

The Sarbanes-Oxley Act May Impact State and Local Governments

Accountability, ethics, transparency, duty, full-disclosure, compliance, responsibility ... More than simply buzz words for public sector organizations who want to meet the expectations of their constituents.

Even the smallest state and local governmental units interact with or impact a significant portion of the population. Public concerns, expectations, and motives have changed significantly in the past several years. Gone is much of the faith and trust the public originally placed in the units of government they formed. Many believe they can no longer rely on a community-service-ethic driving the actions of public employees, management, committee members, and/or their governing boards. Some of us even fear that the approximately 100,000 general and special purpose governments and their component units may never fully recover the esteemed position they held with their constituents.

Rather than focus on why things have changed, this document addresses the current business environment and provides suggestions as to how state and local units of government can use the spirit and certain provisions of the Sarbanes Oxley Act to react to this change.

The Sarbanes-Oxley Act (the Act) is one of the most significant business related events to impact the commercial market place in recent years. As issued, most provisions of the Act are only applicable to public companies and their auditors. However, special interest groups and oversight agencies have been questioning why it shouldn't be applied, at least in some respects, to the public sector. A number of oversight agencies have been debating and considering various proposals to increase public sector accountability. While most of this focus has been on nonprofit organizations, it is only a matter of time before state and local government agencies are placed under the same microscope.

Our intent here is to provide a broad view of the Sarbanes-Oxley Act and its key provisions to help you understand why so many constituency groups and oversight agencies are focusing their attention on the Act's application to the public sector even though, as written, they were principally designed for public companies.



Briefly, the Act's principal reforms include:

- Creation of an independent public company accounting oversight board (the PCAOB)
- Auditor independence provisions that restrict non-audit services that accountants may provide to their public audit clients
- A heightened level of corporate governance and responsibility measures
- Expanded corporate, financial and insider disclosure requirements
- Mandatory disclosure by analysts of potential conflicts of interest
- A range of tough new penalties for fraud and other violations

A summary of key provisions of the Act is available on the American Institute of Certified Public Accountants Web site: http://www.aicpa.org/info/sarbanes_oxley_summary.htm. A complete text of the Sarbanes-Oxley Act is located at <http://financialservices.house.gov/media/pdf/hr107610.pdf>.

Key Objectives of the Sarbanes-Oxley Act

- Increase investor/shareholder confidence in public reporting
- Increase management's accountability for financial reporting and information disclosed to the market
- Develop a stronger, more independent audit system
- Reduce accounting irregularities/aggressive financial reporting
- Ensure that the internal controls surrounding financial reporting are effective via internal monitoring functions
- Reduce fraud and increase accountability for expenses

It's apparent these objectives could easily be applied to the public sector accounting, and financial and compliance reporting environment. It's all about members of management, various committees, and the governing board, as well as the organization's external auditor, acting with integrity and recognizing their responsibility to be accountable to specific constituent groups as well as the general public.

Let's delve deeper into some of the more significant provisions of the Act.

Corporate Governance

The Act requires:

- Audit committee members to be on the board and be independent (i.e., not part of management or compensated outside of board service)
- Audit committee to have (or to disclose why they don't have) at least one member who is a "financial expert" and who
 - Understands GAAP and financial statements
 - Can assess accounting principles
 - Has experience with preparing, auditing, and analyzing statements
 - Understands internal controls and audit committee functions
- Audit committee to be directly responsible for hiring, setting compensation, and overseeing auditor activities
- Auditor must report directly to audit committee
- Audit committee to approve non-audit services of audit firm

Governance is an especially relevant topic for public sector entities. The governing board, finance committee, and audit committee are often responsible for protecting the interests of a large number of constituency groups who could have very different views and opinions about how their interests are best addressed. While it is impossible to please all-of-the-people all-of-the-time, these constituents expect their interests to be addressed.

We have learned in the external financial and compliance reporting area, that governance is best addressed through the creation and operation of a strong and independent audit committee. The Government Finance Officer's Association (GFOA) includes the establishment of audit committees as one of their recommended practices that helps "...focus and document the government's process for managing the financial statement audit."

To help build and strengthen audit committees, McGladrey & Pullen's National Public Sector Practice has published the *Audit Committee Guide for State and Local Government Units*. A printed version is available from your local McGladrey & Pullen, LLP office or an electronic version is available on our Web site at <http://www.mcgladrey.com/>.

Auditor Responsibilities

The Act requires:

- Lead and reviewing partner of audit firm to rotate every five years
- Auditor is prohibited from providing certain non-audit services
- Audit committee to pre-approve most non-audit services (i.e. tax preparation)
- All critical accounting policies and practices used by the company and management's application of them must be disclosed to the audit committee

The audit committee should be very involved in the audit arrangements and post audit review process. According to the GFOA, "A properly constituted audit committee helps to enhance the financial statement auditor's real and perceived independence by providing a direct link between the auditor and the governing board." For certain very small governments, it may be appropriate for the governing board to assume the responsibilities of an audit committee.

