



Estimating the Costs and Benefits of Rendering an Opinion on Internal Control over Financial Reporting

A Joint Study by the
Chief Financial Officers' Council
and the
President's Council on Integrity and Efficiency

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Reason for Survey and Recommendations

The Department of Homeland Security Financial Accountability Act, P.L. 108-330, directs the Chief Financial Officers Council (CFOC) and the President's Council on Integrity and Efficiency (PCIE) to conduct a joint study on the potential costs and benefits of requiring the Chief Financial Officers (CFOs) Act agencies to obtain audit opinions on internal control over financial reporting. This report contains the results of that joint study. Because the estimates to render an opinion on internal control are so substantial, both CFOs and Inspectors General (IGs) recommend that all CFO Act agencies should not be required to conduct such an audit at this time. Rather, agencies should be given the opportunity to implement the revised Office of Management and Budget (OMB) Circular A-123, *Management's Responsibility for Internal Control*, (A-123) and obtain an internal control audit only where particular circumstances warrant such an audit.

Executive Summary

Much of the debate on the internal control provisions of Section 404 of the Sarbanes-Oxley Act (Section 404) (which requires management to provide an assessment on the effectiveness of internal control and the auditor to attest to, and report on, the assessment made by management) centers around the costs and related benefits of the additional audit assurance. The value and benefit of rendering a separate opinion on internal control over financial reporting must be balanced against the added costs. Estimating these added costs, however, is challenging given the lack of hard data and the number of factors that go into developing a reliable estimate. Similarly, measuring the benefits of the independent audit assurance is equally difficult since ongoing and new management initiatives and existing audit coverage also contribute to strengthening internal control in the Federal Government. Chief among the management initiatives expected to significantly contribute to improved internal control are the recent revisions to A-123.

The cost information provided in this report was developed using estimates and should not be considered "hard" numbers. Moreover, quantifying the incremental benefits of obtaining an audit opinion on the internal control over financial reporting, and hence performing any sort of meaningful cost/benefit analysis, has proven elusive. How does one, for example, assign a dollar value to preventing a misstatement or fraud of an unknown amount that may or may not occur, or may occur with unknown frequency?

Federal IGs estimate that the incremental costs of the audit work needed to render an opinion on internal control for all 24 CFO Act agencies would be more than \$140.6 million. Approximately 60 percent of this total, or \$84.4 million, is the estimate to render an opinion on internal control for the Department of Defense (DoD). For the 24 CFO Act agencies, the average estimated incremental audit cost is approximately 51 percent of the financial statement audit costs, or more than \$5.8 million per reporting entity. Excluding the costs to audit DoD's internal control, the average estimated incremental audit cost is reduced to \$2.4 million per reporting entity.

Although these estimates are not hard numbers and could be less over time as auditors gain more experience developing a fully integrated audit approach, these costs are significant. These numbers also represent only the increased costs directly attributable to the requirement to

render an opinion on internal controls. Several Offices of the Chief Financial Officers (OCFOs) believe they also will incur additional costs to support the audit effort. The additional costs that management must incur to support this effort are not part of this report.

A majority of the OIGs and OCFOs believe that some benefits may be derived from this type of audit. They cited (1) improved internal control and reduced material weaknesses, (2) reduced errors and improved data integrity, documentation reliability and reporting, and (3) improved agency focus and oversight as the top three potential benefits that may be gained from an opinion on internal control. They also believe that identifying new material weaknesses and reportable conditions are possible benefits.

Both groups, however, believe that these benefits should largely be achieved when agencies effectively implement the revisions to A-123. The revisions strengthened the requirements for management's assessment of internal control over financial reporting. Because the IGs assisted OMB in revising A-123, along with the CFOs, there is a level of confidence that, if agencies properly implement A-123, the result should be an effective internal control review and testing program. Therefore, except for the additional assurance provided by an opinion on internal control, the benefits can already be realized from an internal control review program implemented by management (similar to Section 404).

An effective and meaningful cost/benefit analysis should not compare the incremental audit costs to all of the benefits that could be achieved through a process similar to that under Section 404. The true benefit of the auditor's opinion on internal control is the added independent assurance it provides that management's assessment of its internal control is fairly presented. It is difficult, if not impossible, to determine the incremental benefit of the auditor's opinion without first knowing how well management does in performing its assessment under the revised A-123. That knowledge will come, at least in part, through the financial statement audit process, as auditors are required to report on an agency's compliance with laws and regulations. While not a formal opinion, it will be a useful tool in helping OMB and other stakeholders assess the implementation effort on the part of federal managers.

