

Accounting and Auditing Regulatory Structure: U.S. and International

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Summary

Accounting and auditing standards in the United States are promulgated and regulated by various federal, state, and self-regulatory organizations (SROs). Accounting and auditing standards are also influenced by practitioners from businesses, nonprofits, and government entities. Congress has allowed financial accounting and auditing practitioners to remain largely self-regulated while retaining oversight responsibility. At certain times, Congress has sought to achieve specific accounting- and auditing-based policy objectives by enacting legislation such as the Sarbanes-Oxley Act of 2002 (SOX; P.L. 107-204) and the Federal Credit Reform Act of 1990 (FCRA; P.L. 101-508).

The informational needs of stakeholders differ between the different sectors of the economy—the private sector, the federal government, and state and local governments. As a consequence, different accounting and auditing standards have evolved in these sectors. In the private sector, financial statements communicate to stakeholders how the company used its resources to generate profit and expand its business, or how the company incurred loss and the chances the business will survive over the long run. In comparison, public-sector entities such as the federal, state, and local governments issue reports to communicate how tax revenues were used to benefit citizens. State and local governments have standards distinct from those of the federal government. As such, accounting and auditing standards can be classified into three areas: (1) private industry standards, (2) federal government standards, and (3) state and local government standards.

The accounting and auditing standards created for publicly traded companies are subject to the Securities and Exchange Commission's (SEC's) oversight. Congress has oversight over the SEC and annually appropriates its funding. Throughout its history, the SEC has relied on SROs to establish financial reporting standards for the private sector; these are known as Generally Accepted Accounting Principles (GAAP). Currently, the SEC recognizes the Financial Accounting Standards Board (FASB) as the designated authority for establishing GAAP. SOX created the Public Company Accounting Oversight Board (PCAOB) to oversee the auditing profession for the private sector. The SEC has oversight responsibility over FASB and PCAOB.

The Federal Accounting Standards Advisory Board (FASAB) was created to establish the financial reporting and accounting standards for the federal government. The Government Accountability Office (GAO) has responsibility for establishing auditing standards for federal government agencies, including federal grant recipients in state and local governments.

A counterpart to FASAB for state and local governments is the Government Accounting Standards Board (GASB). Many of the underlying principles between FASAB and GASB are the same, but each state or territory is allowed to choose whether it follows GASB standards in full or modifies the standards to fit local needs. Auditing standards vary by state and local governments.

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 in other countries. In particular, there is debate over whether or to what degree international accounting and auditing standards should influence U.S. GAAP and U.S. Generally Accepted Auditing Standards (U.S. GAAS), respectively.

The second is to what degree business risk should be evaluated based on sustainability issues. Increasingly, investors expect firms to respond to environmental, social, and governance (ESG) issues. The Sustainability Accounting Standards Board (SASB) has created a series of provisional standards for the private sector. SASB is an independent organization that is not recognized by Congress or the SEC as an official standard-setting body.

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Introduction

Accounting is commonly considered the language of finance. A common set of principles and rules help establish accounting standards. Accountants who audit financial statements (auditors¹) also adhere to a common set of audit principles and rules to examine financial statements.

In the United States, accounting and auditing standards are promulgated and regulated by various federal, state, and self-regulatory agencies. Accounting and auditing standards are also influenced by practitioners from businesses, nonprofits, and government entities (federal, state, and local). Congress has allowed financial accounting and auditing practitioners to remain self-regulated while retaining oversight responsibility. At certain times, Congress has sought to achieve specific accounting- and auditing-based policy objectives by enacting legislation such as the Sarbanes-Oxley Act of 2002 (SOX)² and the Federal Credit Reform Act of 1990 (FCRA).³

This report examines the U.S. accounting and auditing regulatory structure. It first provides background on why different accounting standards exist between the private and public sectors. The next three sections of the report discuss how accounting and auditing standards are created and regulated in the private sector, the federal government, and state and local governments. Some of the common concepts that affect accounting and auditing standards across all sectors are discussed in detail in the private-sector segment of the report. Then, the report discusses the relationship between (1) international accounting and auditing standards and (2) the United States Generally Accepted Accounting Principles (U.S. GAAP) and Generally Accepted Auditing Standards (U.S. GAAS). Next, the report discusses the newly emerging Sustainability Accounting Standards for the private sector. Lastly, this report has three appendixes. **Appendix A** provides a table of acronyms that are common to the accounting and auditing profession and used throughout this report. **Appendix B** provides a glossary that explains the various financial statements listed in **Table 1**. **Appendix C** provides the American Institute of Certified Public Accountants' (AICPA) Principles of Professional Conduct for Certified Public Accountants (CPAs).

