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Auditor Reform Proposals: A Side-by-Side Comparison

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Summary

This report compares the major provisions of three auditor and accounting reform proposals: H.R. 3763 (passed by the House on April 24, 2002), S. 2673 (reported by the Senate Banking Committee on June 25th and debated on the Senate floor beginning July 8th), and proposed rules that the U.S. Securities and Exchange Commission (SEC) published on June 26th under its existing authority.

The cornerstone of U.S. securities regulation is disclosure. According to this approach, the best way to protect investors from fraud, hype, and irrational exuberance is to require companies selling stocks and bonds to the public to disclose detailed information about their financial strengths and weaknesses. Without complete and accurate information, investors cannot make rational decisions, and the market cannot allocate funds to the most productive users. Ill-informed investment choices hurt individual investors, but there are also costs to the national economy in terms of wasted resources, jobs not created, and innovations forgone. If investors decide they cannot trust corporate disclosures, they will be less likely to buy stocks and bonds, raising the cost of capital for all firms, good and bad.

Since the market's peak in January 2000, U.S. stocks have lost over $4 trillion in value. The share prices of firms that fail to meet their own profit projections, or Wall Street's expectations, are apt to plummet. The desire to avoid or postpone stock market losses creates a powerful incentive for corporate management to engage in accounting practices that conceal bad news. The cases of Enron, WorldCom, and a growing list of others suggest that this incentive is often strong enough to overwhelm the watchdog mechanisms in place to prevent deceptive financial reporting.

H.R. 3763, S. 2673, and the SEC proposal seek to restore confidence in corporate reporting by enhancing the oversight of financial accounting. All three proposals would create a new oversight body to regulate independent auditors (whose certification the law requires to be affixed to the annual reports of all publicly traded corporations). Under current practice, auditors are regulated mainly by private professional accounting groups; the new bodies would also be private, but would operate under the direct oversight of the SEC. A majority of board members would be non-accountants (or accountants a certain number of years removed from active practice). The proposals differ in the scope of authority granted to the new board; the Senate version gives the board the most sweeping powers. Among the other provisions that appear in one or more of the proposals are the following: auditors would be prohibited from providing certain non-audit consulting services to their audit clients; top corporate officials would have to personally attest to the accuracy of their firm's accounting (and face penalties if financial statements were later found to be erroneous); stock trades by corporate insiders would have to be made public within a day or two; and the oversight role of the board of directors would be strengthened. This report compares the major features of the three proposals. It will be updated as legislative developments warrant.

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The table below presents a side-by-side comparison of H.R. 3763 (passed by the House on April 24, 2002), S. 2673 (reported by the Senate Banking Committee on June 25th and debated on the Senate floor beginning July 8th), and proposed rules that the U.S. Securities and Exchange Commission (SEC) published on June 26th under its existing authority.

The provisions are set out in seven categories:

- creation of a new auditor oversight body;
- auditor independence;
- enhanced accounting disclosure requirements;
- stock analysts;
- corporate executive accountability;
- corporate boards; and
- other provisions.

Table 1. Comparison of Provisions of H.R. 3763, S. 2673, and SEC Proposed Auditor Reform Rule

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
I. Creation of a New Auditor Oversight Board.			
Name of new regulator	Public Regulatory Organization	Public Company Accounting Oversight Board	Public Accountability Board
Number of board members	Five	Five	Nine
Board composition	Two members would be accountants with recent experience in auditing public companies; two could be CPAs, provided they had not worked in the accounting industry for two years; and at least one member must never have been a CPA	Three must never have been practicing accountants; two may be accountants who have not practiced actively for five years	Three members may be licensed CPAs, but they would not vote on disciplinary matters. The remaining six would be public members, representing public companies and investors

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
Scope of board’s activity	(1) to review auditors’ work product, (2) to enforce (but not set) standards of competency and professional ethics, and (3) to review conflicts of interest between auditors and their clients.	(1) set auditing, quality control, and independence standards, (2) inspect the auditing operations of public accounting firms (required to register with the board and file annual reports if they audited public companies), and (3) investigate violations of securities laws, standards of ethics, competency, and conduct set by the accounting profession, and the board’s own rules	(1) conduct quality control reviews of audit procedures and practices of accounting firms (annually for firms with 70+ audit clients, at least triennially for others) to ensure that auditors have and follow appropriate policies re: independence, objectivity, and integrity; personnel management; acceptance and termination of audit engagements; and audit performance, methodology, and disputes; and (2) enforce ethical and competency standards
Who must register with the board?	No registration requirements	Accounting firms that audit public companies	(1) Accountants who perform audits and (2) public companies (as adjunct members)
Standard-setting powers	None	Would set auditing, quality control, and independence standards	Would set ethics, auditing, and quality control standards, or could rely on (and oversee) private accounting groups as source of standards

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
Disciplinary powers	Could impose a variety of sanctions, including a determination that a firm is not qualified to audit public companies. SEC and state accountancy boards would be notified of final sanctions	Could impose a variety of sanctions, including a determination that a firm is not qualified to audit public companies. SEC and state accountancy boards would be notified of final sanctions	Could impose fines, censures, and suspend firms from auditing publicly traded corporations. SEC would be notified of final sanctions
SEC to review and possibly reduce board sanctions?	Yes	Yes	Yes
SEC oversight authority to abrogate, add to, or modify any of the board's rules?	Yes	Yes	Yes
Source of funding	Specifies that the board will not be solely dependent on the accounting profession for its funding	Funded by accountants, who would pay the cost of mandatory registration with the board, and by companies that sell securities to the public, who would be assessed a fee proportional to the value of their securities in circulation in the public market.	Funded by accounting firms and publicly traded companies

