Challenges Facing the Accountability Profession

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Presentation Framework

The Environment

Lessons Learned

Where Do We Go From Here?

Building the Public Trust

Implications of the Sarbanes-Oxley Act

Questions and Comments

The Environment

The Era of Financial Reporting Breakdowns

- Enron
- WorldCom
- Tyco
- Global Crossing
- Quest
- Adelphia
- CreditSuisse First Boston
- 10 Largest Wall Street Firms
- CitiGroup
- Lucent Technologies
- HCA
- Micro Strategy
- ImClone
- Royal Ahold, NV
- Waste Management
- Xerox
- Health South
- Superior Federal Savings Bank
- Parmalat
- Countless Restatements

And the Beat Goes On. . .

Now GM Has Woes on Audits: Faulty Numbers Go Back to 2000

"You have to question what controls are in place. When companies like GM are profitable, there is not a need to engage in aggressive accounting. What we are seeing now is a pattern of very aggressive accounting that took them well beyond the limits of generally accepted accounting practices."

Charles W. Mulfurd
Professor of Accounting
Georgia Tech
New York Times, March 18, 2006

And on…

"Unfortunately, concerns about truth and transparency aren't limited to the private sector. Washington got an unpleasant wakeup call when two government-sponsored enterprises, Fannie Mae and Freddie Mac, announced significant earnings restatements for recent years. We at GAO are doing all we can to prevent similar accountability failures in the federal government."

David M. Walker
Comptroller General of the United States
Conference on Public Service and the Law
University of Virginia Law School, March 17, 2006

Forces Leading to Accountability Breakdowns

- Ineffective governance systems
- Ineffective regulation of the accounting profession
- Inadequate accounting and auditing standards
- Inadequate attest and assurance procedures
- Management working to achieve certain reporting results
- Inappropriate and unreasonable executive compensation arrangements
- Individual and corporate greed

Forces Leading to Accountability Breakdowns

- Confusion over who the auditors work for
- Audit failures
- Auditors delivering some services to clients that impaired independence
- Auditors and financial professionals doing what was minimally required and actively fighting tighter standards
- Personal interest trumping the public interest

Lessons Learned

Losing the Public Trust

"Even though most accountants did not participate in such schemes, public trust in the integrity of the financial reporting process and the accounting profession took a big hit."

David M. Walker, Comptroller General of the United States

BNA Tax and Accounting: Accounting Policy & Practice
Vol. 1, No. 3, November 18, 2005

Lessons Learned: A Loud Wake-Up Call

- Must strengthen the systems, oversight mechanisms, and the people involved in the performance and accountability profession

- Reaction to the most recent rash of scandals shows our system can work

A Loud Wake-Up Call

- A reminder that financial “sleight-of-hand” is no substitute for integrity and un-reproachable ethical behavior.
- Increased respect for the importance and value of the audit function when it is done right and a recognition of the devastating impact when audits fail
- Greater recognition that the public interest is not only paramount to accountability but also a good business strategy

Where Do We Go From Here?

The 103rd American Assembly

"Never, in its lengthy history, has the accounting profession been required to deal with the kinds of challenges that it must confront today. A seemingly unending series of sensational accounting scandals has grabbed newspaper headlines over the last three years, eroding public confidence in the accounting profession and leading to the most sweeping amendments to United States securities law since the Securities Act was passed by Congress in 1934. The Sarbanes-Oxley Act of 2002, as well as the Public Company Accounting Oversight Board (PCAOB) established as a result of the Act, now force the profession–and all of those who rely on its services–to rethink its most fundamental principles and practices."