Background

The informational needs of stakeholders differ between the private and public sectors. As a consequence, different accounting and auditing standards have evolved in these sectors to address stakeholders' specific needs. In the private sector, financial statements communicate to stakeholders such as investors, creditors, company employees, regulators, and others how the company used its resources to generate profit and expand its business, or how the company incurred loss and the likelihood the business will survive over the long run. Public-sector entities such as the federal, state, and local governments issue reports to communicate how tax revenues were used to benefit citizens. Their intended audience is usually taxpayers, Congress, or the state and local legislatures. State and local governments have standards distinct from those of the federal government. Thus, accounting and auditing standards can be classified into three areas: (1) private industry standards, (2) federal government standards, and (3) state and local

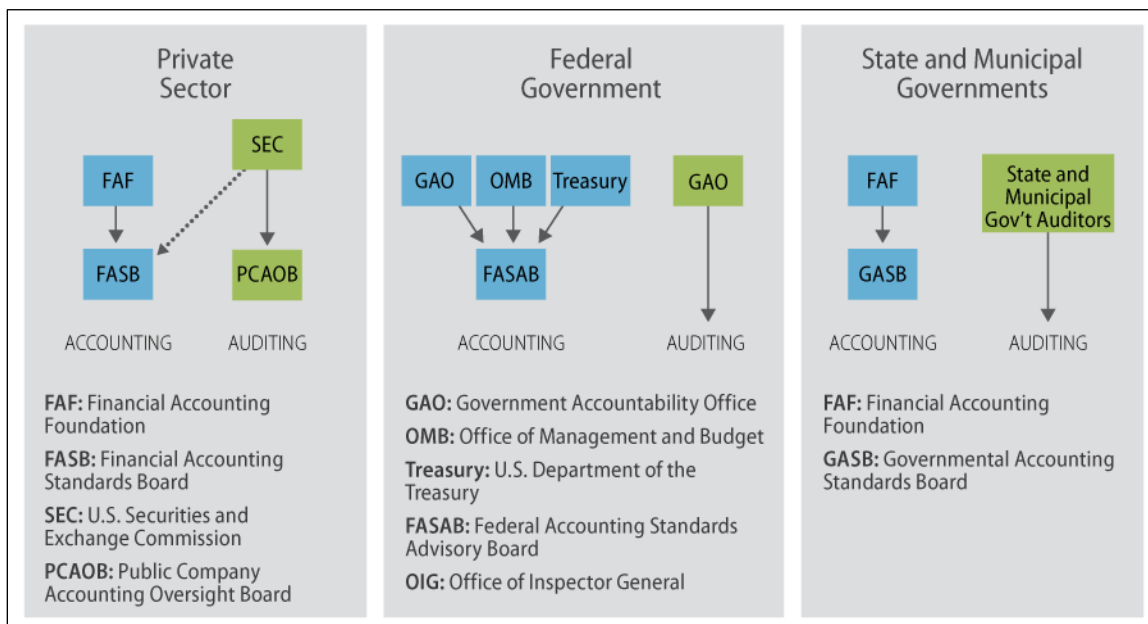
¹ Financial statement auditors are accountants who have specialized training as auditors. Generally, program or statutory auditors are also accountants who have received specialized training.

² P.L. 107-204.

³ P.L. 101-508. For additional information about the Federal Credit Reform Act of 1990 (FCRA), see CRS Report R44193, *Federal Credit Programs: Comparing Fair Value and the Federal Credit Reform Act (FCRA)*, by (name redacted).

government standards. **Figure 1** provides an overview of the accounting and auditing standard-setters for the different segments that will be discussed in this report.

Figure 1. Accounting and Auditing Standard-Setters



Source: CRS.

Note: In the first panel, the striated line indicates the SEC's oversight role over accounting standards promulgated by the FASB. The FASB's parent organization, the Financial Accounting Foundation (FAF), is a nonstock Delaware corporation. Neither FASB nor FAF is a government agency, even though the SEC does have oversight of the budget for FASB and the accounting standards as promulgated by FASB (FAF, "Facts About FAF," <http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1176157790151>).

Private Sector

In the private sector, financial statements provide economy-wide benefits to firms and investors through the dissemination of accurate information. One way these benefits are realized is through the efficient allocation of capital between investors and firms.⁴ Investors rely on financial statements to make informed decisions on how best to invest their savings. Financial statements are a primary means by which firms communicate with capital markets, investors, creditors, regulators, the public, and others. **Figure 2** illustrates the range of private-sector stakeholders.

⁴ Nonprofit entities' financial reporting focuses on how resources are used to benefit the intended purpose of the nonprofit. The standard of measure is the proportion of the donations used for administrative expenses versus operating expenses.

Figure 2. Stakeholders in the Private Sector

Source: Adapted from PricewaterhouseCoopers (PWC), *Understanding a Financial Statement Audit*, January 2013, p. 3, <http://www.pwc.com/gx/en/services/audit-assurance/publications/understanding-financial-audit.html>.

The private sector includes public and private companies⁵ as well as not-for-profit organizations, though this report focuses on public companies. 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 and to maintain fair, orderly, and efficient markets. However, Congress has oversight over the SEC and annually appropriates its funding.⁶

Accountants and auditors, in addition to adhering to accounting and auditing standards, are also subject to the ethical requirements of their affiliated membership organizations, such as CPAs' Principles of Professional Conduct (see **Appendix C**).

Accounting

Accounting is a process by which an entity identifies, measures, and communicates financial information about its economic activities to stakeholders by adhering to a common set of practices, known as Generally Accepted Accounting Principles (GAAP).⁷ The primary way for an

⁵ Privately held companies (non-public firms) are not required by regulators to utilize the same accounting standards as publicly traded firms, but non-public firms often utilize the same standards to have equal access to credit and for either eventually going public or as preparation for a buyout or merger, among other reasons. A more detailed discussion of non-public firms is beyond the scope of this report.

