

# CRS Report for Congress

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## Auditing and Accounting Regulation: Key SEC Powers

Gary Shorter  
Specialist in Business and Government Relations  
Government and Finance Division

### Summary

Key auditing and accounting reform legislation, S. 2673 (Sarbanes), and H.R. 3763 (Oxley), and proposals for auditor oversight by the Securities and Exchange Commission (SEC) have been launched to help restore public confidence in a system of corporate financial accounting tainted by accounting fiascos at companies like Enron, Tyco, and Worldcom. This report provides background on significant current SEC regulatory powers in the area of accounting and auditing. It will be updated if there are changes in SEC authority.

### Introduction

Since late 2001, the United States has experienced a level of heightened concern over accounting shortfalls and failures at publicly traded companies: Accounting fiascos at companies like Enron, Tyco, and Worldcom have garnered considerable national attention and either are or will likely be the subjects of federal and congressional probes. Enron's auditor, Arthur Andersen, one of only five national auditing firms, is in significant legal and financial trouble and the recent pace of corporate earning restatements appears to be unprecedented: There are reports indicating that more than 700 companies restated their earnings between 2000 and mid-year 2002.<sup>1</sup> There is also a widespread perception that at least part of the stock markets' doldrums is attributable to investor skepticism over the trustworthiness of corporate financial disclosures.

It is in this environment that Congress is deliberating on two key bills that seek to restore greater confidence in the integrity of corporate financial disclosures. On April 24, 2002, the House passed H.R. 3763 (Oxley). On June 25<sup>th</sup>, the Senate Committee on Banking, Housing, and Urban Affairs reported S. 2673 (Sarbanes). Though they differ in a number of provisions, both bills would create a new independent panel to regulate

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<sup>1</sup> For example, see: The Huron Consulting Group, "A Study of Restatement Matters: For the Five Years Ended December 31, 2001," June 11, 2002, p. 8, and Jim McTague, "Fixable Flaws," *Barron's*, Jan. 7, 2002, p. 16.

auditors of publicly traded corporations, under the oversight of the Securities and Exchange Commission (SEC), the federal regulatory agency that has the statutory authority to regulate corporate accounting. On June 20, 2002, the SEC itself proposed a rule that would create a new auditor oversight board through the use of the agency's existing authority to regulate the corporate accounting for publicly traded companies.<sup>2</sup>

In light of these congressional and regulatory developments, this report provides background on significant SEC regulatory powers in the areas of corporate auditing and accounting.

Auditing basically consists of examining an organization's financial documents in order to determine if the records and reports are valid and if the information is fairly presented. An independent audit is normally conducted by a certified public accountant (CPA) who then issues an opinion as to whether the statements accurately and fairly represent the firm's operations and financial position. Accountants are also increasingly engaged in a widening array of other services with differing standards and procedures relative to audits.<sup>3</sup>

Financial statement audits of private sector organizations are generally performed by independent accountants (sometimes called external accountants). Independent accountants are owners or employees of private sector firms that are separate from the entities they audit. They are distinct from internal accountants, who work for the entities being audited, and government accountants, who do most auditing of governmental agencies. However, independent accountants may perform both internal and government accounting.

The independent auditors for the public companies that register with the SEC are charged with using generally accepted auditing standards (GAAS) in their assessment of audited firms' status. These are technical, 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, which are used by the auditors to examine an issuer's financial statements. Auditors also use them to issue opinions on whether as a whole the financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP). GAAP are guidelines and rules for use by accountants in preparing financial statements, that have evolved over years, and are designed to help ensure that financial data are presented fairly and are comparable from firm to firm and from industry to industry.<sup>4</sup> In expressing an opinion on financial statements, CPAs are required to stipulate whether or not their statements have been prepared according to GAAP.

While they are different, GAAP and GAAS enjoy a complementary relationship: The goal of an audit, which is governed by GAAS, is the expression of an opinion on

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<sup>2</sup> For a comparative look at the provisions in H.R. 3763, S. 2673, and the SEC rule proposal, see: CRS Report RL31483, *Auditor Reform Proposals: A Side-by-Side Comparison*, by Mark Jickling.

<sup>3</sup> For more on this, see: CRS Report RS21120, *Auditing and Its Regulators: Proposals for Reform after Enron*, by Bob Lyke.

<sup>4</sup> They range from relatively simple conventions like putting assets on the left-hand side of a balance sheet to complex measurements like computing the liability for employee pensions.

financial statements, statements normally prepared in accordance with GAAP. As a consequence, auditors have a strong interest in accounting standards since they must attest to an entity's compliance with those GAAP-based standards.