The Future of the Accounting Profession

103rd American Assembly, November 2003

Excerpts from the 103rd American Assembly Report: The Future of the Accounting Profession*

- **Structural Challenges Facing the Accounting Profession:**
  - Rules-based versus principles-based standards
  - A revised and expanded financial reporting model
  - New and enhanced audit and attestation standards
  - The number of major accounting/audit firms
  - A balanced approach to auditor liability and accountability
  - Valuing quality audits and audit personnel
  - Reinvigorating audit committees
  - Preparing for the future—the talent search

* *The Future of the Accounting Profession*
103rd American Assembly, November 2003

Future of the Profession from the Eyes of the PCAOB

"I have not been shy about telling members of the accounting profession that we expect a lot from them, and that they will have to work harder than they could have imagined before enactment of the Sarbanes-Oxley Act. We will scrutinize accounting records, accountants' practices, and we will adjust the rules as necessary. In the wake of Enron and Arthur Andersen, the accounting profession was weighed and found wanting, but it was given a meaningful shot at redemption. In my mind, facilitating that redemption, and not just punishing miscreants, is a key objective - one that the Board must not lose sight of even when we are, as we will need to be, tough on the profession."

William J. McDonough, former Chairman, PCAOB
Testimony before the Senate Committee on Finance
October 2003

A Precious Franchise

"Every accountant in America has been handed the same precious franchise,granted its special privileges, and charged with its care. But, by the same token, all must bear the burden of its responsibilities if public confidence—this sacred trust—is ever lost."

Arthur Levitt
Former Chairman, SEC

Building the Public Trust

Three Fundamental Conditions

- Incentives for people to do the right thing.
- Transparency to help assure that people do the right thing.
- Effective accountability mechanisms if people don’t do the right thing.

At the core of that system, you must have *People of Integrity*

Key Concepts in the Accountability Profession

- Public vs. personal interests
- Recognizing the difference between the floor (e.g., rules, regulations, laws, accounting standards) and the ceiling (e.g., principles, values)
- Doing what is right vs. what is acceptable
- Economic substance vs. legal form
- Being concerned with both fact and appearance (e.g., independence)
- Using judgment vs. completing checklists
- Recognizing that continuing improvement in today's rapidly changing world is essential
- Remember that trust is hard to earn, but easy to lose

Attention to Ethics

"Professionalism is fundamentally an ethical orientation, implying integrity and adherence to high ideals. Thus, any reform that attempts to articulate, once again, the highest ideals of professionalism for an accountant, must necessarily pay careful attention to ethics. There can be no true professionalism without attention to ethics."

Understanding Accounting Ethics

Mark L. Cheffers and Michael Pakaluk, 2005

What is Ethics?

"Ethics is the careful study of standards of behavior that apply to real-world problems and decisions. It gives us insights into what we should do."

Kirk O. Hanson, Executive Director
Markkula Center for Applied Ethics
Santa Clara University

Ethics Is at the Heart of Trust

Overarching auditor ethical responsibilities to uphold and protect the public trust.

"While audit organizations have overall responsibility for creating the environment to promote conducting audit work in accordance with ethical principles, ethics is also a matter of personal responsibility. Auditors should observe overriding ethical concepts in the performance of their professional responsibilities, including exercising reasonable care and diligence in maintaining high ethical standards. Ethical conduct includes auditors preserving their independence and performing competent work, as well as following applicable standards."

Except from paragraph 2.02
Exposure Draft 2006
Government Auditing Standards

We Are All Personally Responsible

"A nation, as a society, forms a moral person, and every member of it is personally responsible for his society."

Thomas Jefferson

Integrity of Government Is Indispensable

“Public confidence in the integrity of the Government is indispensable to faith in democracy; and when we lose faith in the system, we have lost faith in everything we fight and spend for.”

Adlai E. Stevenson Jr. (1900-1965)

Integrity and Trust in Government

- Without integrity and trust, governments, institutions and leaders cannot succeed.
- With trust, governments, institutions and leaders can achieve great things.
- “Getting it right” will be critical to achieving and maintaining the public’s trust in government.

Leading by Example

- The government accountability profession is well positioned to lead by example.

- Honest, reliable, and transparent financial and performance reporting combined with competent, independent auditing are critical to public trust.

