Major Changes in the Accounting Profession:

Implications for Government Audits

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Presentation Framework

- Government Environment
- Private Sector Accountability Breakdowns
- Sarbanes-Oxley Reforms and Implications for Government Audits
- Issues Facing the Government Accountability Profession

Current Government Environment

- Significant forces/pressures impacting Government
- Demands for government effectiveness and accountability
- Fiscal pressures/increasing costs
  - National and homeland security issues
  - Aging and more diverse population

Federal Government's Fiscal Outlook

- Changing composition of federal spending
  - discretionary vs. mandatory
- Re-emergence of large federal deficits
- Long-term fiscal outlook
  - structural deficit due primarily to known demographic trends and rising health care costs

Federal Government’s Fiscal Outlook

- This spring, for the 5th year in a row, GAO issued a disclaimer on the consolidated U.S. Financial Statements
- The federal government continues to have a significant number of material weaknesses related to
    - Financial systems
    - Fundamental record keeping and financial reporting
    - Incomplete documentation

State and Local Fiscal Outlook

- A growing number of states face potentially large budget shortfalls
- In the 21 states that have prepared estimates of FY 2005 shortfalls, the amounts total about $32 billion to $33 billion, or about 9 percent of those states' expenditures.
- The total will likely increase.

State and Local Fiscal Outlook

- Most states have depleted their reserves and utilized the temporary budget actions (such as accelerating revenues and deferring spending)
- Many states may need to raise taxes or enact additional spending cuts to keep their budgets in balance.
- Even those measures in many states will not be sufficient.

Recent Private Sector Accountability Breakdowns

- The last 2 years witnessed numerous major accountability breakdowns and scandals leading to significant restatements of financial statements and bankruptcy adversely affecting thousands of shareholders and employees.
- Loss of tens of billions in investor capital.

Recent Private Sector Accountability Breakdowns

- Demise of major corporations and institutions.
- Loss of confidence in U.S. capital markets, regulation of financial reporting, and auditing in the US.
- Questions about financial reporting incentives and the role of the auditors
- Passage of Sarbanes-Oxley Act of 2002

Sarbanes-Oxley Act

Sarbanes-Oxley contains sweeping changes for the accounting profession and corporate governance in the following areas:

- oversight of the auditing profession
- auditor independence
- corporate responsibility
- enhanced financial disclosures

Sarbanes-Oxley Act: Oversight of Audits

Title I: Establishes the Public Company Accounting Oversight Board (PCAOB). Principal duties:

- establish or adopt standards for public company audits
- enforce compliance with
  - the Act, the
  - rules of the Board,
  - professional standards, and
  - securities laws governing audit reports and the obligations and liabilities of auditors

Sarbanes-Oxley Act: Oversight of Audits

Principal Duties of the Board (cont.)

- inspect and register public accounting firms
- investigate registered firms for violations of audit rules
- conduct disciplinary proceedings and impose sanctions

Sarbanes-Oxley Act:

Implications of Title I for Government Audits

- New standards setting organization could possible create two, or even three different bodies of audit standards.
- PCAOB's new auditing and attestation standards, quality control standards, and ethics standards for registered firms could change the way audits are done, at least for publicly traded companies.
- Board's oversight and inspection of audit firms may introduce new requirements for quality control procedures for firms auditing public companies.

Sarbanes-Oxley Act:

Implications of Title I for Government Audits (cont.)

- The Board's inspection role will replace peer reviews for publicly traded company audits.
- Some firms will receive both inspection and peer reviews
- Implications for the Yellow Book of the future

Sarbanes-Oxley Act
Auditor Independence (Title II)

It shall be **unlawful** for a registered accounting firm to provide the following nonaudit services if that firm is also the auditor for a registrant:

- bookkeeping or other services related to the accounting records or financial statements
- financial information systems design and implementation
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- actuarial services

Sarbanes-Oxley Act
Auditor Independence

Prohibited nonaudit services (continued)

- internal audit outsourcing services
- management or human resources functions
- broker or dealer, investment adviser, or investment banking services
- legal and expert services unrelated to the audit
- any other service that the Board determines, by regulation, is impermissible

Sarbanes-Oxley Act
Auditor Independence

The auditor must report to the audit committee

- all “critical accounting policies and practices” used in preparing financial statements
- all “alternative treatments of financial information” within GAAP and discussed with management
- preferred treatment
- other material written communication between accounting firm and company management

Sarbanes-Oxley Act Auditor Independence

- It shall be **unlawful** for an accounting firm to perform an audit of a registrant whose CEO, Controller, CFO, Chief Accounting Officer, or person in equivalent position was employed by that accounting firm and participated in any capacity in the audit of that registrant during the one-year period preceding the initiation of the audit.
- SEC's rule applies the one-year cooling-off period to "accounting role or financial reporting oversight role" and expands positions to also include member of Board of Directors, President, COO, GC, Controller, Director of Internal Audit, Director of Financial Reporting, and Treasurer.

