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Auditors' and governmental financial officers' views on expanding the Sarbanes–Oxley Act provisions to state and local governments☆,☆☆

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ABSTRACT

This paper examines whether certain provisions of the Sarbanes–Oxley Act (SOX, 2002) should be expanded to include state and local governmental entities. Surveying governmental financial officials (GFOs) and their external auditors to gauge support for SOX-like legislation for governmental entities, we find the strongest support for auditor independence rules similar to SOX, management assessment of, and reporting on, internal controls, and severe penalties for destruction of records, fraud, and failure to report fraud.

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1. Introduction

The U.S. Congress enacted the Sarbanes–Oxley Act (SOX, 2002) to improve corporate financial reporting, and to increase (1) manager responsibility and transparency; (2) attention to internal controls; and (3) audit quality and auditor independence. While SOX (2002) focuses on public companies, many states in the U.S. now require not-for-profit entities to adopt certain SOX provisions. We address whether state and local governmental entities should do the same (cf., AGA CPAG, 2007). The Securities and Exchange Commission (SEC) recently posed this question in order to better protect corporate and municipal investors, maintain fair, orderly, and efficient markets, and facilitate capital formation (SEC, 2012). Also, while the U.S. Auditing Standards Coordinating Forum (2013)[4] has worked toward convergence in accounting, auditing, and financial reporting for the public, nonprofit, and government sectors much remains to be done, which indicate a need for further research to inform regulators and other stakeholders. However, subjecting governmental entities to SOX-like legislation entails high implementation costs (FEI, 2004; Krishnan, Rama, & Zhang, 2008) that could outweigh its benefits (Engel, Hayes, & Wang, 2007; Zhang, 2007).

The SEC (2012) reports that the U.S. capital market contains one million different municipal bonds totaling $3.7 trillion in the U.S., of which 75% are held by individual "retail" investors. Still, "despite its size and importance, the municipal securities market has not been subjected to the same level of regulation as other sectors of the U.S. capital markets, perhaps due to the broad exemptions under federal securities laws for municipal securities,".

To date only one study has investigated SOX (2002)-like regulation for governmental entities—Frank and Fink (2008), who report results from surveying 132 Florida and Ohio government finance officers. They find support for (a) extending SOX provisions relating to adopting principal officer certification and (b) requiring an independent audit committee for larger cities. We extend this research to include various other SOX (2002) provisions by surveying two groups in a Midwestern state that are involved deeply in the governmental financial reporting process—government financial officers (GFOs) and their external auditors.

We selected these two groups because SOX greatly affects the audit process and the reporting responsibilities of GFOs and their auditors. Also, GFOs and their auditors would be knowledgeable regarding the costs and benefits of implementing SOX-like provisions. We find that both parties show the highest support of SOX-like legislation for auditor independence rules similar to SOX, management assessment of internal controls, and severe penalties for destroying records, committing fraud,

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and not reporting fraud. GFOs generally support establishing an auditor oversight board like the PCAOB and audit partner rotation while auditors are less supportive or neutral.

We discuss our research questions (RQs) based on arguments for and against governmental entities adopting specific SOX provisions, followed by a discussion of our research method and findings. We finish with a summary and our conclusions.

2. Background and research questions

2.1. Arguments for SOX-like legislation in the governmental sector

SOX provisions require entities to strengthen their internal controls and external auditors to enhance audit independence and quality. Thus SOX provisions applied to the governmental setting arguably should help municipalities reduce fraud risks. Elson and Dinkins (2009) suggest that governmental entities adopting SOX will improve their accountability and transparency, thereby protecting citizens' investment in their governments and ensuring that stakeholders receive benefits in the form of a well-run government. Verschoor (2008) suggests that adherence to SOX provisions, such as an effective audit committee and effective internal controls, might have prevented a Washington D.C. public official from embezzling up to $50 million of property tax funds. Also, responding to its discussion of the San Diego charges related to violating conflicts of interest laws, committing consumer fraud, and withholding information about underfunded pensions and misappropriated assets (AAER, 2007), the Association of Certified Fraud Examiners states, “A law similar to the Sarbanes–Oxley Act, which requires the presidents and CFOs of private-sector companies to sign off on financial statements, should apply to governors, mayors, and CFOs in the public sector” (Dasaro, 2009).

Besides potentially reducing fraud, SOX-like provisions would strengthen the municipal sector's governance mechanisms, as SOX did for corporations, and could reduce the risk of bankruptcy through improved financial reporting and financial management (Coates, 2007). Since recent large increases in the municipal bond market have exceeded that of the private sector equity securities market,[5] many creditors would welcome improved financial reporting and managed operations.

