Order Code RS21120
Updated September 3, 2002

CRS Report for Congress
Received through the CRS Web

Auditing and Its Regulators: Reforms after Enron

Bob Lyke
Specialist in Social Legislation
Domestic Social Policy Division

Summary

Accounting problems at Enron, WorldCom, and other companies have raised important questions about the audits of corporate financial statements. These audits usually are done by independent accountants who are certified public accountants (CPAs); they are supposed to be carried out in accordance with generally accepted auditing standards (GAAS), rules which have a carefully defined technical meaning. The U.S. Securities and Exchange Commission requires audited financial statements when public companies register to sell new securities and annually thereafter. Auditor assurances about company financial statements can remove a barrier to the efficient use of capital and offer some protection to third party investors.

Auditors are regulated by both governmental agencies and professional organizations, though many question whether this oversight has been adequate. Enron's auditor, Arthur Andersen, was investigated by the U.S. Securities and Exchange Commission (SEC), several congressional committees, and other agencies, and it is facing numerous law suits. A federal jury convicted the firm on obstruction of justice charges on June 15, 2002, and it ceased all audit work as of the end of August, 2002.

Numerous accounting and audit reforms have been proposed, including some by the accounting industry. On July 30th, the President signed the Sarbanes-Oxley Act of 2002 (P.L. 107-204), which among other things creates a new oversight board for auditors, prohibits auditing firms from providing certain consulting work for audit clients, and requires rotation of audit partners at least every 5 years. The new law also imposes new requirements on corporate boards and executives and increases governmental oversight and criminal penalties. Issues regarding its implementation have already emerged.

What is Auditing?

Broadly speaking, auditing is a systematic process for obtaining and assessing evidence regarding assertions of one kind or another in accordance with established criteria. Serious accounting problems at Enron, WorldCom, and other companies have raised important questions about **financial statement audits** of corporations and other private sector organizations in which accountants express an opinion on financial representations made by the management of these entities. Other types of audits include compliance audits, which see if established policies and procedures are being followed, and operational audits, which see if organizations are efficient and effective. Accountants are also increasingly engaged in a widening array of other assurance services, which have different standards and procedures than audits.

Financial statement audits of private sector organizations usually are done by independent accountants (sometimes called external accountants). Today nearly all of these audits are carried out or supervised by accountants who are certified public accountants (CPAs). Independent accountants are owners or employees of private sector firms that are separate from the entities they audit; they might be distinguished from internal accountants, who work for the organizations being audited, and government accountants, who do most auditing of governmental agencies. However, independent accountants also do internal and government accounting work.

Financial statement audits of private sector organizations are to be conducted in accordance with **generally accepted auditing standards (GAAS)**; their basic objective is to see if the balance sheet and related statements about income, retained earnings, and cash flows are fair presentations, in all material respects, of certain financial information in conformity with generally accepted accounting principles.

- GAAS are *qualitative* standards regarding who is to conduct audits, how audits are to be planned and carried out, and how audit results are to be reported; they are not lists of specific audit procedures.
- GAAS have a carefully defined technical meaning that clarifies both what audits do and what they do not do; understanding these standards is important when questions arise regarding audit engagements.
- GAAS and other standards for private sector audits are established largely by the American Institute of Certified Public Accountants (AICPA).

Generally accepted accounting principles (GAAP) are the conventions, rules, and procedures that define accepted financial accounting practices at a particular time; they include both broad guidelines as well as detailed procedures.

- The most important source of GAAP for private sector entities is the statements and interpretations of the Financial Accounting Standards Board (FASB), a nongovernmental entity that began operating in 1973, and similar issuances of its predecessors.
- Other sources of GAAP with lesser authority include issuances from FASB task forces and staff and from the AICPA, widely accepted industry practices, and other professional positions and literature.
- The U.S. Securities and Exchange Commission (SEC) historically has accepted GAAP developed from these private sources; however, it has broad authority to establish accounting principles for the companies within its jurisdiction (generally, public companies whose securities are offered or sold in interstate commerce).

(On July 10, 2002, the Subcommittee on Commerce, Trade, and Consumer Protection of the House Committee on Energy and Commerce approved an amended version of H.R. 5058 (Stearns) which among other things would establish an Accounting Reform Commission to study and recommend steps for improving accounting standards and the process by which they are set. The bill would instruct FASB to complete work on several projects and develop additional standards regarding off-balance sheet financing and mark-to-market accounting.)

Auditing plays a critical role in modern economies, which are characterized by large multi-faceted organizations, complex economic exchanges, and remote relationships between business managers and the owners and other investors. Managers have the ability to obtain reliable information about their own organizations, at least in theory, but it is risky for outside investors and other creditors to rely on managers' representations alone. To the extent they provide assurances about these representations, auditors remove a barrier to the efficient use of capital and offer some protection to parties that could be indirectly affected by investing decisions. Annual financial statement audits have become common for nearly all large organizations because of the demands of outside investors (in the case of business entities), outside supporters (in the case of not-for-profit organizations), tax authorities, and government regulators. The SEC requires audited financial statements when public companies register to sell new securities and annually thereafter.

