of audit and governance committees; establishment of codes of conduct governing honest and ethical conduct by public authority directors, officers and employees;
5. Policies regarding the procurement of goods and services, the acquisition of real property and the disposal of real and personal property;
6. Public authority employees’/operations’ internal controls.

The Act shall take effect immediately and shall apply to the public authority fiscal year beginning on or after Jan. 1, 2006, provided however that section 27 of this act shall take effect April 1, 2006.

**Focus of the New York Commission**

The Commission will focus on an array of matters pertaining to public authorities, and will be empowered to undertake a broad list of tasks, including:

- Reviewing/evaluating operations and practices of public authorities and assisting authority boards in developing and adopting model governance principles to strengthen oversight, management accountability, internal operations and public disclosure practices.
- Reviewing the potential elimination, dissolution, consolidation, reorganization or merger of authorities
- Recommending public disclosure practices policies, financial reporting practices, and financial auditing procedures and practices of state authorities

**Texas—Public Accountancy Act, Sec 29**

The 78th Texas Legislature, Regular Session, in 2003 directed the Texas State Board of Public Accountancy (Board) on the mandate of Section 29 of the new Public Accountancy Act. This section required the board to study and recommend and appropriate SOX-like provisions in its report. The intent was to ascertain what action was needed, if any. The Act states:

“The Texas State Board of Public Accountancy shall report to the governor, the lieutenant governor and the speaker of the House of Representatives, not later than Dec. 31, 2004 regarding:

1. the requirements of the federal Sarbanes-Oxley Act (Pub. L. No. 107-204), including any restrictions on public interest entities, and any legislation or other action needed to conform state law to the requirements of that Act;
2. the federal Government Accountability Office study on audit firm rotation and any legislation or other action to conform state law to the findings of that study; and

3. the rules adopted by the board that are intended to comply with the federal standards described by Subdivisions 1 and 2 of this section and the board’s actions in implementing and enforcing those rules.”

The report defines public interest entities (PIEs) as: Those entities whose audited financial statements are relied upon by significant numbers of stakeholders to make investment, credit or similar decisions (for example, in the case of a publicly held company) or by regulators in their oversight role (for example, in the case of pension plans, banks, insurance companies and school districts), and therefore, the potential extent of harm to the public from an audit failure involving one of those entities would generally be significant.

The study found that it is important that states agree on which, if any, SOX standards should be applied to nonpublic companies. Otherwise, there will be uniform standards for public companies regulated by the PCAOB and a patchwork of different regulations for nonpublic companies depending on the states in which they do business. The task force doing the study found:

1. In addition to auditor restrictions, SOX establishes board governance and management behavioral standards which should be addressed by Texas Public Interest entity regulators.

2. Texas should not enact laws that unfairly impact the state economic climate compared to other states.

3. Adoption of consistent national standards is preferable to a myriad of state-specific standards.

4. In any guidelines, cost of compliance versus benefits of public protection should be considered.

5. Small entities should not be unduly burdened with provisions pertinent to large entities unless the provision’s benefits clearly outweigh the costs.

6. SOX concepts are continuing to be addressed by multiple standard-setting and regulatory bodies at the national level and the requirements are continuing to evolve. Wherever possible, Texas should adopt the standards established by standard-setting bodies and avoid implementing rules and regulations inconsistent with other states.