⁶ For more information about the Securities and Exchange Commission (SEC), see CRS In Focus IF10032, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by (name redacted)

⁷ Each set of accounting standards that is created for a specific purpose can be considered Generally Accepted Accounting Principles (GAAP). As an example, the private-sector GAAP is different from accounting standards created for the federal government. Similarly, state and local government GAAP differ from private or federal government GAAP. Although creditors and other stakeholders may require private companies to follow GAAP, they

entity to communicate its financial performance to its stakeholders is through financial statements. In simple terms, accounting standards are agreements among practitioners (i.e., accountants, auditors, and regulators) on how each line item on the financial statement should be valued and reported.⁸

One of the powers Congress gave the SEC is the statutory authority to establish accounting standards for the private sector in the United States. Since the creation of the SEC, domestic companies have used GAAP to issue financial statements.⁹ Throughout its history, the SEC has relied on the private sector to establish and develop GAAP in the United States.¹⁰ Currently, the SEC recognizes the Financial Accounting Standards Board (FASB)¹¹ as the designated organization for establishing GAAP for the private sector.¹²

FASB Funding

Since enactment of the Sarbanes-Oxley Act of 2002 (SOX),¹³ FASB has been funded by fees collected from issuers of publicly traded securities. The fees are subject to SEC review.¹⁴ FASB incurred \$40.5 million in program and support expenses in 2016. The expenses were paid in part with \$24.8 million from accounting support fees;¹⁵ the remainder was paid through other revenue sources, such as the sale of publications or subsidies from the Financial Accounting Foundation's (FAF's) excess reserve funds. FASB is a subsidiary of FAF. According to FAF, the FAF, FASB, and Government Accounting Standards Board (GASB) are mainly funded through accounting support fees.¹⁶

Financial statements for publicly traded companies as well as privately held companies commonly include an income statement, a balance sheet, a statement of shareholder equity, and a statement of cash flows. **Table 1** compares the different financial statements presented in annual reports of various entities in different sectors (for an explanation of different statements, see **Table B-1**). As previously discussed, as a consequence of the differences between the private sector and the public sector, the financial statements normally used in one sector might not exist

are not required to follow GAAP unless they are registered with the SEC.

⁸ The field of accounting can be subdivided into different categories, such as financial accounting, tax accounting, managerial or cost accounting, and budget accounting (commonly used by the government sector). The annual report issued by private and public sector entities communicate to their respective stakeholders how the resources of the entity were used to meet the mission of the organization. The annual report might not only contain financial statements but might disclose and share information from other fields of accounting, such as tax accounting and cost accounting.

⁹ The Securities and Exchange Commission (SEC) issued a rule in 2007 that allows foreign issuers of financial statements to file with the SEC using International Financial Reporting Standards without having to reconcile to GAAP. Stephen A. Zeff, "How the U.S. Accounting Profession Got Where It Is Today: Part 1," *Accounting Horizons*, vol. 17, no. 3 (September 2003), pp. 191-193.

¹⁰ Financial Accounting Standards Board (FASB), "Facts About FASB," <http://www.fasb.org/facts/>.

¹¹ P.L. 107-204. In 2007, the chief accountant of the SEC reportedly refused to authorize the budget for FASB until the FASB chairman signed a Memorandum of Understanding (MoU) between the SEC and FASB. The MoU reportedly gave the SEC the power to nominate and interview FASB members and FAF trustees. Alan Rappeport and Marie Leone, "SEC Used Budget to Strong-arm FASB," *CFO.com*, April 3, 2007, <http://ww2.cfo.com/accounting-tax/2007/04/sec-used-budget-to-strong-arm-fasb/>.

¹² The FASB's parent organization, the Financial Accounting Foundation (FAF), is a nonstock Delaware corporation. Neither FASB nor FAF is a government agency, even though the SEC does have oversight of the budget for FASB and the accounting standards as promulgated by FASB. FAF, "Facts About FAF," <http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1176157790151>.

¹³ P.L. 107-204.

¹⁴ 15 U.S.C. §7219.

¹⁵ Financial Accounting Standards Board, *Financial Statements for the Years Ended December 31, 2016 and 2015*, March 22, 2017, p. 1, <http://www.accountingfoundation.org/cs/ContentServer?c=Page&pagename=Foundation%2FPage%2FFAFSectionPage&cid=1176157765746>.

¹⁶ FAF, *How we're funded*, <http://www.accountingfoundation.org/jsp/Foundation/Page/FAFSectionPage&cid=1351027545591>.

in another sector. Further, financial statements within the same sector (e.g., the private sector) will communicate a qualitatively different set of information based on their underlying business activity. As an example, the financial statements for Boeing, mainly a manufacturer of commercial jetliners, defense, space, and security systems, will be qualitatively different from those of T-Mobile, a provider of cell phone service and retailer of cell phones.