Based on cost data currently available from the private sector (which is significantly higher than originally projected) and the estimates that are beginning to be developed for the public sector, most industry experts agree that there are significant incremental costs associated with obtaining an opinion on internal control over financial reporting. In addition, there is a general consensus that, at least in the early stages of implementing Section 404, it is difficult to determine the incremental benefits that might be gained from the additional work. Before incurring these additional costs in the Federal sector, the OIGs and OCFOs believe that it would be prudent to take a less costly approach and allow Federal managers to first implement the revised A-123, and then evaluate that effort, along with the private sector's implementation of Sarbanes-Oxley, as additional information becomes available.

And even then, given the inherent differences between agencies, it might be judicious to follow the same logic that forms the basis for A-123, and implement any incremental work on a case-by-case basis. The decision to obtain an audit opinion must be decided initially by each agency, and other knowledgeable parties, based on the condition of its financial management program. Agencies that already have problems obtaining a clean opinion on their financial statements do not need to obtain an opinion on internal control to tell them they have material

weaknesses. On the other hand, some agencies may want the added assurance that is achieved by obtaining an opinion on internal control.

Introduction

The Department of Homeland Security Financial Accountability Act, P.L. 108-330, directs the CFOC and the PCIE to conduct a joint study, and to report to the Congress and to the Comptroller General of the United States, on the potential costs and benefits of requiring agencies subject to the CFO Act to obtain audit opinions of their internal control over financial reporting. This report contains the results of that joint effort.

Working under the leadership of OMB who chairs both councils, we surveyed the IGs for their estimate of the costs of the incremental audit work and asked the IGs and the CFOs for their input on the challenges and benefits of obtaining an opinion on internal control. In addition, we looked at the experiences of publicly-traded companies which, at this point, have had a year of experience implementing Section 404 of the Sarbanes-Oxley Act. We also considered the environment in which the Federal Government operates which differs considerably from the one in which publicly-traded companies operate. Finally, we considered the anticipated benefits that are expected to be achieved through the revisions to A-123 which become effective in fiscal year 2006.

Where We Are Today

The Federal Environment

Unlike the private sector, the Federal Government operates in an environment that is subject to more legislative and regulatory requirements designed to promote and support effective internal control. Although these laws and regulatory requirements have not proven fully effective in establishing a strong system of internal control by themselves, taken as a whole, they have created an environment in which accuracy, timeliness, and accountability have become a maxim for many Federal agencies. Also contributing to this robust control environment are the rigorous existing auditing requirements relating to internal control and the many initiatives implemented by the Administration through the President's Management Agenda (PMA).

While the Sarbanes-Oxley Act created a new requirement for managers of publicly-traded companies to report on internal controls over financial reporting, Federal managers have been subject to similar internal control reporting requirements for many years as well as other numerous legislative and regulatory requirements that promote and support effective internal control. The Federal Managers' Financial Integrity Act (FMFIA) of 1982 provides the statutory basis for management's responsibility for and assessment of internal control. In addition, the CFO Act, which was passed in 1990, requires agency CFOs to, "develop and maintain an integrated agency accounting and financial management system, including financial reporting and internal controls, which ... complies with applicable ... internal control standards...." The Federal Financial Management Improvement Act (FFMIA) of 1996 and OMB Circular No. A-127, *Financial Management Systems*, instructed agencies to maintain an integrated financial management system that complies with Federal system requirements, Federal accounting standards, and the U.S. Standard General Ledger at the transaction level. The Federal Information Security Management Act of 2002 requires agencies to provide information security controls proportionate with the risk and potential harm of not having those controls in place. The Improper Payments Information Act of 2002 requires agencies to review and "...identify programs and activities that may be susceptible to significant improper payments." The

Inspector General Act (IG Act) of 1978, as amended, requires that IGs submit semiannual reports to the Congress on significant abuses and deficiencies identified in their audits, and to recommend actions to correct those deficiencies.

Just as Federal agency management has been subject to more stringent internal control requirements than private sector entities, auditors of Federal entity financial statements have traditionally been subject to more rigorous auditing requirements relating to internal control than their counterparts in the private sector. Before the passage of the Sarbanes-Oxley Act and its increased audit requirements, auditing standards in the private sector did not require auditors to test internal control if they did not plan to rely on the internal control in performing their audit. These standards also did not require auditors to publicly report, in writing, internal control deficiencies found during the audit. In contrast, the auditing requirements issued by OMB for audits of agency-wide financial statements under the CFO Act have always required the auditor to perform sufficient tests of internal control to support a low assessed level of control risk for those internal controls that have been properly designed and placed in operation. And since 1981, *Government Auditing Standards* have required auditors to publicly report, in writing, deficiencies in internal control found during financial statement audits.