Who Regulates Auditors?

Currently, auditors are subject to regulatory oversight from both governmental agencies and professional organizations. In addition, they can sometimes be legally liable for breach of contract or for a tort (a civil wrong other than breach of contract).

State Boards of Accountancy. These governmental boards (or agencies that perform similar functions) administer state laws governing accountants and accounting services. They are responsible for licensing CPAs, for whom there is no national or federal certification. All states require CPAs to have passed the Uniform CPA Examination, and most now require new candidates to have at least 150 college credit hours (i.e., 5 years of college), including courses in accounting subjects. Most states require CPAs to have 30 to 40 hours of continuing education each year, and some require practical experience before granting full licenses. State accountancy boards can require CPAs and their firms to undertake remedial steps to continue their practice, and they sometimes suspend and terminate licenses. Arthur Andersen, the auditor for Enron, surrendered its license to practice in all states as of August 31, 2002.

American Institute of Certified Public Accountants. The AICPA is a professional trade association of certified public accountants. In addition to establishing auditing standards for the private sector, it has a Code of Professional Conduct for its members with both general principles and rules of conduct. The six general principles provide a framework for professional conduct; they deal broadly with CPA responsibilities, the public interest, integrity, objectivity and independence, due care, and the scope and nature of services. Members are required to comply with the rules of conduct (for which formal interpretations provide additional guidance); they include provisions on independence, engagement standards, confidentiality, contingent fees, discreditable acts, advertising, etc. Violations are considered by the Professional Ethics

Division and may result in requirements for continuing education or prior clearance of future work. Serious misconduct can result in suspension or termination of AICPA membership. **State CPA societies** have similar though not always identical rules for their members. Sometimes state societies and the Professional Ethics Division conduct joint investigations.

Securities and Exchange Commission. The SEC is an independent federal regulatory agency responsible for administering federal securities laws. It has authority to regulate the initial issuance of securities and their subsequent sale; for both, it requires companies to submit financial statements that have been audited by independent accountants. Under Regulation S-X, Rule 2-01, it prescribes qualifications for these accountants, including the rules just mentioned on auditor independence. Historically the SEC has relied on the AICPA to oversee accountants, including those who audit public companies, but under Administrative Rule 2(e) it may disqualify from its practice accountants who are unqualified, lack character or integrity, engage in unethical or improper professional conduct, or willfully violate (or aid and abet others to violate) federal securities laws. Other sanctions include peer review, prohibitions on new engagements, and requirements for continuing education. After its conviction on obstruction of justice charges, Andersen informed the SEC that it would cease practicing before it by August 31, 2002.

Other Legal Liability. Auditors can be sued for breach of contract by their clients (the entities being audited) for failing to carry out their work with due professional care. Among other things, clients usually must show they suffered damages and that there is a close causal connection between the breach and the damages. To reduce this risk, most accounting firms use engagement letters to clarify what they will do and identify client responsibilities.

Third parties normally can sue auditors only in a tort action, not for breach of contract. (One exception would be if the third party is a subrogee of the client, such as a trustee in bankruptcy.) Third parties must also show they suffered damages and that there is a close causal connection between the auditor's breach and the damages. However, in some states, barring a showing of gross negligence or fraud, third parties may be unsuccessful in their suit unless it is shown that the auditors actually foresaw the parties would rely on the audit (or in some states, that the auditors might reasonably have foreseen their reliance). Third parties may also sometimes bring suit against auditors under provisions of federal securities laws.

What Audit Issues Are Being Raised?

Controversy over corporate accounting practices continues to grow as new allegations of errors, misstatements, and fraud keep emerging. It is apparent that the audit problems at Enron were not isolated occurrences, though it remains unclear how widespread and how material audit shortcomings generally are. Nonetheless, it is important to distinguish the following kinds of corporate accounting problems since remedies and steps to prevent future problems would differ:

- was there failure of auditors to select appropriate auditing procedures or to make particular accounting judgments that would have revealed more of a corporation's finances?

- was there failure of auditors to follow generally accepted auditing standards?
- was there failure or weakness of the auditing standards themselves?
- was there failure or weakness of the accounting standards?
- was there failure of the corporation to provide material information?

Audits do not prevent bad business decisions, let alone shield firms from bankruptcy. To some, Enron's bankruptcy might be attributed primarily to its trading in the derivatives market and its continual need for capital. However, others ask whether audit problems may have contributed to both the rapid rise and sharp fall of Enron's stock prices.