Sarbanes-Oxley Act
Auditor Independence

Audit Partner Rotation

- The lead audit and concurring partner and the reviewing partner must rotate every 5 years.

Mandatory Rotation of Registered Public Accountants

- refers to a limit on the period in which a firm may be the auditor of record for a company
- GAO is to report on the potential effects of requiring the mandatory rotation of audit firms

Sarbanes-Oxley Act

Implications of Title II for Government Auditors

- Implement the Yellow Book Independence Standards!
- If you are auditing in an environment where there is an Audit Committee, implement best practices and relevant standards/requirements for dealing with audit committees
- Be sure you are reporting to an appropriate level within the governance structure of the audited entity
- Audit Partner Rotation– watch GAO’s actions on this
- Employment restrictions and mandatory firm rotation– although these requirements don’t apply, some related issues could result in independence problems under current Yellow Book independence standards.

Sarbanes-Oxley Act
Corporate Responsibility (Title III)

Public Company Audit Committees

- Audit Committee Members must be
- on the company's board of directors and
- "independent," which means they must
  - not receive any fee from the company, other than for service on the board
- not be affiliated with the company or a subsidiary

Sarbanes-Oxley Act
Corporate Responsibility

Public Company Audit Committee Responsibilities

- appointment, compensation, and oversight of the work of any public accounting firm employed by the company
- establish procedures for the "receipt, retention, and treatment of complaints" regarding accounting, internal controls, and auditing
- engage independent counsel or other advisors, as it determines necessary to carry out its duties

The company must appropriately fund the audit committee

Sarbanes-Oxley Act
Corporate Responsibility

Corporate Responsibility for Financial Reports

The company CEO and CFO must certify

- the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the company."
- A violation must be knowing and intentional for the company to be held liable.

Sarbanes-Oxley Act
Corporate Responsibility

Improper Influence on Conduct of Audits

- It shall be **unlawful** for officers and directors to take any action to “fraudulently influence, coerce, manipulate, or mislead” the auditor with the purpose of rendering the financial statements materially misleading.

Sarbanes-Oxley Act
Enhanced Disclosures

Internal Control Reporting

- Registrants are required to establish and maintain adequate internal control structure and procedures for financial reporting.
- Include in the annual report, a statement of management's responsibility for and management's assessment of the effectiveness of those controls.
- The company's auditor is required to attest to, and report on management's assessment of the effectiveness of internal control over financial reporting.

Sarbanes-Oxley Act—
Corporate Responsibility and Enhanced Disclosures

Implications of Title III for Government Auditors:

- Government auditors should encourage good governance practices within the entities they audit.
  - audit committees and other governance structures

- Watch for improper management influence or pressure on the auditor.

Auditor opinion on internal control

- Yellow Book currently does not require an **opinion** on controls, even though control reporting is required.

Sarbanes-Oxley Act—
Corporate Responsibility and Enhanced Disclosures

Implications of Title III for Government Auditors (cont.):

- GAO has formed the following position on auditor opinions on internal control:
  - ***where appropriate***, auditor opinions on internal control are critical for monitoring an organization's internal control and accountability.
  - auditor opinions on internal control are appropriate and necessary for major public entities.
  - auditor opinions on internal control are also appropriate in cases where the process adds value and mitigates risk in a cost beneficial manner.

Issues Facing the Government Accountability Profession

Government Accountability Issues

- **Definition of success in financial management**
  - Balanced budget/financial results
  - Clean opinion on financial statements
  - No major control/compliance weaknesses
  - Systems that produce timely, accurate, and useful financial and management information
  - Pressures/incentives

Government Accountability Issues (cont.)

- **Scope of audit**
  - Internal controls
  - Performance and projection information
  - Other value-added assurance
- **Additional issues**
  - Accelerated financial reporting
  - Audit/financial management committees
  - Overall governance structures

Coordination of Audit Standards

GAO is Actively Coordinating with the Other Standard-Setting Organizations

- Provide official comments on drafts of proposed standards from the PCAOB, AICPA, and IIA
- Participate in PCAOB round table discussions on standards setting activities/ priorities
- Comptroller General's proposal for a coordinating committee of the audit standards setters: GAO, PCAOB, AICPA

Government Auditing Issues

- Requirements for large vs. smaller public entities
- Scope of internal control assurance/ reporting
- Coordination of PCAOB inspections and AICPA peer reviews
- Potential for several different bodies of auditing standards

Questions?