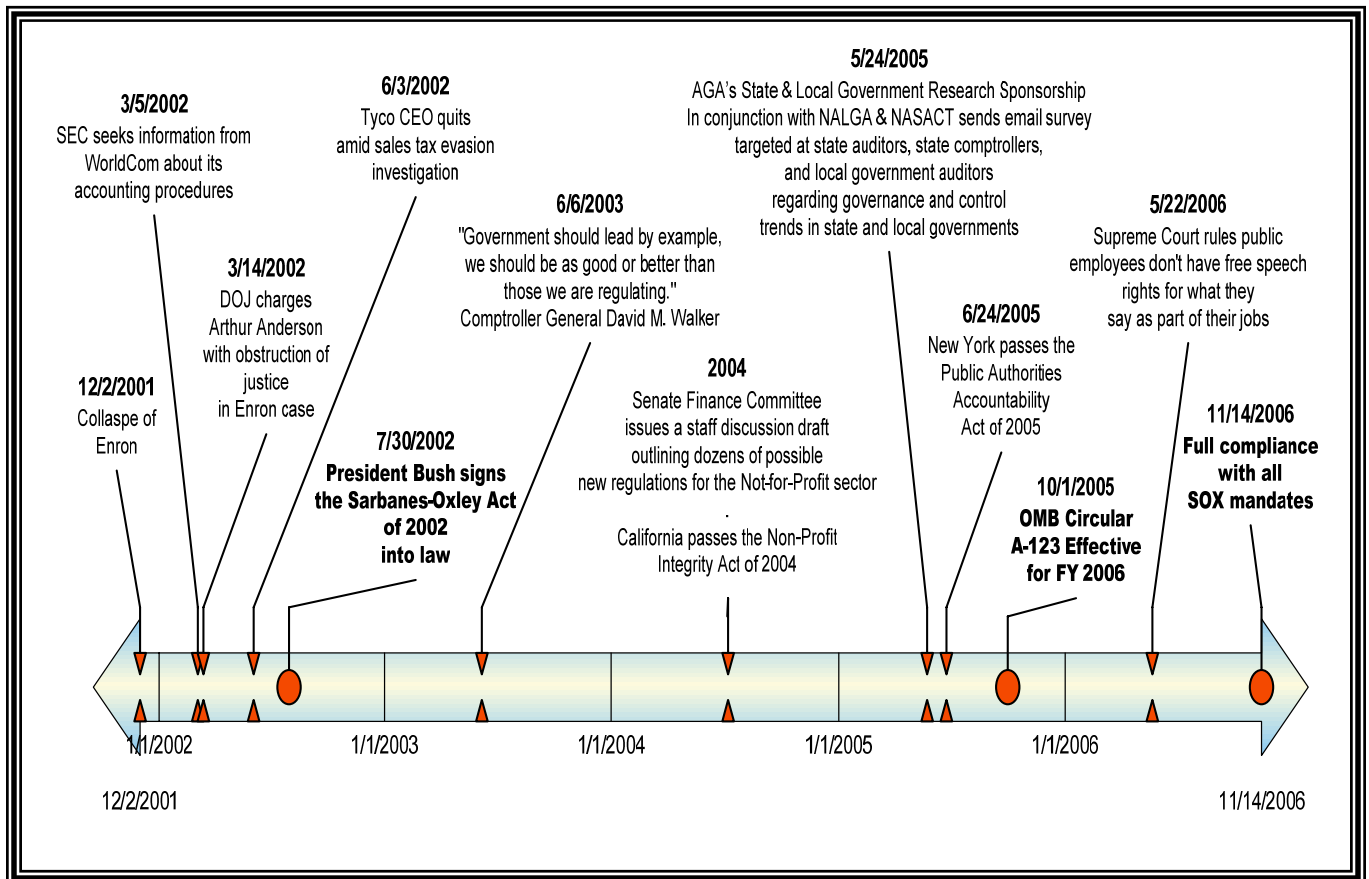


# A How-To for Implementing Sarbanes-Oxley Act Mandates in Government

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## Timeline of SOX Related Events



Enron, Arthur Anderson, Global Crossing, Tyco, Worldcom...to name a few of the dominos that fell to create the biggest boon for the accounting profession since Excel was developed. The rapid rise and fall of these companies and the ramifications of their creative accounting practices brought about mandated business accountability. In 2002, President Bush signed into law the Public Company Accounting Reform and Investor Protection Act of 2002 - more affectionately known as the Sarbanes-Oxley Act or SOX.