## **The SEC, the Federal Securities Laws and Corporate Registration and Financial Disclosure Requirements**

In 1933, Congress enacted the Securities Act of 1933 (Securities Act)<sup>5</sup>, which created the SEC and required publicly owned companies to file registration statements with the SEC. Audited financial statements were also required as a part of this process. In 1934, Congress enacted the Securities Exchange Act of 1934 (Exchange Act),<sup>6</sup> which required companies with registered securities to file periodic reports with the SEC, including audited financial statements. The law also authorized the SEC to determine the manner in which such financial statements were to be disclosed. For example, sections of the Securities Act<sup>7</sup> and the Exchange Act<sup>8</sup> require that the financial statements of registered companies be audited by independent public or certified accountants. Sections of the Exchange Act,<sup>9</sup> and the Investment Company Act (ICA),<sup>10</sup> give the SEC authority to prescribe accounting principles to be used in the preparation of required financial statements.

### **Establishing “Independence”**

The SEC observes that the federal securities laws require, or permit the agency to require, that financial information filed with us be certified or audited by “independent” public accountants, and note that this “franchise” has helped to transform independent auditors into the “gatekeepers” of the nation’s public securities markets. From a public policy perspective, the SEC has said that there are two related goals of ensuring the independence of public accountants: 1) the need to foster high quality audits by minimizing the possibility that any external factors will influence an auditor’s judgments; and 2) the need to promote investor confidence in the financial statements of public companies.

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<sup>5</sup> 15 U.S.C. §§ 77a-77aa. (This and most of the legal citations that follow derive from: The Securities and Exchange Commission, “Final Rule: Revision of the Commission’s Auditor Independence Requirements, “ 2001, footnote 34.)

<sup>6</sup> 15 U.S.C. §§ 78a-78kk.

<sup>7</sup> See: Items 25 and 26 of Schedule A to Securities Act, 15 U.S.C. §§ 77aa(25) and (26).

<sup>8</sup> See: Section 17(e) of the Exchange Act, 15 U.S.C. §§ 78q.

<sup>9</sup> See: 15 U.S.C. §§78q.

<sup>10</sup> See: 15 U.S.C. §§ 80a-30. The ICA regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public. It requires these entities to disclose their financial condition and investment policies to investors when stock is initially sold and on a regular basis thereafter.

Sections of the Exchange Act<sup>11</sup>, the Public Utility Holding Company Act of 1935 (PUHCA)<sup>12</sup>, the ICA,<sup>13</sup> and the Investment Advisers Act of 1940<sup>14</sup> (Advisers Act) give the SEC the authority to require the filing of financial statements that have been audited by independent accountants.

Under authority granted to it by the statutes described above, the SEC has done extensive rulemaking under Regulation S-X, a broad body of SEC-promulgated rules, which provide the standards that registrant companies and their auditors must comply with

when they prepare the financial sections of their SEC filings under the Securities Act and the Exchange Act.<sup>15</sup> Under Regulation S-X, the agency has required that certain financial statements be audited by independent accountants. The Federal securities laws also give the SEC the authority to define the term “independent” accountant. And various sections of the Securities Act,<sup>16</sup> the Exchange Act,<sup>17</sup> PUHCA,<sup>18</sup> and the ICA,<sup>19</sup> give the SEC the authority to define the accounting, technical, and trade terms used in the federal securities laws that have helped to mold the parameters of the definition of an independent accountant.

The Private Securities Litigation Reform Act of 1995 (PSLR), P.L. 104-67,<sup>20</sup> added a new section to the Exchange Act that involved financial statements filed under the Exchange Act’s registration and reporting provisions. Among other things, the PSLR requires an independent accountant to adopt, in accordance with generally accepted accounting procedures as modified or supplemented by SEC rules: (a) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the financial statements; (b) procedures designed to identify related party transactions; and (c) to undertake an evaluation of the issuer’s ability to continue as a going concern during the ensuing year.

<sup>11</sup> See: Sections 12(b)(1)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. §§§§ 78l and 78m.

<sup>12</sup> See: PUHCA, Sections 5(b)(H) and (I), 10(a)(1)(G), and 14, 15 U.S.C. §§ 79e(b), 79j, and 79n. Under PUHCA, interstate holding companies engaged, through subsidiaries, in the electric utility business or in the retail distribution of natural or manufactured gas are subject to regulation under this Act.

<sup>13</sup> See: Sections 8(b)(5) and 30(e) and (g) of the ICA, 15 U.S.C. §§§§ 80a-8 and 80a-29.

<sup>14</sup> See: Section 203(c)(1)(D) of the Advisers Act, 15 U.S.C. §§ 80b-3(c)(1). The Advisers Act regulates investment advisers and generally requires that firms or sole practitioners compensated for advising others about securities investments with at least \$25 million under management must register with the SEC.

<sup>15</sup> For example, see: Article 3 of Regulation S-X, 17 CFR 210.3-01 et seq.

<sup>16</sup> See: Section 19(a) of the Securities Act, 15 U.S.C. §§ 77s(a).