The task force evaluated each SOX provisions and whether any action was needed. In the task force’s opinion existing national standards, GAO and AICPA standards are adequate and applicable to Public Interest entities (PIEs) (Secs. 206, 207). Regarding Sec. 404, the task force found that “there are fundamental differences between publicly traded companies and all other entities, making expansion of Sec. 404 unreasonable. The regulating bodies should determine whether such a requirement should exist for a particular type of PIE. Regarding criminal penalties they found existing protection adequate. They suggest that PIE regulating bodies may consider whether employee protection of PIEs is beneficial for Sec 806, 1102, and 1107.
A Brief History of Internal Control in the Federal Government Environment

The federal government has considered internal control important since the 1950s, although compliance has often been honored more in the breach than the observance. Following is a list of the laws and guidance that have been issued related to internal control. Congress and the Government Accountability Office (GAO) have long recognized the importance of sound internal controls, even if federal agencies have sometimes been somewhat less enthusiastic about applying the rules, especially since compliance is seen by many as an unfunded mandate. In 1999 the Comptroller General of the United States revised the Standards for Internal Control in the Federal Government, which provides guidance for federal agencies, to include guidance on the COSO integrated framework (for discussion of COSO see pages 8-10), the effect of information technology, and the passage of relevant legislation.

The Budget and Accountability Act of 1950 held government management responsible for internal control. The first federal requirement for public companies to implement internal control policies and procedures came with the Foreign Corrupt Practices Act in 1977, intended to prevent corporate bribery by American corporations of foreign officials. It required issuers registered with the SEC to maintain a responsible internal accounting control system. Companies complained about the costs and the stringency of the requirements, and guidance was issued to explain the boundaries.

Then massive internal control breakdowns in the federal arena led to passage of the Federal Managers’ Financial Integrity Act (FMFIA) in 1982. OMB Circular A-123 (A-123) was first developed to provide accompanying guidance for federal agency management on how to assess and report on internal control. In initiating the current revisions to A-123, the Office of Management and Budget cited the new internal control requirements for publicly traded companies that are contained in SOX. FMFIA does not call for an auditor opinion on the effectiveness of internal control, and neither does the revised A-123 guidance. The Department of Homeland Security Accountability Act of 2004 does, but it calls for an audit opinion under attestation standards, that is an examination-level attestation engagement and in conjunction with the audit of the financial statements.

The oversight committees in Congress, Oversight and Government Reform in the House and Homeland Security and Governmental Affairs in the Senate, will monitor the impact on agencies of the revisions to Circular A-123 (A-123) to see whether they are proving effective in creating the improvement that is desired. There is broad bipartisan congressional support for the revisions to a-123 to establish an internal control structure that adequately meets appropriate levels of risk and program complexity, as shown by members’ statements at a hearing in February 2005. In his opening statement at the United States House of Representatives (HOR) oversight hearing on revising A-123, Chairman Todd Platts, R-PA, emphasized that, “Internal controls provide a foundation for accountability, and while they are important in the private sector, sound internal controls are imperative in Government. Public trust depends on nothing less.” At the same hearing, Edolphus Towns, D-NY, ranking member of the subcommittee, stated:

[Considering] “the state of our government’s financial position, I believe it is timely ... to address the issue of internal controls as they relate to improving efficiency and accountability throughout the federal government. The need for adequate internal controls in governing the financial and operational components of our agencies has never been greater as the burden of both federal budget deficits and improper payments diminish the success of many programs...it is only logical to pursue policies than make the federal government more accountable to Congress and taxpayers, just as the private sector must be more accountable to its shareholders and consumers.”

Although the revised A-123 stopped short of requiring an audit opinion on internal controls, there is concern that this may change in the future. The Social Security Administration, the Nuclear Regulatory Commission and the Government Accountability Office (GAO) have long recognized the importance of sound internal controls, even if federal agencies have sometimes been somewhat less enthusiastic about applying the rules, especially since compliance is seen by many as an unfunded mandate. In 1999 the Comptroller General of the United States revised the Standards for Internal Control in the Federal Government, which provides guidance for federal agencies, to include guidance on the COSO integrated framework (for discussion of COSO see pages 8-10), the effect of information technology, and the passage of relevant legislation.

Laws and Guidance Relating to Internal Control

The Budget and Accounting Act of 1950—Placed the responsibility for internal control squarely on the shoulders of federal agency management. Management was made aware that they were responsible for maintaining sound systems of internal control.