Table 1. Comparison of Financial Statements in Various Sectors

| Private Sector ^a | Federal Government ^b | State and Local Governments ^c |
|---|---|--|
| Income Statement | Statement of Operations and Changes in Net Position | Statement of Activities |
| Balance Sheet | Balance Sheet | Statement of Net Position (Assets) |
| Statement of Shareholders' Equity | Statement of Operations and Changes in Net Position | Statement of Net Position (Assets) |
| Statement of Cash Flows | Statement of Changes in Cash Balance from Unified Budget and Other Activities | Statement of Activities |
| Not Applicable | Statement of Net Cost | Required Supplementary Information |
| Not Applicable | Reconciliations of Net Operating Cost and Unified Budget Surplus (Deficit) | Required Supplementary Information |
| Not Applicable | Statement of Social Insurance | Required Supplementary Information |
| Notes to the Financial Statements | Notes to the Financial Statements | Notes to the Financial Statements |
| Management's Discussion and Analysis of Financial Condition and Results of Operation ^d | Management's Discussion and Analysis | Management's Discussion and Analysis |
| Management's Discussion and Analysis of Financial Condition and Results of Operation | Citizen's Guide to the Financial Report of the United States Government | Letter of Transmittal |
| Management's Discussion and Analysis of Financial Condition and Results of Operation | Required Supplementary Information | Required Supplementary Information |
| Management's Discussion and Analysis of Financial Condition and Results of Operation | Budget of the U.S. Government ^e | Statistical Section |

Source: CRS.

- a. Several of the financial statements that exist in the government sector do not exist in the private sector or are not relevant.
- b. The financial statements listed below are from the *Financial Report of the United States Government for Fiscal Year 2015*. The financial statements listed in **Table 1** provide a comparison to the private sector. Individual agency financial reports may differ based on their function and purpose from what is listed for the federal government. See Department of the Treasury, *Financial Report of the United States Government - Fiscal Year 2016*, January 12, 2017, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.
- c. The financial statements listed below are from the Comprehensive Annual Financial Report (CAFR) of the State of Ohio and from the CAFR of the City of New York for FY2016. Other states' and territories' financial statements might differ due to their respective laws and requirements. Only government-wide financial statements are included, and specific fund financial statements, such as proprietary funds, fiduciary funds, and fiduciary component units, are not listed. See The State of Ohio, *Comprehensive Annual Financial Report - The State of Ohio - Fiscal Year Ended June 30, 2016*, December 22, 2016, <http://obm.ohio.gov/StateAccounting/financialreporting/cafr.aspx>.

Other cities' and local municipalities' financial statements might differ due to their respective laws and requirements. Only government-wide financial statements are included, and fund financial statements are not listed. See The City of New York, *Comprehensive Annual Financial Report of the Comptroller for the Fiscal Year Ended June 30, 2016*, October 31, 2016, <https://comptroller.nyc.gov/reports/comprehensive-annual-financial-reports/>.

- d. Some elements of the various statements and schedules in the government sector might be similar in the management's discussion and analysis of financial condition and results of operation in the private sector, but most elements are not relevant or are not presented.
- e. For the purpose of this table, Budget of the U.S. Government includes all supporting schedules. See Office of Management and Budget, *Budget of the U.S. Government*, February 9, 2016, <https://www.whitehouse.gov/omb/budget>.

Annual Report to the SEC: Form 10-K

Federal securities laws require public companies, both domestic and foreign, to share critical information about their performance on an ongoing basis. Domestic companies are required to submit annual reports on Form 10-K, quarterly reports on Form 10-Q, and current events on Form 8-K. Form 10-K provides a comprehensive overview of the company's performance, including audited financial statements, and is required to be filed 60-90 days after the fiscal year-end based on the size of the company. Form 10-Q is required to be filed 40-45 days after quarter end.¹⁷ Form 8-K¹⁸ is required to be filed within four business days to inform shareholders of material corporate events.¹⁹ Companies submit their forms (reports) electronically to SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system.

Foreign companies that participate in U.S. capital markets are required to file a different but comparable set of financial reports. Based on the expectation that the United States will eventually either adopt or converge with International Financial Reporting Standards (IFRS),²⁰ the SEC in 2007 changed the requirement for Foreign Private Issuers (FPIs).²¹ Until 2007, foreign and domestic firms had similar filing requirements with the SEC. In 2007, to prevent foreign firms from potentially delisting from U.S. exchanges, the SEC authorized foreign firms to file either Form 20-F using IFRS or Form 10-K using U.S. GAAP. This ruling eased concerns that some foreign firms might delist from the U.S. exchanges due to additional costs they would incur either reconciling or converting from IFRS to U.S. GAAP. Further, SEC was still debating in 2007 as to whether the United States should converge with the IFRS or continue to follow U.S. GAAP.²²

¹⁷ SEC, *Fast Answers: Form 10-K*, June 26, 2009, <https://www.sec.gov/answers/form10k.htm>.

¹⁸ Foreign firms are required to use Form 6-K to file current events.

¹⁹ SEC, *Fast Answers: Annual Report*, October 15, 2014, <https://www.sec.gov/answers/annrep.htm>.

²⁰ A comparable accounting standard similar to the U.S. GAAP adopted by many foreign countries is the International Financial Reporting Standards (IFRS). Many foreign countries, including those of the European Union (EU), either require or allow IFRS for firms in their jurisdiction. The EU also accepts U.S. GAAP as equivalent to IFRS.

