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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 sector to address the specific needs of their respective stakeholders. This In Focus also discusses two policy issues that might be of interest to Congress and investors.

Private Sector

The private sector includes public and private companies as well as not-for-profit organizations. The accounting and auditing standards created for publicly traded firms are subject to the Securities and Exchange Commission's (SEC's) oversight. Congress created the SEC in 1934 to protect investors; to maintain fair, orderly, and efficient markets; and to facilitate capital formation. Congress has oversight over the SEC and annually appropriates its funding.

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. They are required to submit annual reports providing a comprehensive overview of the firm's performance; this includes the audited financial statements of the firm.

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

Auditing. Private- or public-sector stakeholders need to have reasonable assurance that the financial statements of an entity 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) provides standards of practice on how an audit should be conducted.

Congress created the Public Company Accounting Oversight Board (PCAOB) to provide independent oversight of audits of public companies when it passed the

Sarbanes-Oxley Act of 2002 (P.L. 107-204). The PCAOB also oversees the audits of brokers and dealers, including compliance reports. The SEC has oversight authority over the PCAOB and must approve the board's rules, standards, and budget.

Material misstatement in financial reporting can be defined as information on a financial statement that could potentially affect the investment decision or the conclusions drawn by a reader about the financial status of the 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 revenue and how effective the federal government is at providing services. *The Financial Report of the United States Government* serves the same basic purpose as the annual report issued by a publicly traded company to its investors.

Accounting. The accounting standards established by the Federal Accounting Standards Advisory Board (FASAB) are considered Generally Accepted Accounting Principles for federal financial reporting entities. FASAB was created by the Government Accountability Office (GAO), 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 inspectors general, independent accounting firms, or GAO. GAO is an independent, nonpartisan agency of Congress. GAO's mission is to support Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of taxpayers.

GAO issues the Generally Accepted Government Auditing Standards (GAGAS), also commonly known as the "Yellow Book," which provides a framework for conducting audits. Some audit organizations within the federal government use a hybrid method of external and internal auditors.

State and Local Governments

The Comprehensive Annual Financial Report (CAFR) 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). While 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 to meet their specific needs.

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 by the chief executive of the respective municipal organization with the consent of the legislature. State and municipal auditors, whether required by law or not, might follow the GAGAS issued by GAO, while making appropriate changes to suit their specific needs, or might follow 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 relationship between accounting and auditing standards in the United States and other countries—in particular, to what degree international accounting and auditing standards should influence U.S. GAAP and PCAOB or GAAS auditing standards. The second is the newly emerging sustainability accounting standards for businesses, which encompass environmental, social, and governance (ESG) issues.

International Standards

Capital markets are global. Investors in the United States invest in foreign firms, and investors from other parts of the world invest in U.S. firms. Investors in the United States and elsewhere rely on financial statements to make informed decisions. Similar to how each state or municipality has discretion to either adopt or modify the accounting standards created by GASB, each country has discretion to either adopt or modify international accounting or auditing standards.

Accounting. To establish a common set of accounting standards, many foreign countries, including those of the European Union (EU), either require or allow International Financial Reporting Standards (IFRS) as their domestic GAAP for firms in their jurisdiction. The EU also accepts U.S. GAAP as equivalent to IFRS. The SEC allows foreign firms to file financial statements using IFRS.

Congressional interest in accounting convergence has manifested itself in several ways, including hearings, letters to the SEC, and earlier enacted legislation (e.g., §108(d), P.L. 107-204). The future evolution of accounting standards in the United States could be decided by Congress, the SEC, or FASB. To date, Congress has not passed legislation

requiring or prohibiting the incorporation of IFRS but has encouraged study of the issue.

Auditing. Similar to the expectations that the financial statements of domestic firms should be free of material misstatement whether caused by error or fraud, investors have a similar set of expectations for financial statements of foreign firms. The International Auditing and Assurance Standards Board (IAASB) promulgates International Standards on Auditing (ISA) that it encourages each country to adopt.

Sustainability Accounting Standards

The investing community and various stakeholders—institutional and individual investors, academics, and advocacy groups—continue to have a long-running debate about what should be disclosed by public firms. Issues related to sustainability accounting standards have been at the forefront of that debate. Shareholder expectations for corporations to address material Environmental, Social, and Governance (ESG) issues have continued to increase. In alignment with these increasing shareholder expectations, firms with over \$70 trillion in assets under management have indicated they will consider such ESG issues as political spending, climate change, diversity, and human rights, in the investment management decision-making process.

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. Currently, corporate filers with the SEC are not required to follow standards as promulgated by SASB. Publicly traded firms are subject to certain other ESG-related disclosure requirements (e.g., GAAP disclosure requirements), though these disclosure requirements might not be as relevant for investors' decisions as compared to those proposed by SASB.

Proponents of sustainability accounting standards suggest that investments in material sustainability issues can increase shareholder value by, among other things, differentiating among competitors within each industry, fostering investor confidence, increasing employee trust and loyalty, and increasing access to capital.

Critics argue that Congress has enacted regulations that address many of the ESG issues. Additional disclosures and reporting requirements, they say, could be an unnecessary regulatory burden for firms.

CRS Resources

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

CRS Report R45339, *Banking: Current Expected Credit Loss (CECL)*, by Raj Gnanarajah.

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