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
II. Auditor Independence.			
Bans on provision of certain non-audit services by auditors to their clients	Directs the SEC to revise its auditor independence rules to prohibit an independent auditor from designing or implementing financial information systems or from performing internal audit work for companies for which it is the outside auditor. (Under current SEC rules, auditors are barred from supervising or managing their clients' information systems, and from performing more than 40% of their clients' internal audits.)	Amends statute to ban financial system design and internal audit work. Existing SEC regulations against provision of certain other non-audit services are also incorporated into the statute. Except in certain cases, the Senate bill stipulates that auditors may provide permitted consulting services (such as tax preparation) to their audit clients only with the approval of the audit committee of the client's board of directors	No provisions. PAB would monitor auditors' internal independence rules
Who would set auditor independence standards?	The SEC	The new board	The SEC
Auditor rotation	No provision	Requires the rotation of the chief audit partner after auditing a company for five consecutive years	Would require partner rotation after seven years (the current AICPA standard)

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
Auditor/client employment relationships	No provision	Bars an accountant from serving as the outside auditor for a company where a top officer had been employed by the accountant within the past year	Quality control reviews would address employees of auditors joining clients

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
III. Enhanced Accounting Disclosure Requirements.			
Insider transactions in corporate securities	Stock trades by corporate insiders must be reported electronically to the public on the business day following the transaction. (Under current rules, disclosure may not be required for weeks or months.)	Insider trades must be reported to the public within two business days of the transaction	No provision
Require enhanced disclosure of off-balance sheet transactions, and transactions with unconsolidated subsidiaries?	Yes	Yes	No
Require disclosure of any change in a corporation's code of ethics?	Yes	Yes	No
Other disclosures required	Real-time disclosure of events that would be material to investors' decisions to buy or sell. The SEC would determine the kinds of events subject to real-time reporting	(1) the use of pro-forma financial statements (unaudited reports that do not follow generally accepted accounting principles) and (2) corrections or adjustments of past financial statements that were made at the insistence of a corporation's auditor	Disclosure of any sanctions imposed on a firm's auditor in the past five years

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
Accounting standards setting	No provisions	Directs the SEC to ensure that the Financial Accounting Standards Board, which sets accounting standards, be funded by contributions from securities issuers (rather than by the accounting industry). Also requires FASB to adopt procedures to ensure prompt consideration of needed changes to accounting rules	FASB would be funded out of the contributions of accountants and public companies to the new PAB
IV. Stock Analysts.			
New disclosure requirements and regulation of Wall Street analysts	Directs the SEC to study conflicts of interest that may affect analysts	Directs the SEC or the NASD (which regulates stockbrokers) to adopt rules of conduct for stock analysts. Mandates that these rules require disclosure of analysts' (and their firms') investment in, and business relationships with, the companies they cover	No provision

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
V. Corporate Executive Accountability.			
Requires personal certification of financial statements by CEOs and CFOs?	Yes	Yes. Also requires certification of the adequacy of a company's internal accounting controls	No (but a rule proposed separately by the SEC would require this)
Penalties if financial statements are found to be erroneous?	Profits from insider securities transactions would be disgorged	CEOs and CFOs would forfeit both trading profits and bonuses received before a financial report was restated	No provision
Disclosure of certain loans by firms to top executives?	Yes	Yes	No
Authorizes SEC to bar violators of securities laws from serving as officers or directors of any publicly traded company?	Yes	Yes	No. (Legislation required)
Makes it a criminal offense for an officer or director of a corporation to mislead, coerce, manipulate, or fraudulently influence an independent auditor?	Yes	Yes	No. (Legislation required, although misleading an auditor could in many cases be construed as securities fraud under current law.)

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
VI. Corporate Boards.			
Audit committee provisions	None	Makes the audit committee of the board of directors responsible for the hiring, compensation, and oversight of the independent auditor. Audit committee members would be prohibited from accepting consulting fees from the company, and would be required to establish procedures for receiving complaints about accounting and auditing, including anonymous "whistle blower" reports. At least one member of the audit committee would have to be a "financial expert," to be defined by the SEC	None

Provision	H.R. 3763	S. 2673	SEC Proposed Rule
Auditor report to audit committee	No provision	Requires the independent auditor to report to the audit committee on critical accounting policies followed, any disagreements with management over accounting principles, and other matters	No provision
VII. Other Provisions.			
SEC budget	No provision (but H.R. 3764, reported by House Financial Services Committee, authorizes $776 mil. for the SEC in FY 2003)	Authorizes appropriations for the SEC for FY 2003 of $776 mil., as opposed to $469 mil. in the Administration's budget request	No provision, but would not oppose a budget increase
Studies required	Calls for the SEC to study stock analysts, bond rating agencies, SEC enforcement actions, and corporate governance, and for the GAO to study the role of Wall Street investment banks in corporate accounting deceptions	Directs the SEC to study bond rating agencies, and the GAO to study the effects of consolidation in the accounting industry	No provision