In addition to legislative and regulatory requirements, initiatives implemented by the Administration have also strongly impacted the Federal control environment. Under the PMA, OMB monitors internal control weaknesses regularly. To receive green, or a successful rating, on the PMA scorecard, agencies must eliminate all internal control weaknesses. Quarterly, OMB monitors agency performance in meeting corrective action plan targets established under the PMA scorecard. Agencies are required to submit corrective action plans to OMB to resolve internal control weaknesses reported. Quarterly, agencies are graded on their progress in achieving the corrective action milestones contained in their plans. Across the government, a total of 13 new weaknesses were reported in FY 2004 – a net increase of two new weaknesses from FY 2003. This increase, albeit small, may be attributed to the accelerated reporting requirement mandated by OMB, which placed greater emphasis on the need for effective financial reporting controls. However, as internal control is strengthened at agencies to routinely meet accelerated reporting dates, internal control weaknesses should be reduced. Total FMFIA material weaknesses and nonconformances decreased by nearly 11 percent.

New Efforts to Improve Internal Control

In light of the new requirements for publicly-traded companies contained in the Sarbanes-Oxley Act, OMB re-examined the existing internal control requirements for Federal agencies. As a result, A-123, which implements FMFIA, has been revised to strengthen the requirements for conducting management's assessment of internal control over financial reporting. The circular is effective beginning in fiscal year 2006.

A-123 recognizes that there is an appropriate balance between controls and risk in an agency's programs and operations. Too many controls can result in inefficient and ineffective government. The benefit should outweigh the cost. Under A-123, agencies are required to integrate their internal control efforts to meet the requirements of FMFIA with other efforts to improve effectiveness and accountability. Internal control should be an integral part of the entire cycle of planning, budgeting, management, accounting, and auditing. It should support the effectiveness and the integrity of every step of the process and provide continual feedback to

management. Thus the revisions to A-123 require management to strategically evaluate internal control risks and directly test, document, and report on the effectiveness of financial controls. Additionally, existing audit requirements in OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, require the auditor to obtain an understanding of the process by which the agency identifies and evaluates weaknesses reported under FMFIA, and to report instances where the agency's FMFIA process failed to detect and report material weaknesses.

In keeping with the balance between controls and risk, under A-123 agencies may, at their discretion, elect to receive an audit opinion on internal control over financial reporting. Also, if an agency cannot meet the deadlines outlined in its approved corrective action plan, OMB may, at its discretion, require the agency to obtain an independent audit opinion of the agency's internal control over financial reporting as part of its financial statement audit.

Today, three¹ of the 24 CFO Act agencies have subjected their internal control over financial reporting to examination. In the most recent report on internal control over financial reporting, one agency received an unqualified opinion, and the other two received qualified opinions because of material weaknesses. The agency that received an unqualified opinion identified reportable conditions.

Survey Results

Estimating the Cost to Render an Opinion on Internal Control

Given the IGs' responsibility to audit the financial statements, or to determine the independent external auditor, we asked them to provide an estimate of the cost to render an opinion on internal control over financial reporting. It is important to recognize, however, that estimating the cost to render an internal control opinion is challenging given the lack of hard data and the number of unknown factors that go into developing a strong estimate. While we provide estimated cost information in this report, these estimates should not be considered hard numbers.

In a number of responses, the OIGs reported a range for the cost estimate rather than a single dollar amount. In these cases, the cost estimate that we included in our totals and averages reflects the middle of the range provided by the OIGs. These estimates are only for the incremental cost of the additional internal control work required to render an opinion on internal control. They exclude management's cost to support the audit effort, or to implement the new requirements in A-123, Appendix A. Although we did not collect cost estimates for management's activities, some CFOs believe that additional costs would be incurred. See Table A for information on the estimated incremental audit costs.

In addition, to avoid skewing the overall and agency totals, we also provide estimates that exclude the audit costs for DoD. These alternative numbers are useful since there may be limited utility in obtaining an opinion on internal control given the material weaknesses at DoD, and the

¹ The General Services Administration (GSA), the Nuclear Regulatory Commission, and the Social Security Administration have obtained an opinion on internal control over financial reporting for 12 years, 10 years, and 8 years, respectively. GSA, however, has not subjected its internal control over financial reporting to an audit since fiscal year 2003.

great uncertainty in developing a cost estimate for a department that has not yet established a baseline cost to audit its financial statements.

The estimated costs to render an audit opinion on internal control for all 24 CFO Act agencies is more than \$140.6 million, of which \$56.2 million, or 40%, is for the 23 civilian CFO Act agencies. The average estimated incremental audit costs are estimated to be approximately 51 percent of the financial statement audit costs, or more than \$5.8 million per reporting entity. Excluding DoD, the cost per reporting entity is \$2.4 million. The incremental cost estimates ranged from as low as 6.5 percent to more than 100 percent of the cost of the financial statement audit. In dollar terms, these costs ranged from \$38,000² to \$84.4 million. The wide range of costs reflects the relative size and complexity of the entity being audited.