<sup>17</sup> See: Section 3(b) of the Exchange Act, 15 U.S.C. §§ 78c(b).

<sup>18</sup> See: Section 20(a) of PUHCA, 15 U.S.C. §§ 79t(a).

<sup>19</sup> See: Section 38(a) of the ICA, 15 U.S.C. §§ 80a-37(a).

<sup>20</sup> Securities Exchange Act § 10A(a) P. L. No. 104-67, 15 U.S.C. §§ 77a et seq.

In February 2001, the SEC controversial amendments of Rule 2-01 of Regulation S-X<sup>21</sup> on auditor independence went into effect. The amendments applied to any auditor whose client files audited financial statements with the SEC, and to any accountant who provides audit services to a broker/dealer. Among other things, the SEC was concerned with scenarios in which an auditor has multiple business relationships with an audit client and would not be considered capable of providing an independent audit opinion on the client's financial statements. The amendments restricted independent auditors to no more than 40% of the internal audit services of a public company client. And they made public companies' audit committees responsible for determining whether nonaudit services (other than those that are banned) impair audit independence. The amendments also required public companies to disclose in their annual proxy materials the dollar amounts spent for audit, information technology (IT) consulting, and other nonaudit services.<sup>22</sup>

## **Delegation of the Formulation of Accounting Standards**

The federal securities laws give the SEC statutory authority to require financial reporting, to dictate the form in which financial information is presented in registration statements and periodic reports, the methods to be followed in the preparation of accounts, and the definition of accounting terms. But, occasionally, the SEC issues rules and interpretive releases on the form and content of financial statements through Regulation S-X and its Codification of Financial Reporting Policies. And the agency's staff issue Staff Accounting Bulletins, which are interpretive guidance and practices that the agency used in implementing its financial reporting disclosure requirements. However, early in its history, the agency largely opted to rely on accounting standards established in the private sector as long as such standards had substantial authoritative support. Since 1973, the Financial Accounting Standards Board (FASB) has been the designated organization in the private sector that establishes standards for financial accounting and reporting. An independent, private-sector organization, FASB receives no federal funding of any kind and has no legislative charter or grant of enforcement power. The SEC officially recognizes GAAP standards established by FASB as authoritative. It has specifically stated that the standards promulgated by the FASB and its predecessors have had "substantial authoritative support" and that principles that are inconsistent with such standards do not have "substantial authoritative support."<sup>23</sup>

## **Disciplinary Actions**

Historically the SEC has largely delegated responsibility to the American Institute of Certified Public Accountants (AICPA, the major national association of certified public accountants) to oversee accountants, including those who audit public companies. However, under its Administrative Rule 102(e) it may disqualify from its practice

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<sup>21</sup> 17 CFR 210.2-01.

<sup>22</sup> The Securities and Exchange Commission, "Final Rule: Revision of the Commission's Auditor Independence Requirements," November, 2001.

<sup>23</sup> See: Accounting Series Release No. 150, Fed. Sec. L. Rep. (CCH) ¶ 72, 172.

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. After conviction on obstruction of justice charges, Enron's outside auditor, Arthur Andersen, told the SEC that it would cease practicing before it by August 31, 2002 unless the agency set an earlier date.<sup>24</sup>

Under the Penny Stock Reform Act of 1990's (The Remedies Act, PL. 101-492) amendments to the Exchange Act, the SEC received authority to seek civil penalties in federal district court Securities Enforcement Remedies and Penny Stock Reform Act. Congress buttressed the SEC's enforcement powers, authorizing administrative civil penalties and "cease and desist" orders.<sup>25</sup> Auditors may be subject to such SEC civil actions and orders to cease and desist. Under provisions of the Private Securities Litigation Reform Act of 1995 (PSLR), P.L. 104-67,<sup>26</sup> the Exchange Act was amended so that auditors are required to report to an issuer/client of any illegal act discovered by the auditor. If the company fails to take the necessary corrective action, the auditor may be forced to resign or report the misconduct to the SEC. If an auditor fails to discharge such "whistle blower" duties, it may be subject to SEC administrative sanctions.<sup>27</sup>

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<sup>24</sup> CRS Report RS21120, *Auditing and Its Regulators: Proposals for Reform after Enron*, by Bob Lyke.

<sup>25</sup> The Remedies Act is codified as 15 U.S.C. § 780. Its cease and desist provisions are codified as Section 8A(a) of the Securities Act, 15 U.S.C. §77h-1(a)], 15 U.S.C. §77h-1(a). A cease and desist order is an administrative remedy directing a person to stop illegal activity and to refrain from engaging in such activity in the future.

<sup>26</sup> Securities Exchange Act § 10A(a) P. L. No. 104-67, 15 U.S.C. §§ 77a et seq.

<sup>27</sup> See: 15 U.S.C. §§ 78j-1; 15 U.S.C. §§ 78j-1(b)(1)-(3); and 78j-1(d).