Implications of the Sarbanes-Oxley Act for the Government Environment

Implications of the Sarbanes-Oxley Act for the Government Environment

Current Government Environment

- Continually increasing demands for government effectiveness and accountability
- Fiscal pressures, increasing costs, structural deficit
- Financial and performance reporting pressures and incentives
- Changing laws and regulations
- Changing demographics
- Ability to hire and retain skilled staff
- Control environment/ risk assessment

Sarbanes-Oxley Act of 2002
Major Areas of Reform

Instituted sweeping changes for accountability profession and corporate governance in the following areas:

- audit profession oversight and standards
- auditor independence
- corporate responsibility
- enhanced disclosure requirements (including internal control reporting)

Sarbanes-Oxley Act:
Audit Profession Oversight and Standards

Creation of Public Company Accounting Oversight Board (PCAOB). Principal duties:

- ✓ establish or **adopt standards** for public company audits
- ✓ **enforce compliance** with standards and the Act
- ✓ **inspect** and register public accounting firms
- ✓ **conduct investigations** of firms and disciplinary proceedings
- ✓ **impose sanctions**

Sarbanes-Oxley Act

Auditor Independence

It is **unlawful** for a registered accounting firm to **provide certain nonaudit services to audit clients**, including:

- ✓ accounting and bookkeeping services
- ✓ financial information systems design and implementation
- ✓ appraisal, valuation, and actuarial services,
- ✓ internal audit outsourcing services
- ✓ management or human resources functions

All other nonaudit services provided to audit clients require prior audit committee approval

Sarbanes Oxley Act
Auditor Independence

- ✓ An accounting firm is not allowed to perform an audit of a registrant whose key financial or management personnel were employed by that accounting firm and participated in the audit within one year of the current audit.
- ✓ The auditor must report to the audit committee all “critical accounting policies and practices” used in preparing financial statements
- ✓ The lead audit, concurring and reviewing partners must rotate every 5 years.

Auditor Independence
Implications for Government

- ✓ Yellow Book independence standards became effective in 2003
- ✓ Auditor communications with audit committees.
- ✓ Audit Partner Rotation– no related government requirement.
- ✓ Employment restrictions–watch for situations that could result in appearance of independence problems under current Yellow Book independence standards.
- ✓ GAO Study on Potential Effects of Mandatory Audit Firm Rotation (GAO-04-216), November 2003

Sarbanes Oxley Act

Corporate Responsibility

New Requirements for Audit Committees

✓ Members must be on the Board of Directors and be "independent"

✓ Responsible for the appointment, compensation, and oversight of the auditor

✓ The auditor must report to the audit committee all "critical accounting policies and practices" used in preparing financial statements

✓ Must be appropriately funded by the company

Sarbanes Oxley Act

Corporate Responsibility

Other Corporate Responsibility Requirements

- ✓ The CEO and CFO **must certify** that financial statements and disclosures are appropriate and fairly present, in all material respects, the operations and financial condition of the company.
- ✓ **Unlawful** for officers and directors to “fraudulently influence, coerce, manipulate, or mislead” the auditor

Corporate Responsibility

Implications for Government

- ✓ Auditors and financial professionals should evaluate whether implementing an audit committee or similar type of committee would enhance governance
- ✓ Auditors should encourage good governance practices within the entities they audit.
- ✓ Auditors should report to the appropriate level within the governance structure of the organization
- ✓ CFO and CEO Certification of financial results—Does top management understand, care, and have assurance about what is in the financial statements?
- ✓ Auditors: watch for reporting pressures and improper management on audit or reporting results.

Sarbanes-Oxley Act
Enhanced disclosures

Section 404: Internal Control

- ✓ Management is 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 **auditors** are required to **attest to and report on management's assessment** of the effectiveness of internal control over financial reporting.