Driving these costs are the additional work that the auditor would need to perform beyond the requirements of OMB Bulletin 01-02, *Audit Requirements for Federal Financial Statements*, and the PCIE/Government Accountability Office Financial Audit Manual, in order to render an opinion on an agency's internal control. In general, OIGs believe a substantial amount of additional work would need to be performed in order to render an opinion on internal control, but noted that the extent of additional testing necessary is subject to auditor judgment. Additional or different controls would have to be tested based on management's assessment of those controls and risk factors associated with the entity. In this regard, the auditor would need to evaluate management's own testing and documentation of the controls, assess the criteria used, review the internal control documentation, identify missing controls, test the identified controls, and report on the effectiveness of those controls. See Table B for OIG responses on the additional work needed to render an opinion on internal control.

Observation

A number of OIGs and CFOs believe that significant audit costs are a major deterrent to requiring an opinion on internal control. This is especially true when one considers A-123 since the benefits realized by the Federal sector after implementing the revised circular may not be as dramatic as in the private sector, where companies have gone from virtually no internal control reporting to the requirements of Section 404. See Table C for disadvantages reported by the OIGs. Many OIGs and OCFOs commented that the costs associated with obtaining the audit opinion may exceed the benefit that would be derived from the process. As reported above, the OIGs estimated that the additional work could increase the audit fees by more than 50 percent. Although the costs in the later years may drop, the incremental audit costs are expected to be substantial, costing an estimated average of more than \$2.4 million. It is questionable whether the benefits from obtaining an audit opinion are substantial enough, beyond those derived from implementing the revised A-123, to justify the incremental audit cost and the costs to support the audit.

The OIGs also identified budget constraints as another disadvantage to requiring an opinion on internal control. OIGs commented that some agencies may not be able to obtain the resources, both staff and funding, needed to prepare for a successful audit, let alone the resources

² The actual costs, however, could be higher than the estimates which were reported. One agency reported a cost of \$38,000 but they qualified the amount, noting that it was the amount bid five years ago before the Sarbanes-Oxley Act was implemented. The agency believes that these costs would be significantly higher in the outgoing years.

needed to perform the audit. One OIG noted that strong performance measures, such as a reduction in financial management costs and improved reporting, be in place to ensure the efficient use of resources before an opinion on internal control is required.

Some OIGs commented that their budgets barely cover their costs to meet existing audit requirements. These OIGs felt that if an opinion on internal control is mandated, it must also be funded. They noted that unfunded mandates would be difficult to absorb and would require them to divert resources and funds from other audit areas that could provide far greater benefits than what an opinion on internal control over financial reporting would provide.

Some OIGs and OCFOs also questioned the need to obtain an opinion on internal control in certain circumstances. For example, if an agency is reporting material weaknesses through its financial statement audit process, there is a high likelihood that the auditors would issue a qualified, or disclaimer of, opinion on internal control, adding little benefit for an opinion. Also, if an agency effectively implements the revised requirements of A-123, there may be little value in requiring an opinion on internal control.

Several OIGs commented that any new requirements to obtain an opinion on internal control over financial reporting should be implemented gradually, if at all. It should not be a “one size fits all.” Any requirement to obtain an opinion on internal control should strike a reasonable balance between the costs and benefits, recognizing the strengthened controls and oversight that already exist in the Federal Government.

Identifying the Benefits of Rendering an Opinion on Internal Control

Unlike costs, which to some degree can be estimated, benefits can only be described in general terms, making a cost/benefit analysis difficult. The most easily identifiable benefit is the further independent assurance. Specific OIG responses on the benefits of obtaining an opinion varied, and not all benefits identified are captured in this report. For purposes of effectively analyzing and reporting on the OIG responses, we summarized their responses into seven categories. The seven categories and OIG responses are included in Table D.

The OIGs for the three agencies that already provide an opinion on internal control over financial reporting identified several benefits to obtaining an opinion on internal control over financial reporting. Specifically, all three reported (1) improved internal control and reduced material weaknesses, and (2) reduced errors and improved data integrity, documentation reliability and reporting as benefits of the additional work. Two of the OIGs also reported identifying new material weaknesses and reportable conditions as benefits from this process. One OIG reported improved agency focus and oversight as an additional benefit. None of the three OIGs could quantify the benefits realized.

Most of the OIGs of agencies that do not provide an opinion on internal control over financial reporting believe that benefits may be derived from this type of audit. Their answers were similar to answers provided by their counterparts at agencies that do provide an opinion on internal control. They also cited a third benefit -- improved agency focus and oversight. Six OIGs also reported the detection of new material weaknesses and reportable conditions as possible benefits.

