

Updated January 13, 2022

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 sectors to address the specific needs of their respective stakeholders. Two policy issues that might be of interest to Congress and investors are also discussed.

Private Sector

The private sector includes publicly traded and private companies as well as nonprofit organizations. The accounting and auditing standards created for publicly traded firms are subject to Securities and Exchange Commission (SEC) 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. The companies are required to submit annual reports providing a comprehensive overview of their performance, including their audited financial statements.

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

Auditing. Private- and public-sector stakeholders need reasonable assurance that an entity's financial statements 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) provide standards of practice on how an audit should be conducted.

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

Material misstatement in financial reporting can be defined as misleading information on a financial statement that could potentially affect a reader's investment decisions or conclusions about the financial status of a 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 and other sources of revenue and how effective the federal government is at utilizing the resources. *The Financial Report of the United States Government* serves the same essential purpose as the annual report issued by a publicly traded company.

Accounting. The accounting standards established by the Federal Accounting Standards Advisory Board (FASAB) are considered GAAP for federal financial reporting entities. FASAB was created by the Government Accountability Office (GAO), the 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 agency inspectors general, GAO, or independent accounting firms. GAO issues the Generally Accepted Government Auditing Standards (GAGAS), also commonly known as the "Yellow Book," which provide a framework for conducting audits.

State and Local Governments

The Annual Comprehensive Financial Report (ACFR) 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). Although 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 as needed.

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 the chief executive of the respective municipal organization with the legislature's consent. State and municipal auditors might follow GAGAS or 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 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. The SEC and the PCAOB have entered into various bilateral or multilateral agreements with various foreign regulators over the past decade. Nevertheless, the SEC and the PCAOB still face limitations with regulators in certain countries, including the People's Republic of China.

For example, the Chinese government restricts the PCAOB from inspecting the audit work and practices of PCAOB-registered accounting firms in China, including Hong Kong. Meanwhile, according to the U.S.-China Economic and Security Review Commission, U.S. exchanges list 248 Chinese companies with \$2.1 trillion in combined market capitalization as of May 2021. (Most major U.S. exchanges provide information identifying foreign-headquartered companies, although NASDAQ stopped providing this information in 2019.)

Congress passed the Holding Foreign Companies Accountable Act (HFCAA, P.L. 116-222) to address audit limitations faced by the PCAOB. HFCAA requires foreign companies listed in U.S. stock exchanges to be subject to the same accounting and audit oversight as listed domestic companies. The law requires the SEC to identify each foreign firm not in compliance and suspend trading of those companies from U.S. exchanges after three years of noncompliance. Without any changes to the existing law, these companies would be delisted from U.S. exchanges beginning in 2024. In the 117th Congress, the Senate passed a bill accelerating HFCAA (S. 2184) to shorten the noncompliance period to two years and begin delisting foreign companies not in compliance with the PCAOB audit requirements beginning in 2023. The House is considering a similar proposal.

At least some of the Chinese listed companies would likely not want to be subject to public audits. For example, eight of the companies are national state-owned enterprises. Since October 2020, 17 Chinese companies have delisted from U.S. exchanges for various reasons, including material misstatements. (Four companies delisted after being identified in Executive Orders 13959 and 14032 restricting certain U.S. investments in certain firms identified as tied to China's military.)

Some Members have also expressed concerns about the SEC's oversight of the PCAOB and the culture within the board.

ESG Disclosures

Companies, investors, and various stakeholders—including academics and advocacy groups—continually debate exactly what should be disclosed by public firms. Recently, issues related to sustainability accounting standards and increasing shareholder expectations for corporations to address material ESG issues are at the forefront of those debates. For example, demand for “ESG funds”—funds that invest in companies deemed to be especially responsible on ESG issues—continues to increase. Reportedly, ESG funds' assets have surpassed \$2 trillion globally. Meanwhile, the SEC continues to scrutinize “greenwashing”—labeling funds or bonds as ESG investments while the criteria used to make the classification are questionable or not disclosed.

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. In 2021, SASB merged with the International Integrated Reporting Council (IIRC) to form the Value Reporting Foundation. While SASB Standards and the IIRC framework are considered complimentary, corporate filers with the SEC are not required to follow either of the protocols. Publicly traded firms are subject to certain other ESG-related disclosure requirements (e.g., GAAP disclosure requirements). These disclosure requirements might not be as relevant for ESG investors' decisions as compared with those proposed by SASB or other standards developers.

One ongoing debate is whether companies should be required to make certain ESG disclosures. Proponents of ESG disclosures suggest that investments in material issues (e.g., climate change) can increase shareholder value by differentiating among competitors within each industry, fostering investor confidence, increasing employee trust and loyalty, and increasing access to capital, among other things. Critics argue that existing regulations address many of the ESG issues or allow issuers to disclose voluntarily information that is material. Additional disclosures and reporting requirements, they say, could be an unnecessary regulatory burden for firms and distract firms from increasing shareholder value. Congress has a range of legislative options on this issue if it wanted to make changes to disclosure rules, including explicitly making all ESG disclosures strictly optional to requiring certain ESG disclosures.

CRS Resources

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

CRS In Focus IF11716, *Introduction to Financial Services: Environmental, Social, and Governance (ESG) Issues*, by Raj Gnanarajah and Gary Shorter.

CRS In Focus IF11803, *U.S. Capital Markets and China: Issues for Congress*, by Michael D. Sutherland and Karen M. Sutter.

Raj Gnanarajah, Analyst in Financial Economics

IF10701

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