Sarbanes-Oxley Act

Section 404: Internal Control

PCAOB Auditing Standard No 2:

"Audit of Internal Control over Financial Reporting in conjunction with Audit of Financial Statements"

Requires auditor opinions on

- ✓ internal control effectiveness
- ✓ management's assessment of internal control effectiveness

Internal control audit must be performed in conjunction with financial statement audit

Sarbanes-Oxley Act Internal Controls Implications for Government

- GAO strongly supports section 404
- At the same time, efficiencies can be gained in the process through
  - streamlining
  - better integration of the financial audit and internal control audit
  - adopting a risk-based approach using reasoned risk and experience-based auditor judgments in areas such as rotation of testing and additional flexibility in using the work of others
  - use of common sense strategies in large and small environments

Opinions on Internal Control

Under Sarbanes-Oxley

- Management is required to establish and maintain an 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.

Under Financial Integrity Act

- Agency heads are required to establish and maintain adequate internal control over financial reporting and program operations as well as a continuous assessment process.
- Agency heads are required to report to the President annually on the adequacy of internal control and accounting systems.
- No corresponding audit requirement.

Internal Control Reporting
Getting Started

- Does management have a credible basis for a conclusion about the effectiveness of internal control over financial reporting?
- What is the level of maturity of the internal control systems in place for financial reporting?
- What are the associated risks?
- What is the targeted level of maturity for internal controls?
    - Small, simple entities vs. large, complex entities
- What are benefits and cost of an audit of internal control, given where the entity is in the process?

Internal Control Reporting
Getting Started

Internal controls maturity framework:

Level 1: Unreliable

- Unpredictable environment
- controls not designed, in place

Level 2: Informal

- controls designed, in place
- not adequately documented
- mostly dependent on the individuals doing the function
- no formal training or communication of results

Level 3: Standardized

- controls in place, documented, and communicated to employees
- deviations may not be detected

Level 4: Monitored

- standardized controls with periodic testing for effective design and operation, reporting to management

Level 5: Optimized

- integrated internal control framework
- real-time monitoring by management with continuous improvement
- automation to support controls and make rapid changes to controls if needed

•Source: Pricewaterhousecoopers, The Sarbanes-Oxley Act of 2002: Strategies for Meeting New Internal Control Reporting Challenges: A White Paper, 2002

Internal Control Assessment Challenges

- **Achieving efficient, effective project scope, using risk assessment and professional judgment**
  - appropriate balance: risk, controls, costs, and benefits
- **Integrating the “top-down” approach with the process and testing levels**
  - define and assess the control environment
  - determine impact on risk and scope at the cycle level
- **Integration of A-123 process with program operations and other accountability activities**
  - Process should be “built in” not “added on” to operational processes and controls, and other accountability activities and mandates
  - Ultimate goal is to achieve entity-level monitoring of preventive controls that are defined, operationally integrated, and improved when deviations are detected.
- **Effectively implementing A-123 to:**
  - increase quality and value while reducing risk,
  - streamline processes and controls,
  - increase management assurance, and
  - increase integrity, and therefore, public confidence in government programs.

Sarbanes-Oxley Act Internal Controls Implications for Government

- Sarbanes-Oxley Act: Considerations of Key Principles Needed in Addressing Implementation for Smaller Public Companies (GAO-06-361), April 2006.
- Ongoing GAO study of the joint CFO Council/ PCIE report, “Estimating the Costs and Benefits of Rendering and Opinion on Internal Control over Financial Reporting.”

GAO
Accountability * Integrity * Reliability

Concluding Thoughts

- The concept of accountability and trust is key to the effective functioning of a healthy democracy.

- As government accountability professionals, it is critical that each and every one of us “get it right” in the areas of accountability, transparency, integrity, and ethics in order to build and uphold trust in government.

In Thinking about the Challenges Ahead of Us

"The dogmas of the quiet past are inadequate to the stormy present. The occasion is piled high with difficulty, and we must rise with the occasion. As our case is new, so we must think anew and act anew."

Abraham Lincoln

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