Four OIGs reported that there is little or minimal benefit in obtaining an opinion on internal control over financial reporting. For example, if an agency receives a clean opinion, has no material weaknesses or reportable conditions, and actively corrects the identified internal control deficiencies; new material weaknesses may not be identified. Conversely, in situations where an agency has existing material weaknesses, it may not be an efficient use of resources to require an opinion on internal control over financial reporting until the material weaknesses are resolved.

Observation

The benefits identified above should largely be achieved by a number of management and audit initiatives that are currently underway, and cannot be attributed solely to an opinion on internal control. Specifically, many of these benefits should be achieved when agencies effectively implement the revisions to A-123³ which strengthened the requirements for management's assessment of internal control over financial reporting. Because the OIGs assisted OMB in revising A-123, along with the CFOs, there is a level of confidence that, if agencies properly implement A-123, the result should be an effective internal control review and testing program. Therefore, except for the additional assurance provided by an opinion on internal control, the benefits can already be realized from an internal control review program implemented by management (similar to Section 404). In addition, the financial statement audits as currently conducted include tests of compliance with laws and regulations, which will provide an independent check on agencies' A-123 implementation efforts.

In addition, as part of the financial statement audit, the auditor must already (1) obtain an understanding of the process by which the agency identifies and evaluates weaknesses required to be reported under FMFIA and related agency implementing procedures, and (2) compare material weaknesses disclosed during the audit with those material weaknesses reported in the agency's FMFIA report that relate to the financial statements and document material weaknesses disclosed by the audit that were not reported in the agency's FMFIA report. The auditor must also consider whether the failure to detect and report material weaknesses constitutes a reportable condition or material weakness in the entity's internal control.

Other initiatives currently underway that contribute to the achievement of the above benefits include the process and control improvements resulting from accelerated reporting, and the focus on internal control in the Executive Scorecard that rates agencies' performance in meeting the PMA initiative on improving financial management.

³ The revised A-123 now requires Federal managers, as a subset of FMFIA Section 2 reporting, to provide an assurance statement on internal control over financial reporting. To make this assurance statement, the agency must establish a senior assessment team to ensure that staff or contractors carry out the assessment in a thorough, effective, and timely manner. If A-123 is effectively implemented, the assessment team will be able to conclude whether the design and operation of the internal controls over financial reporting were effective or whether material weaknesses exist in the design or operation of internal control over financial reporting. To evaluate internal control at the process, transaction or application level, the assessment team must: (1) determine significant accounts; (2) identify and evaluate major classes of transactions; (3) understand the financial reporting process; (4) gain an understanding of control design to achieve management's assertions; and (5) test controls and assess compliance to support management's assertions.

An effective and meaningful cost/benefit analysis should not compare the incremental audit costs reported above to all of the benefits that could be achieved through a process similar to that done under Section 404. The real benefit of the auditor's opinion on internal control is the added independent assurance it provides that management's assessment of its internal control is fairly presented. It is difficult, if not impossible, to determine the incremental benefit of the auditor's opinion without first knowing how effectively management performs on its assessment under the revised A-123.

To some extent, this assessment will be done under the current requirements for Federal financial statements since the auditor must obtain an understanding of the process by which the agency identifies and evaluates weaknesses required to be reported under FMFIA and to report instances where the reporting entity's FMFIA process failed to detect and report material weaknesses. Beginning in fiscal year 2006, this process will be done using the revised A-123 which strengthened management's assurance statements process.

Experiences of Publicly-Traded Companies

In addition to surveying the OIGs and OCFOs, we also reviewed information about the private sector to provide additional insight on the costs, benefits, and challenges of obtaining an opinion on internal control over financial reporting. The information is drawn from articles on the costs, and associated benefits, of complying with the Sarbanes-Oxley Act and statements made by representatives of public companies, members of audit committees, and auditors who testified before the Securities and Exchange Commission on their experiences implementing the Act. We did not corroborate this information.

Experience Estimating the Cost

Initial cost estimates to comply with the Sarbanes-Oxley Act were low. Studies conducted by an association for financial executives⁴ found that total costs, including the costs of management's assurance assessment, averaged \$4.36 million. These costs were up 39 percent from the \$3.14 million they expected to pay initially. Total cost of compliance averaged \$1.34 million for internal control, \$1.72 million for external costs, and \$1.30 million for auditor fees. The auditor fees are in addition to companies' financial statement audit fees, on average 57 percent higher.

Data in another study⁵ from 90 Fortune 1000 companies⁶ who are audited by the nation's four largest accounting firms⁷ shows that issuers spent substantial sums to comply with the new

⁴ Financial Executives International (FEI) Survey: Section 404 Costs Exceed Estimates. Copyright 2005 FEI. http://www.fei.org/404_survey_3_21_05.cfm.

⁵ Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates From a Sample of Fortune 1000 Companies, CRA No. D06155-00. <http://www.sec.gov/spotlight/soxcomp/soxcom-all-attach.pdf>.