To maintain independence, we recommend that both management and the audit committee take great care when making any arrangements for the auditor to provide non-audit services. When an audit or attest engagement is performed in accordance with the Government Auditing Standards (GAS), issued by the Comptroller General of the United States, the auditor is currently restricted as to the type, as well as the manner in which many non-audit services are provided. We have designed extensive internal policies and comprehensive guidance to comply with the GAS independence requirements. These tools enable us to avoid casting even the perception that our audit independence is impaired.

We have not seen proof that any benefits will be achieved by requiring an audit partner rotation, and if there are, whether they will be sufficient to offset related costs. The Government Accounting Office (GAO) has even issued a report that questions the relative benefits of such a requirement. Therefore, we do not support this specific provision of the Act. However, we have learned that changes in staffing below the partner level, on a periodic basis, add value to the audit process.

Financial Statement Certification

Another requirement of the Act addresses the certification of financial statements by the chief executive and financial officers (CEO and CFO). These individuals could even face the threat of serving jail time for false certifications. Additionally, this section of the Act mandates that the CEO, CFO, controller and/or chief accounting officer cannot have worked for the auditing firm for one year preceding the audit.

As with most of the previous requirements, we can't take exception to the spirit behind these requirements. The CEO and CFO should understand enough about the financial, compliance and other external information reporting to sign such a certification or they should be required to gain such skills. For years, the audit profession has asked these individuals and other members of management to sign letters representing to the accuracy of audited financial statements; the Act just takes that responsibility a step farther.

We believe the employment requirement is primarily designed to strengthen auditor independence and is similar to provisions found in the GAS independence standards. Therefore, we support adoption of such a policy, especially when the government participates in federal award programs.

Insider Trading and Conflict of Interest

These provisions prohibit loans to any directors or executives of the company.

The implications of this provision on governmental units should be minimal. Board and committee members, officers, and employees of most governmental entities are typically subject to different conflict of interest policies and provisions as a result of state laws and regulations, contract provisions, or as a matter of internal policy. However, if your organization has not already done so, we suggest you adopt a formal policy prohibiting such transactions.

Whistle-Blower Protection

The Act encourages individuals to report problems and concerns by allowing criminal penalties for action taken in retaliation against whistleblowers. The Act also increases a whistleblowing employee's:

- Ability to sue an employer
- Ability to collect a civil remedy if discriminated against
- Ability to receive special damages and attorney's fees

Many units of government have had whistle-blower policies and protection in place for years. However, if your governmental unit does not, we recommend you take steps to protect your government and its component units, including:

- Identify weak spots
- Install processes to guard against fraud abuse
- Do not tolerate misconduct
- Develop procedures to handle employee complaints
- Take complaints seriously and handle them appropriately
- Establish a confidential and anonymous mechanism to encourage employees to report
- Make sure no punishment for reporting claims is allowed even if the claims are unfounded

Sample whistleblower policies are available on the Municipal Research & Services Center of Washington Web site [<http://www.mrsc.org/subjects/personnel/whist.aspx?r=1>].

Document Destruction

Provisions of the Act make it a crime for an entity to destroy, alter, cover up, or falsify (or to persuade someone else to do so), a document to prevent its use in an official proceeding.

This is another requirement most governments have dealt with for years, because of public laws, regulations or agreements. However, if you haven't, your organization should develop and follow a formal document retention and destruction policy. Maintain and archive all appropriate records about your operations (e.g., financial records, significant contracts, real estate and other major transactions, tax assessments and returns, employment files, etc.).

Internal Control Disclosures

The Act's Section 404 requirements are turning out to be the most costly provisions for public companies to address. Internal control disclosures require that:

- Management establish and maintain an adequate internal control structure and procedures for financial reporting
- Management assess the effectiveness of the internal control structure
- Auditors attest to and report on the assessment made by management

Internal controls are the cornerstones for building, maintaining and improving stakeholder confidence, and these controls also provide a process to reasonably assure achievement in:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws, regulations and agreements

- Safeguarding assets

In 2004 the GFOA adopted a recommended practice to enhance management involvement with internal control. They recommend financial managers "...obtain the information and training needed to meaningfully take responsibility for internal control."

We clearly support the need for management to establish, maintain, and document significant financial and compliance controls for the public sector entity they represent. For many years, governmental units subject to Single Audit have had more attention focused on their internal controls than most commercial entities, including certain public companies.

We are concerned that financial management for many governmental units may not be adequately trained and/or prepared to assess the effectiveness of internal controls. Further, we have learned from the commercial sector that the cost of the auditor attestation would be quite significant. Therefore, we support the GFOA's recommended practice and stand prepared to assist local governments with its implementation.

In Conclusion

We are not advocating that state and local government units adopt all of the provisions of the Sarbanes-Oxley Act. However, we feel we cannot simply put our heads in the sand and hope this issue just passes us by.

Before regulatory and oversight agencies make the decision for you, acquaint yourself with key provisions of the Act. Balance the needs and expectations of your constituents with any resource limitations you may have and try to achieve the best accountability improvement bang for the buck. We would be glad to help.

We all need to start working towards helping the industry regain the "good faith and trust" that the public has placed in its state and local units of government.