Updated January 5, 2023

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—providing a consolidated report of the U.S. government. The various agencies and departments within the U.S. government issue their own reports.

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 more than 50 foreign regulators over the past several years. Nevertheless, the SEC and the PCAOB still face limitations with regulators in 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. The PCAOB and Chinese financial authorities agreed on a new Statement of Protocol in 2022. The PCAOB is expected to reassess the effectiveness of the new protocol. Meanwhile, according to the U.S.-China Economic and Security Review Commission, U.S. exchanges list 262 Chinese companies with $775 billion in total market capitalization as of September 2022.

The Statement of Protocol includes commitment from Chinese authorities on four issues:

1. **Engagement Selection:** PCAOB has discretion to select audit firms and clients that it examines.
2. **No Redaction:** PCAOB can see all audit work papers without any redactions. For restricted data, including personally identifiable information, there are specific processes for viewing.
3. **Testimony:** PCAOB can interview and obtain testimony from audit firm personnel in China and Hong Kong.
4. **Onward Sharing:** Information, including restricted data, can be shared with the SEC for all purposes, including administrative and civil enforcements.

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 addition to other Chinese companies that have delisted from U.S. exchanges for various reasons in recent times, five State-Owned Enterprises (SOEs) announced in August 2022 that they would voluntarily delist. Another SOE delisted in July 2022. Combined, these six SOEs represent $341 billion in market capitalization.

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 $2.7 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, created a set of standards to help corporations address increased shareholder interest in ESG issues. Over the past few years, there has been some consolidation among ESG standards—SASB standards are now part of International Sustainability Standards Board (ISSB) standards. However, corporate filers with the SEC are not required to follow SASB or ISSB standards. 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 created 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. 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.

CRS Resources

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

CRS In Focus IF11716, *Introduction to Financial Services: Environmental, Social, and Governance (ESG) Issues*

CRS In Focus IF12212, *U.S.-China Auditing Agreement and Issues for Congress*

Raj Gnanarajah, Analyst in Financial Economics

IF10701

Disclaimer