²¹ There are specific requirements that must be met to qualify as a Foreign Private Issuer (FPI). Generally, an FPI could be defined as any company that is registered in a foreign country but wishes to participate in U.S. capital markets. A foreign company may qualify as a foreign private issuer if 50% or less of its outstanding voting securities are held by U.S. residents if certain other conditions are met. A company may still qualify as an FPI even if more than 50% of voting securities are held by U.S. residents, if certain other conditions are met. SEC, *Accessing the U.S. Capital Markets - A Brief Overview for Foreign Private Issuers*, October 16, 2014, <https://www.sec.gov/divisions/corpfin/internatl/foreign-private-issuers-overview.shtml#1>.

²² In 2014, more than 5,000 companies were listed on the major U.S. exchanges. See Dan Strumpf, "U.S. Public Companies Rise Again - Stock Market Listing Grow for First Time Since the Internet Boom," *The Wall Street Journal*, February 5, 2014, <http://www.wsj.com/articles/SB10001424052702304851104579363272107177430>.

Annual Report to Shareholders

The annual report to shareholders is distinct from Form 10-K. The annual report to shareholders is considered a state-of-the-company report to its shareholders and potentially interested stakeholders. It usually contains a letter from the CEO, financial data, results of operations, market segment information, new product plans, subsidiary activities, and research and development on future programs. The SEC requires the annual report to be sent to shareholders. The SEC also requires listed companies to post their annual reports and proxy materials on the firm's website.²³ Proxy materials provide the firm's shareholders with information on substantive issues related to the firm. It also provides an avenue for the shareholders to influence the decisions of the firm's board of directors and management, including the selection of the board of directors and compensation of company executives.²⁴

The annual report filed with the SEC on Form 10-K might contain more detailed information about the company's financial condition than the annual report to shareholders. Companies may send their annual 10-K report to shareholders instead of creating a separate annual report. Registered FPIs are required to follow a similar set of requirements as domestic firms.

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.²⁵ 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 material²⁶ respects for a given period of time in accordance with GAAP.²⁷

As a consequence of financial accounting fraud in the early 2000s, Congress passed the Sarbanes-Oxley Act of 2002. SOX created the Public Company Accounting Oversight Board (PCAOB) as a

The SEC estimates that there were nearly 1,000 FPIs in 2014. Information on the number of FPIs was obtained through an email from the SEC on April 3, 2015. For more information on accounting standards convergence, see CRS Report R44089, *U.S. Capital Markets and International Accounting Standards: GAAP Versus IFRS*, by (name redacted)

In 2016, 525 FPIs with a market capitalization of approximately \$7.3 trillion filed under IFRS without reconciling to U.S. GAAP. See Wesley R. Bricker, *Working Together to Advance High Quality Information in the Capital Markets*, SEC, December 5, 2016, <https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html>.

²³ SEC, *Fast Answers: Annual Report*, October 15, 2014, <https://www.sec.gov/answers/annrep.htm>.

²⁴ Proxy materials will usually contain the annual report, proxy statement, voting instruction form, and proxy card (voting card). The SEC, *Spotlight on Proxy Matters*, March 31, 2015, <https://www.sec.gov/spotlight/proxymatters.shtml>.

²⁵ Public Company Accounting Oversight Board (PCAOB), *Auditing Standard No. 16 - Matters Included in the Audit Engagement Letter*, http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_16_Appendix_C.aspx.

²⁶ 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. 17 C.F.R. §221.

²⁷ There are different types of audits and reviews beyond financial statement audits, such as financial reviews, operational audits, department reviews, information systems audits, integrated audits, investigative audits or reviews, forensic audits, tax audits, environmental and social impact audits, compliance audits, and follow-up audits.

nonprofit corporation to provide independent oversight of audits of public companies. The PCAOB also oversees the audits of brokers and dealers, including compliance reports.²⁸

The five board members of the PCAOB are appointed to staggered five-year terms by the SEC, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. The SEC has oversight authority over the PCAOB, including the approval of the board's rules, standards, and budget. SOX was amended by the Dodd-Frank Act,²⁹ which established funding for the PCAOB's activities, primarily through the annual accounting support fees assessed on public companies and other issuers, as well as brokers and dealers registered with the SEC.³⁰ The PCAOB's budget for 2017 was \$269 million. Approximately \$233 million of the accounting support fees to be collected will be allocated to public companies and \$35 million to brokers and dealers.³¹

Along with the creation of PCAOB, SOX (§404) also requires public companies' annual reports to include the company's own assessment of internal control³² over financial reporting and an auditor's attestation (audit). The different types of audit opinions an auditor may issue are discussed next, followed by a discussion of internal control integrated frameworks.

Audit Opinions

Auditors form audit opinions by examining the types of risks an organization might face and the types of controls that exist to mitigate those risks. Once the risks and controls to mitigate those risks have been determined, the auditors will examine the supporting evidence and determine if management is presenting the financial statements fairly in all material respects.³³ Although most entities will usually receive an unqualified opinion, the auditor may express other types of opinions based on the circumstances. There are four different types of audit opinions an auditor may express.³⁴

1. **Unqualified Opinion.** An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP. This is the opinion expressed in the standard report. Under certain circumstances explanatory language might be added to the auditor's standard report, while not affecting the auditor's unqualified opinion on the financial statements.
2. **Qualified Opinion.** A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly in all material respects the financial position, results of operations, and cash flows in conformity with GAAP.