⁶ The average company revenues were \$8.1 billion.

⁷ Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, and PricewaterhouseCoopers LLP.

reporting requirements. On average, the companies in the sample each spent \$7.8 million to implement Section 404 overall. Audit fees accounted for approximately one quarter of the total compliance costs, or an average of \$1.9 million.

Some have suggested that Section 404 compliance costs will decline over time, pointing to one-time start-up expenditures and “learning curve” costs that typically occur with any new reporting requirement. Others have suggested that first year costs include deferred maintenance of internal control systems that have been allowed to degrade. If these views are correct, compliance costs would be expected to decline over time. Survey responses by audit firms support this hypothesis. On average, audit firm respondents believe that the total 2005 compliance costs of the clients in the sample, including Section 404 audit fees, will average \$4.2 million – 46 percent less than the estimated 2004 costs.

First Year Benefits Realized

A primary benefit cited by many observers is that the heightened attention to internal control will enhance the reliability of financial statements by helping companies to identify internal control deficiencies and remediate these deficiencies in a timely manner. To assess the full effects of the new reporting requirement, Charles River Associates⁸, a consulting firm, sampled 90 Fortune 1000 companies to gather information about the total number of deficiencies identified by the issuer or the auditor in the Section 404 process regardless of whether the deficiency was remediated prior to the year-end assessment date.⁹

On average, for year-end 2004, management and the independent auditor identified 348 deficiencies per company. Of these, management remediated an average of 271 deficiencies prior to their year-end assessment date. The remaining 77 deficiencies are expected to be remediated in the future. Of the unremediated deficiencies, almost 96 percent were classified as control deficiencies not rising to the level of a significant deficiency or material weakness. The data showed an average of 74 control deficiencies and three significant deficiencies per company still existed at year-end. A *total* of five material weaknesses were unremediated as of the year-end assessment date across the 90 companies for which data was available.¹⁰

⁸ Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates From a Sample of Fortune 1000 Companies, CRA No. D06155-00. <http://www.sec.gov/spotlight/soxcomp/soxcom-all-attach.pdf>.

⁹ For Section 404 purposes, management and the independent auditor are required to disclose in their public reports only material weaknesses that exist as of the year-end assessment date. Whether deficiencies are identified by management or the auditor, management may implement new controls or strengthen existing procedures to correct deficiencies before the company’s year-end assessment date, in effect remediating these potential problems. By identifying and remediating control deficiencies during the year, fewer material weaknesses are likely to be reported.

¹⁰ If a deficiency was remediated prior to the year-end assessment date, management and the auditors would not necessarily have evaluated whether it would have been a significant deficiency or a material weakness as defined by the Public Company Accounting Oversight Board Auditing Standard No. 2. Therefore, the number of deficiencies remediated prior to the year-end assessment date was collected in the aggregate without determination as to whether some would have been classified as significant deficiencies or material weaknesses.

Observation

Recognizing that the number of the findings per company is quite substantial, the number of material weaknesses for 90 companies was low, with only five unremediated material weaknesses at the end of the assessment period. The cost for 90 companies to identify these material weaknesses, however, was significant, totaling \$702 million¹¹.

Also, on the whole, it is difficult to imagine that Federal agencies would identify the same number of deficiencies that publicly-traded companies identified in their first year of implementing Section 404. Although companies in the private sector have been required to maintain effective internal controls under the Foreign Corrupt Practices Act of 1977, many behavioral changes did not occur until the Sarbanes-Oxley Act. The same cannot be said of the Federal Government, which has seen tremendous improvements in financial management practices in the past 15 years. Passage of key legislation, more congressional oversight on financial management matters, hiring highly recognized CFOs from the corporate world, and the PMA have all contributed toward creating an environment that supports strong internal control.

Many of the articles and links that we used in conducting this study are included in Attachment A.

Conclusion

Based on data currently available from the private sector and the estimates that are beginning to be developed for the public sector, most industry experts agree that there are significant incremental costs to obtaining an opinion on internal control over financial reporting. In addition, there is a general consensus that, at least in the early stages of implementing Section 404, it is difficult to determine the incremental benefits that might be gained from the additional work.

The critical question which needs to be addressed in assessing the benefits of obtaining an audit opinion on internal controls is whether the benefits derived significantly exceed the results of agencies' implementation of the revised A-123. Before incurring these additional costs, it would be prudent to see how Federal managers implement the revised A-123 and evaluate the private sector's implementation of Sarbanes-Oxley when additional information becomes available.