Discussion of the oversight of government accountability, effectiveness and efficiency soon followed. In June 2003, the stage was set by Comptroller General David M. Walker for SOX-like compliance measures when he said, "Government should lead by example, we should be as good or better than those we are regulating." New York State, New Jersey, and California have set into motion state legislation and executive orders relating to not-for-profits compliance with SOX-like mandates. In 2005, the AGA, in conjunction with ALGA, and NASACT conducted a research project sponsored by KPMG. They surveyed local governments regarding internal controls and other areas relating to SOX. The NASACT website states that the full report will be available soon. To view a presentation on some of the results, access the following website. [www.nasact.org/onlineresources/downloads/2005\\_NASACT/H/cs4\\_valley.pdf](http://www.nasact.org/onlineresources/downloads/2005_NASACT/H/cs4_valley.pdf).

It seems inexorable, based on these events that compliance with some of the tenants of SOX will filter down to local governments in the not too distant future. Funds provided by federal programs may provide the perfect segue for applicable SOX mandates to open up the floodgates to state and local government compliance measures. To become proactive, in light of what appears to be an inevitable development, let's take a look at SOX and how its provisions may be applied to state and local governments.

### **KEY OBJECTIVES**

The key objectives of SOX were increasing investor confidence in public reporting; emphasizing management's accountability in their reporting and the information that they gave to the market; developing more independent audit processes; making management responsible for internal controls and their monitoring; and reducing fraud.

Government is well served by these objectives and although their residents are not called investors, their role should be seen in the same light. They have invested their hard earned money into an enterprise in hopes of receiving the most cost effective services as a return on that investment. How do SOX key objectives translate into government objectives?

They could:

- Increase the public's confidence level in government operations.
- Increase management's accountability for financial reporting and information disclosed to the public.
- Reveal the critical need for management's well-defined job requirements, skills and training necessary to address the needs of government.
- Develop a stronger, more independent audit system.
- Develop enterprise systems that track government-wide data.
- Ensure that internal controls are effective via internal monitoring functions and reporting
- Consolidate government-wide functions (e.g. MIS, document management, case management, asset management, payroll, purchasing, accounts payable and receivable, fleet management, human resources, insurance, travel) with strengthened oversight by advisory boards and monitoring by internal audit.
- Solidify the need for more shared services within communities to address the dwindling supply of public funds and increased need for services.
- Reduce fraud and increase accountability.

## **CORPORATE GOVERNANCE**

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.” SOX sets forth audit committee requirements.

Government can easily mirror these requirements.

- Establish an independent Audit Committee. [In 2003, the GAO’s revised Government Auditing Standards required auditors to communicate certain information to an audit committee or to the individuals with whom they have contracted for the audit.]
- Develop by-laws/policies and procedures for Audit Committee.
- Ensure that at least one member is a financial expert who:
  - Understands GAAP/GAGAS principles.
  - Has experience with preparing, auditing and analyzing financial statements.
  - Understands internal controls and audit committee functions.
- Require that the internal audit department/auditor and the financial auditor report directly to Committee.
- Make the audit committee directly responsible for hiring or making hiring recommendations for subcontracted auditing services ~~to the state~~, setting compensation, and overseeing auditor activities.
- Require approval by the Committee of any non-audit projects or services.
- Create an internal audit department, reporting directly to the Committee, if that function has not been established in a local government.

## **AUDITOR RESPONSIBILITIES**

The Act establishes auditor requirements and audit committee oversight of the auditor. One of the provisions states that the lead and reviewing partner must rotate every five years.