²⁸ PCAOB, *Mission and Vision*, <https://pcaobus.org/About/History/Pages/default.aspx>.

²⁹ P.L. 111-203.

³⁰ 15 U.S.C. §7219. PCAOB, *About the PCAOB*, <https://pcaobus.org/About/Pages/default.aspx>.

³¹ PCAOB, *PCAOB Approves 2017 Budget and 2016-2020 Strategic Plan*, November 17, 2016, <https://pcaobus.org/News/Releases/Pages/PCAOB-2017-budget.aspx>.

³² Internal control helps entities achieve important objectives and sustain and improve performance. Entities whether private or public use internal controls as a means to achieve the objectives of the organization by designing processes that control the risk of the organization.

³³ PWC, *What is an audit?* <http://www.pwc.com/m1/en/services/assurance/what-is-an-audit.html>.

³⁴ Public Company Accounting Oversight Board, *AS 3101: Reports on Audited Financial Statements*, <https://pcaobus.org/Standards/Auditing/Pages/AS3101.aspx>.

3. **Adverse Opinion.** An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with GAAP.
4. **Disclaimer of Opinion.** A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

Independent audit opinions do not fully guarantee the financial statements are presented fairly in all material respects for the following key reasons:

- The auditors use statistical methods for random sampling and look at only a fraction of the economic events or documents during an audit. It is cost- and time-prohibitive to recreate or sample all economic events at an entity.
- Frequently many line items on the financial statements involve subjective decisions or a degree of uncertainty as a result of using estimates.
- Audit procedures cannot eliminate potential fraud by management, though it is possible an auditor may find fraud committed by management during the audit process.

Thus, the auditor provides only a *reasonable* assurance about whether the financial statements are free of material misstatement.

COSO Framework

Section 404 of SOX requires management at public companies to select an internal control framework and then assess and report annually on the design and operating effectiveness of their internal controls. The internal control framework widely used by the business community is the one created by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).³⁵ COSO is a private-sector initiative dedicated to improving organizational performance and governance through effective internal control, enterprise risk management, and fraud deterrence.³⁶

SEC Internal Control—Integrated Framework Requirements

A requirement of SOX was for the SEC to create rules that would require public companies' annual reports to contain (1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures; and (2) management's assessment of the internal control structure and procedures for financial reporting. Under SEC's final rules, annual reports on internal control are required to contain

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year; and
- a statement that its auditor has issued an attestation report on management's assessment.

The COSO framework was created by the business community to meet the above requirements.

³⁵ There are five private-sector entities that support COSO: American Accounting Association, American Institute of Certified Public Accountants, Financial Executives International, The Association of Accountants and Financial Professionals in Business, and The Institute of Internal Auditors.

³⁶ J. Stephen McNally, CPA, *The 2013 COSO Framework & SOX Compliance - One Approach To An Effective Transition*, Committee of Sponsoring Organizations of the Treadway Commission (COSO), June 2013.

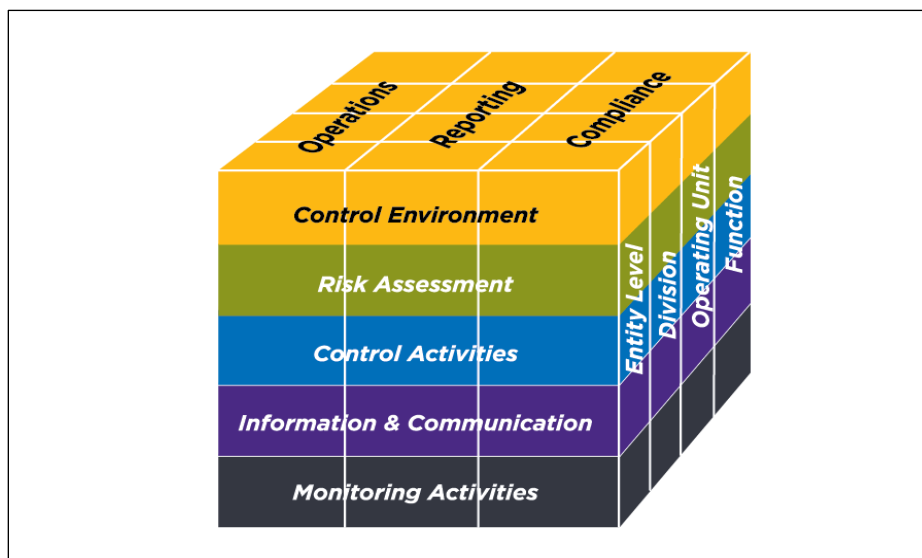
Internal control helps entities achieve important objectives and sustain and improve performance. Entities, whether private or public, use internal controls as a means to achieve the objectives of the organization by designing processes that control the risk of the organization. An effective internal control framework requires an entity's management and board of directors to use judgment that is dynamic, integrated, and responsive to the needs of the company,³⁷ rather than rigidly adhere to past policies and procedures.

