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Auditor Oversight: Proposals for a New Regulator

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Summary

The collapse of Enron Corp. in late 2001 put the obscure topics of corporate accounting and auditing under intense scrutiny. Through the first half of 2001, Enron's public financial statements showed steady profits and fast-growing revenues. In fact, the company was using dubious accounting maneuvers to conceal both serious business and investment losses and the size of its debt burden. That these questionable accounting methods were not exposed and rejected by Enron's outside auditor has led to calls for reform in the regulation of corporate financial reporting. Uncertainty in the stock market has risen, as investors fear the discovery of "other Enrons." Reforms proposed by Congress and the executive branch focus on oversight of the independent auditor, whose responsibility (in the broadest sense) is to certify that a corporation's accounting statements reflect its true financial condition. This report provides basic background information on current regulation of auditors and summarizes alternatives now under consideration. See CRS Report RS21135 for an overview of Enron-related financial issues. The report will be updated to reflect new legislative and regulatory developments.

Federal securities law requires corporations that sell stock or bonds to the public to disclose detailed information about their financial condition. The most comprehensive disclosure documents are the registration statements that must be filed with the Securities and Exchange Commission (SEC) before a public sale of securities can take place, and the annual reports required of all companies whose securities are traded in public markets. Two major requirements that apply to these disclosures are that (1) the financial statements they contain must be prepared in accordance with generally accepted accounting principles and (2) they must be certified by independent (or outside) auditors.

The independent auditor's role is to serve as a watchdog, or gatekeeper, and to provide the markets with assurances about the reliability of corporate financial statements. To many observers, the failure of firms like Enron and Global Crossing, and the suspicion that overly "creative" accounting methods may be in wide use, indicate that the watchdog function of the independent auditor needs strengthening. The regulation of auditors has become the major locus for post-Enron accounting reform proposals.

Current Regulation of Auditors¹

The securities laws give the SEC broad authority to regulate all aspects of accounting by publicly traded companies, including the performance of independent audits. Historically, however, the SEC has not attempted to regulate directly, but has relied on private-sector bodies to set accounting and auditing standards, and to enforce those standards. The SEC does review corporate disclosure filings, issue staff bulletins that interpret accounting rules, and impose sanctions on accountants, but it recognizes that direct supervision of all corporate accounting is beyond its capacity.²

The most comprehensive supervision of auditors of public companies is exercised by the American Institute of Certified Public Accountants (AICPA) and its SEC Practice Section (SECPS). These private accounting bodies, while they do have a regulatory and disciplinary role, do not have the same formal relationship to the SEC as the National Association of Securities Dealers (NASD) and the stock exchanges. These latter institutions are explicitly recognized in the securities statutes as “self-regulatory organizations” (SROs), which must register with the SEC and are charged with specific responsibilities and duties to maintain fair and orderly markets and protect public investors. The SEC must approve major changes in NASD or exchange rules, and may impose new rules upon them if it sees fit. No federal agency exercises this degree of control over private accounting organizations.

The degree to which the acts or omissions of Enron’s outside auditor contributed to its collapse is likely to be the subject of complex civil and/or criminal litigation. However, concerns about independent audits go well beyond Arthur Andersen’s difficulties. The broad question is whether auditors are an effective barrier to financial reporting that is opaque, misleading, or, at worst, fraudulent. Are auditors more likely to challenge (or refuse to certify) financial statements that mask their clients’ financial problems, or to accommodate corporate management? Do auditing firms (in their dual capacity as consultants and financial engineers) often help devise structures and transactions that may meet the letter of the law but allow manipulation of reported profits?³ In the wake of Enron, the answers to these questions are not clear, and this uncertainty is driving calls for reform.

¹ For more on auditor regulation, see CRS Report RS21120, *Auditing and Its Regulators: Proposals for Reform After Enron*, by Bob Lyke.

² To put the limitations in perspective, consider that Enron paid \$25 million for audit services in 2000, while the SEC’s budget that fiscal year was \$368 million. Thus, auditing Enron alone would have consumed nearly 7% of the SEC’s resources – and over 17,000 companies file financial statements with the SEC.

³ Arthur Andersen billed Enron more than \$1 million for advice on the Raptor “special purpose entity” transactions, which hid (for a time) over \$1 billion in losses.

Proposals for Reforms in Auditor Regulation

Auditor regulation is the preferred target of the many bills introduced post-Enron that seek to improve corporate financial reporting. The legislative proposals take three distinct approaches. First, several bills propose to increase auditors' exposure to civil suits in cases of securities fraud. Second, other bills seek to reduce conflicts of interest by putting limits on the kinds of non-audit services that outside auditors can provide to their audit clients.⁴ Finally, and the focus of this report, are five bills – and proposals from President Bush and SEC Chairman Harvey Pitt⁵ – that would create a new regulator to shift auditor oversight away from private groups towards direct government oversight.

The proposals for a new auditor oversight body differ in detail. (A side-by-side comparison of the major features of each proposal appears in table 1 below.) Implicitly, however, they share a common assumption that the present system of oversight by private industry groups is inadequate and that a more direct government regulatory role is needed. Several elements common to all the proposals would remove the control and funding of auditor oversight from the accounting industry. These include the following:

- A majority of the new regulator's governing board would consist of non-accountants.
- The oversight body would either be part of the SEC, or would be under direct SEC oversight.
- The new regulator would enforce standards of ethics, competence, and/or independence, and would be responsible for maintaining quality control in auditing. (An exception is the organization proposed by H.R. 3795, which would conduct audits itself.)
- The audit regulator's funding would not depend on voluntary contributions by accountants and accounting firms.