Governments, after creating an audit committee, will more effectively monitor audits and the implementation of management responsibility for addressing recommendations by taking the following actions:

- Requiring the Audit Committee to pre-approve non-audit services.
- Prohibiting auditors from providing certain non-audit services.
- Mandating the Audit Committee be involved in the selection of the financial auditor (if outsourced), constantly monitor audit activities and receive regular updates from the financial auditor.
- Mandating consistent and diligent monitoring by the Audit Committee of the implementation of management’s action plan.
- Requiring the rotation of auditors. [Rotating auditors is good practice because auditing firms grow accustomed to financial procedures of an entity. Bringing in a new firm helps ensure that all financial practices are more closely examined.]

## **FINANCIAL STATEMENT CERTIFICATION**

This provision of the Act brings with it severe penalties, including both fines and imprisonment. The CEO and CFO must certify the financial statements of the company. The CEO and CFO should understand or be required to gain said understanding of financial, compliance and other

information reporting necessary to sign the certification. The CEO, CFO, controller and/or chief accounting officer cannot have worked for the auditing firm for one year prior to the audit.

Possible government compliance would entail:

- CAFR certification by the local government's officeholders/Chief Executive and/or Administrative Body responsible for providing financial information and the Chief Financial/Fiscal Officer responsible for preparing the CAFR.
- Strict penalties for false certifications.
- A requirement that certifying officeholders have the skills to understand financial, compliance and other external information reporting.
- A requirement that they gain such skills within a designated timeframe.

### **INSIDER TRADING AND CONFLICT OF INTEREST**

The Act prohibits loans to directors or executives of the company and addresses conflicts of interest policies.

Although loans to government staff members are prohibited, excessive personal benefit and self-dealing all cause serious ramifications. In order to formally address this issue, government should:

- Legislate a formal standardized conflict of interest policy.
- Develop an annual conflict of interest statement to be completed by elected officials and upper management and reviewed for compliance with strict penalties.
- Provide strict penalties for noncompliance.

### **WHISTLE-BLOWER PROTECTION**

The Act provides protections for whistleblowers and criminal and civil penalties for retaliatory actions taken against them by companies.

Unfortunately, the 5/30/2006 Supreme Court decision may make this more difficult in the government arena. In Opinion No. 04-473 GIL GARCETTI, ET AL., PETITIONERS v. RICHARD CEBALLOS (<http://www.supremecourt.us/opinions/05pdf/04-473.pdf>), the Court opinion states:

When public employees make statements pursuant to their official duties, they are not speaking as citizens for First Amendment purposes, and the Constitution does not insulate their communications from employer discipline.

To provide the same protection for its workers, government can legislate whistleblower protection for its employees which

- Can establish comprehensive whistle-blower policies and procedures that outline very specific processes for handling employee or constituent complaints (e.g. Ohio Revised Code § 4113.52, Right of employee to report violation of law by employer or fellow employee)
- Promote government's accountability without exposing employees to litigation.

### **DOCUMENT DESTRUCTION**

The Act makes 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. Automatic document destruction must be monitored, justified, and carefully administered.

Government information is all over the landscape – located in databases, enterprise systems, Excel spreadsheets, electronic files, or hard copies stored in file cabinets, people’s desks, or housed in off-site storage facilities. Some governments have formalized document management legislation already in place. To conform to the Act’s mandates, units could:

- Establish a mandatory, standardized document retention and destruction system with policies & procedures and documentation for all governmental entities. [The policies and procedures should address not only hardcopies, but also electronic files and voicemail as they have the same status as paper files in litigation-related cases.]
- Create back-up procedures. [Archiving documents, and regular check-ups of the reliability of the system should also be addressed.]
- Form an oversight board to monitor government-wide document management.
- Explore document management systems. A system that will centralize data and documents for ease of search and review.