And even then, given the inherent differences between agencies, it would be judicious to implement the incremental work on a case-by-case basis. The decision on whether to obtain an opinion needs to be decided by each agency, and other knowledgeable parties, depending on the condition of its financial management program. Agencies that already have problems obtaining a clean opinion on their financial statements do not need to obtain an opinion on internal control to tell them they have material weaknesses. On the other hand, agencies that believe they are

¹¹ Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates From a Sample of Fortune 1000 Companies, CRA No. D06155-00. <http://www.sec.gov/spotlight/soxcomp/soxcom-all-attach.pdf>.

leading organizations may want the added assurance that can be achieved by obtaining an opinion on internal control.

Objectives, Scope, and Methodology

The objective of our study was to gather information on the potential costs and benefits of requiring the CFO Act agencies to obtain audit opinions on internal control over financial reporting. To accomplish this objective, the CFOC and the PCIE, under the leadership of OMB, who chairs each council, canvassed the Federal community for their input.

OMB requested that the PCIE Audit Committee coordinate the collection of cost and benefit information from the IG community. The Audit Committee Chair sent a questionnaire to the IG community to gather data on the estimated audit costs and the benefits of performing an examination under the standards of AT § 501, *Reporting on an Entity's Internal Control Over Financial Reporting*. The Audit Committee received responses from each of the IGs at the 24 CFO Act agencies and then summarized the information. We shared the summary with the respondents to ensure that we had accurately captured their comments.

To gather input from the CFOs on the challenges and benefits of obtaining an opinion on internal control, we shared the results of the IG survey with the CFOC's Policies and Practices Committee and incorporated their comments. We then shared the draft study with the full PCIE and CFOC whose comments and insights were also subsequently incorporated. During this final comment period, we also asked the members to respond to two questions about the expected benefits of A-123 and obtaining an opinion on internal control.

Because publicly-traded companies had one year of experience implementing Section 404, we also looked at their experiences. We considered these experiences in light of the different environments in which the Federal Government and publicly-traded companies operate. We also considered the revisions to A-123, effective beginning in fiscal year 2006, which has many similarities to Sarbanes-Oxley.

We did not ask for supporting documentation on how the OIGs developed the cost estimates and we made some interpretation in analyzing the results. We reviewed numerous articles, surveys, and statements made before regulatory bodies relating to the implementation of Section 404 of the Sarbanes-Oxley Act. We did not, however, review all statements made before regulatory bodies.

Attachment A

Below are some of the links to articles or studies that we used that provide cost/benefit information related to implementation of Sarbanes-Oxley or similar requirements related to reporting on internal control over financial reporting.

1. <http://www.nysscpa.org/cpajournal/2004/1104/perspectives/p6.htm>
2. <http://www.404institute.com/docs/SOXSurveyJuly.pdf>
3. <http://www.managementconsultancy.co.uk/news/1137963>
4. http://www.usatoday.com/money/companies/regulation/2003-10-19-sarbanes_x.htm
5. http://www.auditnet.org/articles/Sarbanes-Oxley_Implementation_Costs.pdf
6. http://www.cfo.com/index.cfm/1_emailauthor/3661477/c_3661527/2984986
7. http://www.cfo.com/article.cfm/3010299/1/c_3046597?f=TIFarticle021105
8. http://searchcio.techtarget.com/originalContent/0,289142,sid19_gci1031357,00.html
9. http://www.404institute.com/archived_results.aspx
- 10.



Sarbanes-Oxley for
Feds.doc



SO Act Section 404
Practical Guide July 21



Federal Agencies -
Will Sarbanes-Oxley F



SOX 404.doc



Audit Fees Double
Due to Sarbox.doc

11. <http://accounting.smartpros.com/x46291.xml>
12. <http://accounting.smartpros.com/x42491.xml>
13. <http://www.eweek.com/article2/0,4149,1238790,00.asp>
14. http://techupdate.zdnet.com/techupdate/stories/main/Sarbanes_Oxley_Compliance_Spending.html?tag=tu.fd.css.link
15. <http://www.cfodirect.com/>
16. <http://www.amrresearch.com/content/resourcecenter.asp?id=429#>
17. <http://www.fei.org/> (numerous Sarbanes-Oxley articles and resources)
18. <http://www.sec.gov/spotlight/soxcomp.htm>