A COSO framework, depicted in **Figure 3**, was created to help practitioners assess internal controls not as an isolated issue, but rather as an integrated framework for how internal controls work together across an organization to help achieve the objectives as determined by management.

The cube represents the integrated perspective recommended by COSO for practitioners who are creating and assessing internal controls. The cube may be best understood by examining each set of components separately.

- The three objectives—Operations, Reporting, and Compliance—are represented by the columns. The objectives are designed to help an organization focus on different aspects of internal control to help management achieve its objectives.
- The five components—Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring Activities—are represented by the rows. The components represent what is required to achieve the three objectives.
- An entity's organizational structure—Entity-Level, Division, Operating Unit, and Function—is represented by the third dimension. For an organization to achieve its objectives, according to COSO, internal control must be effective and integrated across all organization levels.³⁸

Figure 3. COSO Framework



Source: COSO, *Internal Control - Integrated Framework*, Executive Summary, May 2013, p. 6.

³⁷ COSO, *Internal Control - Integrated Framework*, Executive Summary, May 2013, p. 6.

³⁸ COSO, *Internal Control - Integrated Framework*, Executive Summary, May 2013, p. 6.

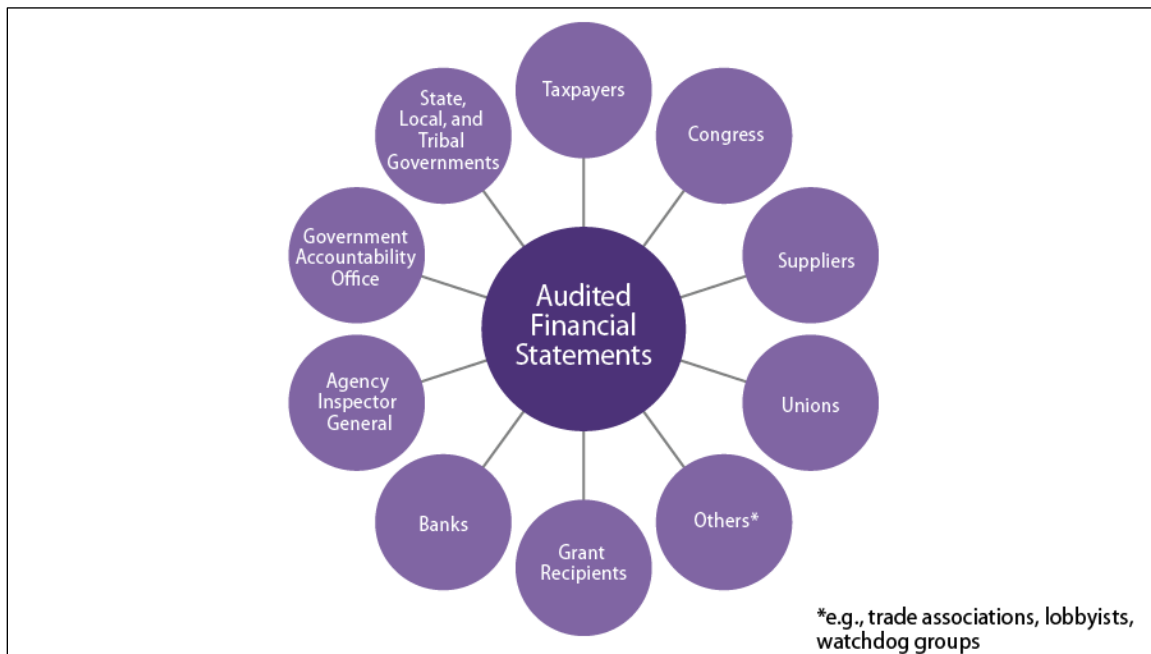
Federal Government

Taxpayers want the government to use their economic resources effectively and efficiently. There is also considerable debate as to whether the current generation of citizens should shift the costs for the benefits derived in the near term to future taxpayers (i.e., deficit spending to meet the current needs of the government). Thus, periodically assessing if the government's financial position has improved or deteriorated is important not only from an economic perspective but also because it has social and political implications.

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 statements report the U.S. government's financial position and condition, its revenues and costs, assets and liabilities, other responsibilities and commitments, and other financial issues. The U.S. government's financial report is a means of communicating to multiple stakeholders, which are depicted in **Figure 4**. *The Financial Report of the United States Government*, issued by the Department of the Treasury, serves the same basic purpose as the annual report issued by a publicly traded company to its investors.

Although the underlying accounting and auditing concepts in the federal government closely follow those in the private sector, the expected outcomes are different. Thus, financial reporting and auditing standards in the federal government have a different focus than in the private sector. The standard-setting body for federal financial reporting is the Federal Accounting Standards Advisory Board (FASAB). The standard-setting body for federal auditing standards is the GAO.³⁹

Figure 4. Stakeholders in the Federal Government



Source: CRS.