Any of the proposals, if put into place through legislation or SEC rule making, would bring to the accounting industry a combination of the kind of self-regulation (with SEC oversight) that currently applies to stock brokers and exchanges, and direct SEC regulation of the kind that applies to mutual funds and other aspects of the securities industry. As Table 1 shows, the mix of self- and direct regulation varies from proposal to proposal, but any of them would represent a marked change in how independent auditors – the accounting watchdogs – are themselves watched.

⁴ An indexed list of Enron-related legislation appears on the CRS website.

⁵ The President's proposal (which covers other aspects of accounting as well) was set out in a speech on March 7, 2002. See [www.whitehouse.gov/news/releases/2002/03/20020307-3.html] Chairman Pitt's proposal was set out on January 17, 2002, in a speech, "Regulation of the Accounting Profession." See [www.sec.gov/news/speech/spch535.htm].

Table 1: Proposals for a New Auditor Oversight Body

	SEC Chairman's Proposal	President Bush's Proposal	H.R. 3763 (Rep. Oxley)	H.R. 3795 (Rep. Kucinich)
New Regulator	Private sector regulatory body	Independent Regulatory Board	Public Regulatory Organization (PRO)	Federal Bureau of Audits (FBA)
Membership/Governance	Dominated by public membership	Not specified, but would be under SEC supervision	Accounting professionals, and public members (who shall constitute at least 2/3 of the governing board)	Part of the SEC; officers to be presidential appointees, with Senate confirmation
Scope of Jurisdiction	Disciplinary power in cases of violations of ethical and/or competence standards; permanent peer review/quality control staff	Ability to monitor, investigate, and enforce its ethics principles (see below) by punishing individual offenders	Only PRO-certified accountants can perform independent audits; PRO can impose sanctions on violators of standards of competence, ethics, or independence	Would conduct annual audits of all corporations that report to the SEC
Accounting Standards	No provisions	Would develop standards of ethics and competence; CEO to certify financial statements	No provisions.	SEC, not FBA, would assume control of generally accepted auditing standards
Auditor Independence	No provisions/SEC would retain existing authority	SEC to strengthen independence rules	PRO would review potential conflicts of interest and impose sanctions where SEC rules were violated or independence was impaired.	10-year prohibition on FBA employees taking jobs with issuers or accounting firms that provide audit-related services
Source of Funding	Unspecified (but private)	Unspecified	Self-funded, but not solely by the accounting profession	Fees sufficient to cover operations would be collected by the SEC from securities issuers
Source of Authority	Existing SEC authority	Existing SEC authority	New legislation	New legislation

Table 1 (continued): Proposals for a New Auditor Oversight Body

	H.R. 3818 (Rep. LaFalce)	H.R. 3970 (Rep. Dingell)	S. 2004 (Sens. Dodd & Corzine)
New Regulator	Public Accounting Regulatory Board	Independent National Board of Accountancy	Independent Public Accounting Board
Membership/ Governance	7 board members selected by SEC and Comptroller General; 2 members would be accountants	5 members appointed by SEC – no more than 2 to be accountants (who could not be in current practice)	5 board members (no more than 2 to be CPAs), appointed by SEC, the Fed, and the Treasury
Scope of Jurisdiction	All public accountants who perform audits must register with the board, which will establish standards for auditors, conduct quality reviews and direct inspection of audits, and inspect registered public accounting firms	All accountants who prepare SEC-required documents must register and make periodic disclosures; board would inspect auditing and accounting practices of registered firms; board to make and enforce quality control and audit standards	Under SEC oversight, the board would annually inspect accounting firms that perform audits, review selected audits, and issue a public report on its findings. Public accountants who perform audits must register with the board
Accounting Standards	Board will establish quality control and professional and ethical standards for auditors	SEC would conduct an annual review of FASB (with GAO evaluation of review process); CEO and CFO must certify financial statements	Board would establish auditing and quality control standards; SEC would designate a new accounting standard setting board, to be funded by securities issuers
Auditor Independence	Board would establish standards for auditor independence. Prohibition on provision of many non-audit services to audit clients	Broad prohibition of non-audit services by auditors; board to enforce SEC independence rules; auditor rotation required every 7 years	Provision of certain non-audit services prohibited; others permitted if approved by the issuer's audit committee
Source of Funding	To be funded by fees on securities issuers whose financial statements must be audited	Registration fees and annual dues paid by registered accounting firms	Registration fees and annual dues collected from registered accounting firms
Source of Authority	Amendments to Securities Exchange Act of 1934	New legislation	New legislation

Latest Developments

On April 16, 2002, the House Financial Services Committee passed H.R. 3763, by a vote of 14-12. In addition to creating the Public Regulatory Organization described in Table 1, the bill would require real time disclosure of certain information, including insider transactions, and prohibit corporate insiders from trading while the company pension fund was “locked down.” The bill directs the SEC to issue rules to improve the transparency of financial reports, including treatment of off-balance sheet entities and related-party transactions. GAO and the SEC are directed to study and report on several issues, including stock analysts, bond raters, corporate attorneys, the role of investment banks in manipulative accounting, corporate governance, and SEC review of financial statements and enforcement actions.