Foreign Corrupt Practices Act of 1977 (FCPA)—Companies registered with the Securities and Exchange Commission (SEC) were required to institute and maintain an internal accounting control system to assure management’s responsibility for internal control, authority and responsibility over a firm’s assets. The definition of internal control was broad, and described as the protection of assets and prevention of improper payments. Predictably, critics contended that the internal accounting controls required were too costly and burdensome on domestic firms, especially as potential criminal penalties in the FCPA for failure to institute adequate controls arguably made officials of firms overly and unnecessarily cautious in implementing costly accounting controls. Critics argued for a materiality standard for public record keeping in which a firm would be required to report only expenditures and outlays deemed material to the profits and revenues of the firm. In 1988 amendments were made
that for the purposes of the accounting standards, “reasonable assurances” and reasonable detail” mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct if their own affairs. The prudent man qualification was adopted to clarify that the current standard does not require an unrealistic degree of exactitude or precision. The most recent changes to the FCPA were made in the 105th Congress in P.L. 105-366 to prohibit conduct intended to obtain improper advantages from foreign officials by securities issuers, officials of international organizations and domestic concerns.

Federal Managers’ Financial Integrity Act (FMFIA) of 1982—In 1982, faced with a series of major internal control breakdowns within the federal government, Congress passed the Federal Managers’ Financial Integrity Act (FMFIA). It required that agency heads made an assertion as to whether their internal control systems meet the requirements established by the Comptroller General (the Red Book). FMFIA required the Office of Management and Budget (OMB) to develop and issue guidance to help Executive Branch agencies assess and report on internal control (31 U.S.C. 3512).

Guidance in OMB Circulars—OMB first issued Circular A-123, then titled Internal Control Systems, in 1981 in anticipation of FMFIA becoming law. Then, in December 1982, OMB issued Internal Control Guidelines, with an associated Questions and Answers document in 1984. They were succeeded in August 1986 by OMB Circular A-123, Internal Control Systems. In June 1995, in an atmosphere of reducing paperwork and red tape, OMB made major revisions and renamed the Circular “Management Accountability and Control.” The revisions provided a framework for integrating internal control assessments with other work performed, and relaxed the assessment and reporting requirements, giving the agencies discretion to determine the tools to use in arriving at their annual FMFIA assurance statements. The pendulum has now swung back, with the most recent revision, issued in December 2004, “Management’s Responsibility for Internal Control,” strengthening the process by which agencies assess the effectiveness of internal control over financial reporting. OMB worked closely with the CFO Council and the President’s Council on Integrity and Efficiency (PCIE) to develop the revised circular. Circular A-123 provides a single source of guidance for federal agency management to assess and report on the effectiveness of their internal controls, although it does not require the external auditor to give an opinion on management’s assertion.

There is currently no similar comprehensive requirement for state and local governments and nonprofits and no requirement to obtain an audit opinion from the external auditor on internal controls. The closest is the Single Audit Act reporting requirements and the related OMB Circular A-133 guidance, which require three reports: on the audited financial statements; on internal control (where the auditor provides negative assurance, not an opinion); and on compliance with applicable laws and regulations. Like PCAOB AS2, the reports on internal control and compliance must be done in conjunction with the audit of the financial statements.

OMB Circular A-123, Appendix A—Appendix A was added to define the process by which agencies assess the effectiveness of internal control over financial reporting. The process requires:

- documentation of the assessment methodology and key processes such that a reader can understand the process flow and controls surrounding the process;
- direct testing of key controls to determine operating effectiveness; and
- a new assurance statement for internal control over financial reporting (as a subset of the overall FMFIA assurance statement).