Supporting Tables

**Additional Work Required to Render
an Opinion on Internal Control Over Financial Reporting**

Table B

Agency	Test Additional/ Different Controls Based On Management's Assessments	More Planning and Coverage Of Cycles, Understanding, Identifying, Documenting, Reviewing Internal Control and Activities/ Other Components Of Internal Control	Management Must Document/Test Internal Control; Inadequate Documentation/ Testing May Cause Rework Or Increase In Scope	Number/ Severity Of Control Deficiencies And Evaluation And Classification Of Control Deficiencies Will Increase Level Of Work	Won't Be Able To Rotate Testing Of Controls Or Totally Rely On Other Firm's Work, Thus Increasing The Amount Of Testing	New Or Modified Systems Processes; Controls Can Increase the Scope Of Work; Will Have To Document/Test IT/General And Application Controls Testing Increase	Reporting - Extra Time Needed To Complete Auditor's Report, Including Consultation Of Wording Of Report.	Minimal Additional Testing/ Or No Answer
AID	x					x	x	
DHS	x	x					x	
DOC								x
DOD						x		
DOE	x	x						
DOI	x	x						
DOJ	x	x	x					
DOL	x					x		
DOT			x					
ED	x	x	x	x	x	x	x	
EPA	x	x				x		
GSA *	x							
HHS	x	x			x	x		
HUD	x						x	
NASA	x	x						
NRC *	x	x				x		
NSF								x
OPM	x							
SBA		x	x			x	x	
SSA *		x		x		x		
STATE	x	x						
TREASURY	x	x	x					
USDA	x		x					
VA	x							
Sum Totals	18	13	6	2	2	9	5	2
Opinion	2	2	0	1	0	2	0	0
No Opinion	16	11	6	1	2	7	5	2
All- 24	75.0%	54.2%	25.0%	8.3%	8.3%	37.5%	20.8%	8.3%
Opinion	8.3%	8.3%	0.0%	4.2%	0.0%	8.3%	0.0%	0.0%
No Opinion	66.7%	45.8%	25.0%	4.2%	8.3%	29.2%	20.8%	8.3%

* Agency previously has obtained an opinion on internal controls

**Disadvantages of Opining on
Internal Control Over Financial Reporting**

Table C

Agency	Contentious Dealings With Management/ Management Only Focused On Compliance/ Short Term Fixes	Not Aware Of Any/Not Apparent/ Did Not Identify Any	Increased Audit Costs/Cost Exceed Benefit	More Funding Needed/Inability To Fix Weaknesses/ Budget Constraint/Lack Of Staff	Other Than Clean Opinions Rendered On Internal Controls While Receiving Clean F/S Opinions/Or Just Disclaimer	Increased Agency Costs Documentation/ Testing/ Implementing Controls/Time To Put Internal Control In Place First	Would Not Identify New or Significant Findings/ Issues
AID			x		x	x	
DHS			x	x		x	
DOC			x	x	x		x
DOD			x	x		x	
DOE			x	x		x	
DOI			x				
DOJ			x			x	
DOL			x	x			x
DOT				x			
ED			x		x	x	
EPA			x				
GSA *			x				
HHS				x			
HUD					x	x	
NASA						x	
NRC *	x					x	
NSF					x		
OPM			x	x			
SBA			x	x		x	
SSA *		x					
STATE	x		x	x			
TREASURY			x	x		x	
USDA			x				
VA			x				
Sum Totals	2	1	17	11	5	11	2
Opinions	1	0	1	0	0	0	0
No Opinion	1	1	16	11	5	11	2
All- 24	8%	4%	71%	46%	21%	46%	8%
Opinions	33.3%	0.0%	33.3%	0.0%	0.0%	0.0%	0.0%
No Opinion	4.8%	4.8%	76.2%	52.4%	23.8%	52.4%	9.5%

* Agency previously has obtained an opinion on internal controls

**Benefits of Opining on
Internal Control Over Financial Reporting**

Table D

Agency	Improved Agency Focus/ Oversight/ Assessment/ Management/ Ensure Compliance	Improved Internal Controls/ Reduced Weaknesses/ Take Corrective Action	Decreased Processing Time/ Increase in Efficiency or Production	Better Use of Funds/ Saved Money/ Reduced Audit Costs	Reduced Errors/Improved Data Integrity, Reliability, Documentation, & Reporting/ Enhance Public Confidence	Limited/ Minimal Benefits	Identify New Material Weaknesses or Reportable Conditions/ Deficiencies
AID					x		x
DHS	x	x	x	x	x		
DOC						x	
DOD	x	x		x	x		x
DOE		x					
DOI		x			x		
DOJ	x						
DOL						x	
DOT		x					
ED	x	x			x		
EPA	x	x					
GSA *		x			x		
HHS						x	
HUD	x						
NASA	x						x
NRC *	x	x			x		x
NSF	x					x	
OPM		x					
SBA	x			x	x		
SSA *		x			x		x
STATE			x	x	x		x
TREASURY	x				x		x
USDA		x			x		
VA		x			x		x
Sum Totals	11	13	2	4	13	4	8
Opinion	1	3	0	0	3	0	2
No Opinion	10	10	2	4	10	4	6
All 24	45.8%	54.2%	8.3%	16.7%	54.2%	16.7%	33.3%
Opinion	33.3%	100.0%	0.0%	0.0%	100.0%	0.0%	66.7%
No Opinion	47.6%	47.6%	9.5%	19.0%	47.6%	19.0%	28.6%

* Agency previously has obtained an opinion on internal controls