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IN FOCUS

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Introduction to Financial Services: Accounting and Auditing Regulatory Structure, U.S. and International

This In Focus provides an overview of how accounting and auditing standards are created and regulated in the private sector, the federal government, and state and local governments. Different accounting and auditing standards evolved in the private and public sector to address the specific needs of their respective stakeholders. This In Focus also discusses two policy issues that might be of interest to Congress and investors.

Private Sector

The private sector includes public and private companies as well as not-for-profit organizations. The accounting and auditing standards created for publicly traded firms are subject to the Securities and Exchange Commission's (SEC's) oversight.

Federal securities laws require public companies, both domestic and foreign, to share critical information about their performance on an ongoing basis with investors, regulators, and other stakeholders. They are required to submit annual reports providing a comprehensive overview of the firm's performance; this includes the audited financial statements of the firm.

Accounting. Throughout its history, the SEC has relied on the private sector to establish and develop Generally Accepted Accounting Principles (GAAP) in the United States. GAAP is a common set of principles and practices to measure and report the economic activities of an organization. Currently, the SEC recognizes the Financial Accounting Standards Board (FASB) as the designated organization for establishing GAAP for the private sector.

Auditing. Private- or public-sector stakeholders need to have reasonable assurance that the financial statements of an entity are free of *material misstatement* whether caused by error or fraud. In the private sector, independent assurance to shareholders and other stakeholders is provided by a qualified external party—an auditor. The auditor is engaged to give an unbiased professional opinion on whether the financial statements and related disclosures are fairly stated in all material respects for a given period of time in accordance with GAAP. Generally Accepted Auditing Standards (GAAS) provides standards of practice on how an audit should be conducted.

Congress created the Public Company Accounting Oversight Board (PCAOB) as a self-regulatory organization to provide independent oversight of audits of public companies in the Sarbanes-Oxley Act of 2002 (P.L. 107-204). The PCAOB also oversees the audits of brokers and dealers, including compliance reports. The SEC has oversight authority over the PCAOB and must approve the board's rules, standards, and budget.

Material misstatement in financial reporting can be defined as information on a financial statement that could potentially affect the investment decision or the conclusions drawn by a reader about the financial status of the firm.

Federal Government

The financial statements of the U.S. government and its agencies provide taxpayers and Congress a comprehensive view of how the government manages tax revenue and how effective the federal government is at providing services. *The Financial Report of the United States Government* serves the same basic purpose as the annual report issued by a publicly traded company to its investors.

Accounting. The accounting standards established by the Federal Accounting Standards Advisory Board (FASAB) are considered Generally Accepted Accounting Principles for federal financial reporting entities. FASAB was created by the Government Accountability Office (GAO), Department of the Treasury, and the Office of Management and Budget.

Auditing. The financial statements of federal agencies and the U.S. government are audited by inspectors general, independent accounting firms, or GAO. GAO is an independent, nonpartisan agency of Congress.

GAO issues the Generally Accepted Government Auditing Standards (GAGAS), also commonly known as the "Yellow Book," which provides a framework for conducting audits. Some audit organizations within the federal government use a hybrid method of external and internal auditors.

State and Local Governments

The Comprehensive Annual Financial Report (CAFR) issued by a state or local jurisdiction serves the same purpose as the annual report issued by a publicly traded company to its investors. States and territories have the flexibility to choose the accounting and auditing standards that suit their needs.

Accounting. The voluntary standard-setting body for state and local governments' accounting standards is the Governmental Accounting Standards Board (GASB). While the SEC requires publicly traded companies to follow the accounting standards created by FASB, state and municipal governments are not required to follow accounting standards promulgated by GASB. States and municipalities can voluntarily adopt GASB accounting standards without any changes, choose not to adopt a specific standard, or modify a standard to meet their specific needs.