Appendix A has strengthened Circular A-123 to require management to take a “proactive” approach to assessing and improving internal control effectiveness but has stopped short of requiring an audit opinion on management assessment of the effectiveness and efficiency of the internal controls.

internal controls over its financial reporting; and requires performance and accountability reports for fiscal years after 2005 to include an assertion of the internal controls that apply to financial reporting by the DHS. DHS is required to provide an assertion on the effectiveness of internal control over financial reporting for fiscal year 2005 and to obtain an auditor’s opinion on its internal control over financial reporting for fiscal year 2006. Not later than 180 days after the effective date of the legislation, the CFO Council and the PCIE were required by the DHS legislation to jointly study the potential costs and benefits of requiring CFO Act agencies to obtain audit opinions on their internal control over financial reporting and GAO was to perform an analysis of the information provided in the report and provide any findings to the House Committee on Government Reform and the Senate Committee on Homeland Security and Governmental Affairs. These reports were issued and are cited in the text. The DHS requirement to provide an auditor’s opinion on the effectiveness of its internal controls is also discussed in page 98 of the text of this report.


Opinion on Internal Control

In our opinion, GAO maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance as of September 30, 2006, that provided reasonable assurance that misstatements, losses, or non-compliance material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. 3512 (c) (d), the Federal Managers’ Financial Integrity Act, and the Office of Management and Budget (OMB) Circular A-123, Management’s Responsibility for Internal Control.
End Notes

1. Recent proposed revisions to Rule 2-02(f) of Regulation S-X clarify that an auditor should only express a single opinion directly on the effectiveness of a company’s internal control over financial reporting, rather than an opinion on the effectiveness and a separate opinion on management’s assessment, with conforming revisions to rule 1-02(a) (2) of Reg. S-X which defines “attestation report on management’s assessment of internal control over financial reporting.”

2. The Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act to set auditing standards.

3. PCAOB News, Board to Consider Proposing a Revised Auditing Standard on Internal Control over Financial Reporting.

4. PCAOB Standard No. 2 (AS2) states that, “Throughout this standard, the auditor’s attestation of management’s assessment of the effectiveness of internal control over financial reporting required by Section 404(b) of the Act is referred to as the audit of internal control over financial reporting.” The standard states that the ‘audit of internal control ...’ refers to the process, the ‘auditor’s attestation of management’s assessment ... ’ to the result of the process.


6. Public float is the aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer. Public float excludes shares held by affiliates such as firm officers, directors, or controlling-interest investors and requires subjective determination that entails some uncertainty. Some sources use market capitalization instead, defining all companies with market capitalization of $700 million or less as smaller public companies. Market capitalization is the number of shares outstanding multiplied by the price per share. Public float is a subset of market capitalization.

7. Issued by the GAO, formerly the General Accounting Office, now the Government Accountability Office.

8. Some states use the word ‘opinion,’ others use ‘assurance.’

9. Received from the GAO.

10. Chief Financial Officers Council and the President’s Council on Integrity and Efficiency (PCIE). The PCIE is the organization of presidentially appointed federal inspectors general (IGs).

11. Senate Committee on Homeland Security and Governmental Affairs and House of Representatives Committee on Government Reform


18. Control Objectives for Information and Related Technologies. The city of Phoenix is in the planning stages of a COBIT implementation, according to a May 15, 2006 article in Computerworld, IT Auditors Turn to COBIT for Sarb-Ox Guidance at www.computerworld.com/news/special/pages/0,10911,2025,00.html.


22. Window on Texas Local Government, June 2005

23. COBIT stands for Control Objectives for Information and related Technology. It was developed by the Information Systems Audit and Control Foundation in 1996. It is a framework providing a tool for business owners to efficiently and effectively discharge their information security responsibilities. COBIT incorporates both COSO and the Institute of Internal Auditors Research Foundation’s SAC (Systems Auditability and Control). COBIT takes its definition of internal control from COSO and its definition of Information Technology control objectives from SAC. SAC and COSO both incorporate the guidance from the SASs 55 and 78. SAS 78 reconciled COSO and SAS 55 guidance.


28. GAO-05-22IT.