Questions regarding the Enron audits have received widespread publicity. Perhaps the most important for the accounting industry is whether Andersen's extensive consulting work for Enron – $27 million in its last audit year alone – compromised the independence it should have maintained throughout its work. The AICPA has long had rules on independence (codified in Rule 101 of the Code of Professional Conduct), and it had been cooperating with the SEC to strengthen them for audits of public companies. Nonetheless, criticism of independence standards has increased in recent years as accounting firms have expanded their consulting work. In June 2000, the SEC proposed substantially more restrictive rules for audits of public companies, though the final provisions adopted that November were generally seen as favorable for the accounting firms. For further information about this particular controversy, see CRS Report RS20707, *Auditor Independence: the SEC's New Rule*, by Mark Jickling.

What Reforms Have Been Proposed?

Numerous accounting and auditing reforms have been proposed, including some by the accounting industry. Most of the leading proposals would establish a new oversight board for auditors of public companies, though they differ on the scope of its powers and the degree of its independence from the SEC and from the firms and accountants it would regulate.

House Legislation. The leading House bill was an amended version of H.R. 3763 (Oxley), which the House approved on April 24, 2002. Other relevant House bills include H.R. 3617 (Markey), H.R. 3671 (Hastings), H.R. 3693 (Jackson-Lee); H.R. 3736 (Ackerman); H.R. 3795 (Kucinich), H.R. 3818 (LaFalce), H.R. 3829 (Stupak), H.R. 3970 (Dingell), and H.R. 4083 (LaFalce).

Senate Legislation. The leading Senate bill (S. 2673) was reported by the Committee on Banking, Housing, and Urban Affairs on June 25, 2002. Floor debate began on July 8, and an amended version passed on July 15. Other relevant Senate bills include S. 1896 (Boxer), S. 1933 (Shelby), S. 2004 (Dodd), S. 2056 (Nelson), S. 2247 (Durbin), and S. 2460 (Levin).

Conference Agreement. On July 24, a conference committee reached agreement on the differences between the bills passed by the House (H.R. 3763) and the Senate (S. 2673, formally an amendment to H.R. 3763). The agreement, the Sarbanes-Oxley Act of 2002, largely follows the Senate amendment, though some modifications proposed by the House were accepted. Both the House and Senate approved the agreement on July 25, and the President signed it on July 30th (P.L. 107-204). Among other things, the agreement creates a new oversight board for auditors, prohibits auditing firms from providing certain consulting work for audit clients, and requires rotation of audit partners at least every 5 years. The law also imposes new requirements on corporate boards and executives and increases governmental oversight and criminal penalties. For details, see CRS Report RL31483, *Auditor Reform Proposals: A Side-by-Side Comparison*, by Mark Jickling.

How the Sarbanes-Oxley Act will be implemented has already become an issue. Within a week of the signing ceremony, some Members of Congress accused the Administration of taking a narrow view of provisions regarding securities fraud, whistle-blower protection, and punishment for shredding documents. There is also growing interest in whom the SEC will name to the new oversight board.

The SEC. On June 26, 2002, the Commission published proposed rules to reform oversight and improve accountability of auditors of public companies. For details, see [http://www.sec.gov/rules/proposed/33-8109.htm]. The central part of the proposal, a requirement that companies' auditors be members of a new independent public accountability board (PAB), was largely superceded by the Sarbanes-Oxley Act. On June 28, the Commission identified 945 companies with annual revenues exceeding $1.2 billion whose chief executive and chief financial officers would have to personally certify that the most recent reports filed with the Commission are both complete and accurate. For most of these companies, the deadline for these certifications is August 14, 2002.

Since the Enron controversy broke, the SEC has stepped up its review of company financial statements and started investigations of a number of accounting irregularities. Some question whether the agency has enough resources to monitor accounting practices at all public companies, let alone take on new oversight responsibilities. The U.S. General Accounting Office (GAO) has found that the SEC does not have sufficient staff or authority even for all of its current work and that it lacks a comprehensive strategy for dealing with these problems (GAO-02-483T). The Sarbanes-Oxley Act increased the authorization for SEC appropriations.

The President. On March 7, 2002, President Bush outlined a 10-point plan to improve corporate responsibility and shareholder protections. Included were proposals for an independent regulatory board for the accounting profession, for greater investor confidence in auditor independence and integrity, and for accounting standards more responsive to investor needs. On July 9, the President called for longer prison sentences for executives convicted of fraud, a new task force to pursue and prosecute criminal activity, and additional personnel and funding for the SEC.

The Accounting Industry. The AICPA and the largest accounting firms generally opposed strict external oversight of auditing, arguing that new regulatory bodies would be cumbersome and lack professional expertise. They generally opposed wide bans on providing consulting services for audit clients. For the most part, they favored the House bill (H.R. 3763) rather than the Senate bill (S. 2673). Since Arthur Andersen can no longer perform audits, the so-called "Big-5" accounting firms have been reduced to four: PricewaterhouseCoopers, Deloitte and Touche, KPMG, and Ernst and Young.