### **INTERNAL CONTROL DISCLOSURES**

Internal controls are the cornerstones for building, maintaining and improving constituents’ confidence. “Management controls are the organization, policies, and procedures used to reasonably ensure that (i) programs achieve their intended results; (ii) resources are used consistent with agency mission; (iii) programs and resources are protected from waste, fraud, and mismanagement; (iv) laws and regulations are followed; and (v) reliable and timely information is obtained, maintained, reported and used for decision making.” (Alice M. Rivlin, OMB Director, June 21, 1995 memo)

This provision of the Act is the most onerous and has cost business the most time and money in compliance measures. There are four directives in this provision as follows:

- Establishment and maintenance of adequate internal control structure and procedures for financial reporting.
- Assessment of the effectiveness of said internal control structure by management.
- Review by the auditors of the internal control structure and the effectiveness assessment of management.
- Attestation by the auditors thereto in a report to management.

Many government agencies have addressed internal controls due to compliance audits by the federal or state agencies that fund them. Government management as a whole can do a better job in establishing and assessing its internal control structure. Some suggestions to attain a strong control structure:

- Certify the sufficiency of the governmental unit’s internal control structure and provide appropriate penalties for non-compliance
- Establish an internal audit department to monitor internal controls and to safeguard the assets of the community. [This department should report to an independent audit committee.]

- Perform a government-wide risk assessment to determine liabilities and identify internal control needs.
- Establish internal controls structure with policies and procedures to address them.
- Develop assessment and monitoring mechanisms for oversight and provide assurances to constituents as to the effectiveness and efficiency of operations; compliance with laws, regulations and agreements.
- Provide training for management in their responsibilities for establishing and assessing internal control structures and financial reporting basics.
- Develop internal control tool/questionnaire in a standard format to assist management with their review and a standardized disclosure statement for signature by management.
- Establish a standard formalized review and assessment process for use government-wide by all management.
- Develop government-wide strategic planning with all entities coming together to identify government goals, mission, vision statements and produce a 5-20 year plan to be utilized to overcome politically motivated measures.
- Develop information systems that interface with one another.
- Develop shared systems to eliminate redundancy and promote regionalism.

### **THE WRITING IS ON THE WALL**

The Federal OMB, GAO and the GFOA have affirmed their commitment to SOX-like oversight as reflected below.

#### **The Federal Office of Management and Budget Institutes SOX Mandates**

In 2004, the Office of Management and Budget (OMB) issued Circular A-123 – Management’s Responsibility for Internal Control. This circular became effective for fiscal year 2006. The circular requires internal control structure creation and oversight by management, who are required to attest to same via an assurance statement. The circular falls short on one SOX mandate – the auditor’s opinion on internal control over financial reporting. To review the Implementation Guide for OMB Circular A-123, Management’s Responsibility for Internal Control Appendix A, Internal Control over Financial Reporting, go to the following website: [http://www.cfoc.gov/documents/Implementation\\_Guide\\_for\\_OMB\\_Circular\\_A-123.pdf](http://www.cfoc.gov/documents/Implementation_Guide_for_OMB_Circular_A-123.pdf)

#### **The Government Accountability Office (GAO)**

In its 2003 revision of the Government Auditing Standards, the GAO states, “The audit organization's independence is enhanced when it also reports regularly to the entity's independent audit committee and/or the appropriate government oversight body.” The 2006 revision of the standards, still under review, strengthens the interaction with audit committees and independence standards. The below excerpts from the draft, seem to reflect the GAO’s commitment to mirroring SOX mandates. In a recent audio conference presented by GAO staff, they stated that the GAO was working with the AICPA and the Public Company Accounting Oversight Board (PCAOB), the entity that oversees compliance with SOX, in an attempt to echo those standards for government. (document at URL - <http://www.gao.gov/govaud/d06729g.pdf>)

**Page 6 - #4.** The discussion of nonaudit services and their impact on auditor independence has been significantly streamlined and reorganized from the 2003 revision of the standards to provide clarity. The discussion is in paragraphs 3.30 through 3.35.

Additional information on nonaudit services that are generally unique to government audit organizations is presented in the appendix, paragraphs A3.02 through A3.03.