Auditing. State and municipal government audits are conducted by either an elected or appointed auditor. Elected auditors conduct their work at all levels of government, from states to cities and towns. Appointed auditors are often appointed by the legislature or by the chief executive of the respective municipal organization with the consent of the legislature. State and municipal auditors, whether required by law or not, might follow the GAGAS issued by GAO, while making appropriate changes to suit their specific needs, or might follow other audit standards that meet their specific needs.

Policy Issues

Two policy issues might be of particular interest to Congress and investors. The first is the limits encountered by PCAOB to inspect the work of foreign accounting (audit) firms that audit the foreign firms listed on the U.S. exchanges. The second is the newly emerging sustainability accounting standards for businesses, which encompass environmental, social, and governance (ESG) issues.

PCAOB Inspection Limits

Foreign firms accessing U.S. capital markets use foreign auditors from their home countries to audit their financial records. Over the past decade, the SEC and the PCAOB have entered into various agreements either multilaterally or bilaterally with various foreign regulators, but they face limitations with regulators in certain countries.

For example, the PCAOB is restricted from inspecting the audit work and practices of PCAOB-registered accounting firms in China, including Hong Kong, to the extent their audit clients have operations in China. The PCAOB has identified 224 unique issuers with $1.8 trillion in combined market capitalization whose auditors are located in jurisdictions where it faces obstacles. Out of these 224 issuers, 213 have auditors based in mainland China or Hong Kong, while the remaining 11 issuers have auditors based in Belgium. The PCAOB can inspect the work of another 207 U.S.-listed companies but not all of the auditors' work.

China has invoked state security laws governing the protection of state secrets and national security to limit foreign access to China-based business books, records, and audit work papers.

Some Members of Congress have proposed legislation to address the limits placed on PCAOB oversight. These proposals in the 116th Congress would require increased disclosure about noncompliance by the foreign firms listed on U.S. exchanges and eventual delisting—S. 945, S. 1731, and H.R. 3124. Some Members have also expressed concerns about the SEC's oversight of the PCAOB and the culture within the board.

ESG Disclosures

The investing community and various stakeholders—institutional and individual investors, academics, and advocacy groups—continue to engage in a long-running debate about what should be disclosed by public firms. Issues related to sustainability accounting standards have been at the forefront of that debate. Shareholder expectations for corporations to address material environmental, social, and governance (ESG) issues have continued to increase. In alignment with these increasing shareholder expectations, firms with over $70 trillion in collective assets under management have indicated they will consider ESG issues, such as political spending, climate change, diversity, and human rights, in the investment management decisionmaking process.

The Sustainability Accounting Standards Board (SASB), a U.S.-based nonprofit, has created a set of standards to help corporations address increased shareholder interest in ESG issues. Currently, corporate filers with the SEC are *not required* to follow standards as recommended by SASB. Publicly traded firms are subject to certain other ESG-related disclosure requirements (e.g., GAAP disclosure requirements), though these disclosure requirements might not be as relevant for investors' decisions as compared to those proposed by SASB.

Congress could continue to allow companies to voluntarily choose to disclose ESG issues, require companies to disclose ESG issues, or make it harder for institutional investors to call for ESG disclosures. The legislation Members have introduced to address certain ESG requirements includes H.R. 1018, H.R. 3279, H.R. 4329, and S. 592.

Proponents of sustainability accounting standards suggest that investments in material sustainability issues can increase shareholder value by, among other things, differentiating among competitors within each industry, fostering investor confidence, increasing employee trust and loyalty, and increasing access to capital.

Critics argue that existing regulations address many of the ESG issues or allow issuers to voluntarily disclose. Additional disclosures and reporting requirements, they say, could be an unnecessary regulatory burden for firms and distract firms from increasing shareholder value.

CRS Resources

CRS Report R44894, *Accounting and Auditing Regulatory Structure: U.S. and International*, by Raj Gnanarajah

CRS In Focus IF11221, *Introduction to Financial Services: Corporate Governance*, by Raj Gnanarajah and Gary Shorter

CRS In Focus IF11256, *SEC Securities Disclosure: Background and Policy Issues*, by Eva Su

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