2.2. Arguments against SOX-like legislation in the governmental sector

High implementation and compliance costs constitute the key argument against SOX-like legislation for the governmental sector, where costs could well parallel those in the private sector. Governments could even face disproportionately higher costs similar to those of smaller public entities (AGA CPAG, 2007; Gowans-Miller, 2007). In the current adverse economic environment of tight governmental budgets, additional compliance costs could well make the situation worse.

Governmental entities already face many SOX-like provisions, including their auditor's reporting all internal control material weaknesses and significant deficiencies (Single Audit Act, 1996; USGAO, 2011) and auditor's independence rules and regulations (USGAO, 2011). Thus, additional legislation may be unnecessary. Finally, municipalities could face difficulty implementing SOX-like audit partner rotation rule because some (1) states allow only state auditors to perform some of these audits, and (2) audit firms performing these audits are relatively small (AGA CPAG, 2007).

[5] For example, while from 1975 to 2008, the Dow Jones Industrial Average grew from 5,776 to 13,930 points, the municipal securities market concurrently grew from $25 to $49 billion to nearly $2.8 trillion (Walter, 2009). Also the U.S. stock market's value grew from $1.4 to $17.1 trillion from 1980 to 2010 (Blume & Klein, 2012).

Table 1
Descriptive statistics on demographic variables.
Mean (Std. Dev.) for the first two variables (Scale: 1–5 for strongly disagree to strongly agree), Dichotomous for other variables.

Variable	Subject differences: Auditors (N = 109)	GFOs (N = 76)	Overall (N = 185)	Statistic* (Significance)
Familiarity with SOX-Overall	3.93 (.86)	3.64 (1.15)	3.81(1.00)	T-stat = 1.91 (.058)
Familiarity with SOX-Accounting	3.64 (.98)	3.32 (1.06)	3.51 (1.02)	T-stat = 2.16 (.035)
Gender:				
Female	31 (28.2%)	34 (44.7%)	65 (34.9%)	Chi-Sq = 5.42
Male	79 (71.8%)	42 (55.3%)	121 (65.1%)	(.020)
Degree:				
Undergraduate	73 (73.7%)	40 (57.1%)	113 (66.9%)	Chi-Sq = 5.10
Graduate	26 (26.3%)	30 (42.9%)	56 (33.1%)	(.024)
Certification:				
Yes	100 (93.5%)	58 (87.9%)	158 (91.3%)	Chi-Sq = 1.61
No	7 (6.5%)	8 (12.1%)	15 (8.7%)	(.205)

GFO = governmental financial officials.
Depending on the nature of the data, this is either the two sample T-statistic or the Pearson χ^2 statistic of the expected versus observed frequencies. Significant statistics are highlighted.

The above discussion raises questions on whether additional SOX-like legislation is beneficial for governmental entities. We address key SOX provisions in the six research questions listed below.

RQ1: Do participants support a governmental accounting oversight board (GAOB) to set and enforce auditing standards for governmental entities?

Table 2
Tests of research questions: specific SOX provisions.
Scale: 1–5 (1 = strongly disagree, 3 = neutral, 5 = strongly agree).
(N = 185, smaller for variables that had missing responses).

SOX title question	Mean (Std. Dev.): Auditors N = 107	GFOs N = 75	All N = 182	T-stat** (Sig.)
RQ1. A Governmental Accounting Oversight Board (GAOB) should exist to set and enforce auditing standards for governmental entities.	2.79 (1.30)	3.35* (1.25)	3.02 (1.30)	−2.87 (0.005)
RQ2. Auditors of governmental entities should be held to the same independence standards as do auditors of public entities, consistent with current Government Auditing Standard 3.03 (Yellow Book.).	3.77* (1.14)	4.20* (1.15)	3.95* (1.16)	−2.50 (0.013)
RQ3. The audit and second review partners on a governmental entity audit should rotate off every 5 years.	2.94 (1.41)	3.79* (1.14)	3.29* (1.37)	−4.28 (<0.001)
RQ4. Governmental entities should be required to have an independent audit committee to oversee the audit process, just like public companies.	3.21 (1.31)	3.34* (1.37)	3.27* (1.33)	−0.64 (0.520)
RQ5. Management should assess and make representations about the effectiveness of the internal control structure and financial reporting procedures of the governmental entity.	4.03* (0.96)	4.18* (0.93)	4.09* (0.95)	−1.04 (0.298)
RQ6. Governmental entity employees, who destroy records, commit fraud or fail to report fraud should face severe criminal/civil penalties.	4.36* (0.86)	4.47* (0.85)	4.40* (0.85)	−0.80 (0.426)

GFO = governmental financial officials.
* T-test of difference from neutral (i.e., 3.00) is significant at the .05 level or lower (two-tailed).
** This is the two sample T-test of the difference in means of auditors and GFOs.

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