**Page 54 – Section 3.21** The audit organization should report regularly to the entity’s independent audit committee and/or the appropriate government oversight body.

**Page 85 – Section 4.11 and Page 121 - Section 6.10** Under AICPA standards and GAGAS, auditors should establish a written understanding with those charged with governance and communicate with audit committees.

### **GFOA Recommended Practice: Enhancing Management Involvement with Internal Control**

In 2004, the GFOA released its Recommended Practice stating that, “Ultimately, it is the responsibility of appropriate elected officials to ensure that the managers who report to them fulfill their responsibility for implementing and maintaining a sound and comprehensive framework of internal control.” The GFOA gave procedures for accomplishing this statement. (document at URL - <http://www.gfoa.org/services/rp/documents/rpic040204.pdf>)

### **THE PENALTIES OF SOX**

The penalties of SOX may also filter down to government. Sarbanes-Oxley-101.com states in its FAQs, “Besides lawsuits and negative publicity, a corporate officer who does not comply or submits an inaccurate certification is subject to a fine up to \$1 million and ten years in prison, even if done mistakenly. If a wrong certification was submitted purposely, the fine can be up to \$5 million and twenty years in prison.”

### **THE “UPSIDE” OF SOX**

Although SOX-like mandates have not trickled down to state and local government as of yet, this seems to be on the horizon. Government is in the service business and as such must provide the best service for its constituents’ money. Bringing SOX directives to government is not only prudent, but in this day and age of steeply escalating operating expenses, facilitating state and local government efforts to cooperate in the delivery of services on a broader regional basis is a viable method to reduce taxpayer costs. With the dawning of the reality of the retiring boomer generation accompanied by its erosion of the income tax base coupled with the increase in the needs for that aging population, consolidation of services and efficiency of operations is crucial.

The governments that implement well-defined management requirements, significant internal control creation and oversight, as well as regional service partnerships will be the survivors. The “upside” of SOX could be far reaching. Positive bond ratings could be affected by statements of assurance. Education could have the funds available to accomplish their goals and consolidation of shared services and management could provide more money for the classrooms. Fiscal and management expertise could become election prerequisites. When a tax measure is brought before the voters, it could be looked upon as a real need. Elections could be decided by an informed constituency.

Government’s transparency of operational processes, open for the public’s review, is central to bringing about management responsibility. More importantly, requiring skills and training for

elected officials and their management team fulfills the expectation that they are responsible for the performance quality of their programs. This could be the opportunity of a lifetime for government to evolve into the more accountable, efficient, and effective environment that we all advocate.

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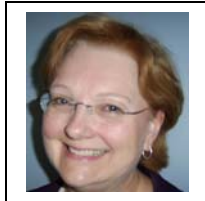
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Lisa graduated from the University of Akron where she obtained her B.S. in Accounting. She began her accounting career in public accounting at Deloitte & Touche in the Audit and Attestation section. Her experience gained in the health care industry led her to leave Deloitte & Touche and continue her auditing career in the Internal Audit Department of University Hospitals Health System of Cleveland. She is currently the Assistant Director of the Summit County Internal Audit Department. The County of Summit, Ohio is the only county in Ohio which is organized as a charter form of government. The Internal Audit Department's mission is to recognize and address the risks and vulnerabilities that can impact Summit County in order to assist, coordinate and facilitate positive change and promote sound business practices for all countywide operations while ensuring that the resources entrusted to county offices, courts, boards and commissions, and agencies are used efficiently, effectively and properly.



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Teri is an innovative and resourceful professional with experience in private industry, government, and the academic setting with expertise in the information technology, marketing, and legal fields. She has more than 15 years experience in business management. She strategically planned and affected the spin-off of an incubator technology company from Kent State University of which she was senior management and a partner. One of Teri's major accomplishments both professionally and personally was her role in the renovation, opening, and administration of Kent State University's Moulton Hall Learning Technology Center. In 2002, she coordinated the opening of the new Summit County Internal Audit Department and acts as business manager for the department.