³⁹ For additional information on federal financial reporting, see CRS Report R42975, *Federal Financial Reporting: An Overview*, coordinated by (name redacted)

Accounting

The accounting standards established by FASAB are considered Generally Accepted Accounting Principles for federal financial reporting entities.⁴⁰ FASAB was created by the GAO, Department of the Treasury, and the Office of Management and Budget; they are also its current sponsors. FASAB is funded by the three sponsors, and its budget for 2017 was \$2.0 million.⁴¹

According to FASAB, there are four objectives of federal financial reporting.⁴² The following four objectives, phrased here as FASAB's recommendations, consider the many needs expressed by current and potential users of federal financial information, and they provide a framework for assessing the federal government's existing financial reporting systems:

Budgetary Integrity. Federal financial reporting should assist the government in being accountable in its tax expenditures. Federal financial reporting should thus provide information that helps stakeholders determine

- how budgetary resources have been obtained and used and whether their acquisition and use were in accordance with the legal authorization;
- the status of budgetary resources; and
- how information on the use of budgetary resources relates to information on the costs of program operations, and whether information on the status of budgetary resources is consistent with other accounting information on assets and liabilities.

Operating Performance. Federal financial reporting should provide information for evaluating the services, efforts, costs, and accomplishments of the government. Federal financial reporting should provide information that helps stakeholders determine

- the costs of providing specific programs and activities;
- the efforts and accomplishments associated with federal programs and the changes over time and in relation to costs; and
- the efficiency and effectiveness of the government's management of its assets and liabilities.

Stewardship. Federal financial reporting should help in the assessment of the government's operations and investments for the given period and how, as a result, the government's and the nation's financial condition has changed and may change in the future. Federal financial reporting should provide information that helps to determine whether

- the government's financial position improved or deteriorated over the period;
- future budgetary resources will likely be sufficient to sustain public services and to meet obligations as they come due; and
- government operations have contributed to the nation's current and future well-being.

⁴⁰ Generally Accepted Accounting Principles (GAAP) is different for private, federal, and state and local governments, although they may share many common principles.

⁴¹ Federal Accounting Standards Advisory Board (FASAB), *Annual Report Fiscal Year Ended September 30, 2016*, November 15, 2016.

⁴² FASAB, *Statements of Federal Financial Accounting Concepts and Standards*, June 2009.

Systems and Control. Federal financial reporting should assist stakeholders in determining whether financial management systems and internal accounting and administrative controls are adequate to ensure that

- transactions are executed in accordance with budgetary and financial laws and other requirements, consistent with the purposes authorized, and are recorded in accordance with federal accounting standards;
- assets are properly safeguarded to deter fraud, waste, and abuse; and
- performance measurement information is adequately supported.⁴³

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.⁴⁴ In addition to meeting this legal mandate, GAO also does work at the request of congressional committees. GAO's budget authority for 2017 (excluding offsetting collections) was \$545 million.⁴⁵

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. Whether external or internal auditors perform the function, they are required to adhere to the standards established under GAGAS.

The Yellow Book requires auditors to consider the visibility and sensitivity of government programs in determining the materiality threshold:⁴⁶

Additional considerations may apply to GAGAS financial audits of government entities or entities that receive government awards. For example, in audits performed in accordance with GAGAS, auditors may find it appropriate to use lower materiality levels as compared with the materiality levels used in non-GAGAS audits because of the public accountability of government entities and entities receiving government funding, various legal and regulatory requirements, and the visibility and sensitivity of government programs.⁴⁷

The Yellow Book further notes that audits performed in accordance with GAGAS can lead to improved government management through better decisionmaking and oversight, effective and efficient operations, and accountability and transparency for resources and results.⁴⁸

⁴³ FASAB, *Statements of Federal Financial Accounting Concepts and Standards*, June 2009.

⁴⁴ U.S. Government Accountability Office (GAO), *About GAO*, <https://www.gao.gov/about/>.

⁴⁵ CRS Report R44515, *Legislative Branch: FY2017 Appropriations*, by (name redacted)

⁴⁶ Government auditing standards issued by the GAO refer to the American Institute of Certified Public Accountants' (AICPA's) definition of *materiality*. Part of the definition of materiality provided by the AICPA states that "misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users made on the basis of the financial statements." See AICPA, *Materiality in Planning and Performing an Audit*, AU-C Section 320, 2016.

⁴⁷ GAO, *Government Auditing Standards*, 2011 Revision, December 2011, <http://www.gao.gov/products/GAO-12-331G>.

⁴⁸ GAO, *Government Auditing Standards*, 2011 Revision, December 2011, p. 5, <http://www.gao.gov/products/GAO-12-331G>.

Similar to the requirements in the private sector, GAGAS requires federal financial reporting to disclose compliance with laws, regulations, contracts, and grant agreements that have a material effect on the entities' financial statements.⁴⁹ In addition to the COSO framework for internal control policies and procedures, GAGAS also recommends utilization of the Standards for Internal Control in the Federal Government⁵⁰ and the Internal Control Management and Evaluation Tool⁵¹ created specifically for federal government entities by the GAO.⁵²

Whether from academia or other nonprofits that promote specific auditing techniques or guidance, over time practitioners adopt and incorporate best practices from various entities as part of the required audit practice. In addition to the Yellow Book⁵³ issued by the GAO, there are other standards or guidance promulgated by different organizations that influence the auditing standards of the federal government, including⁵⁴

- The Red Book—International Professional Practices Framework, issued by the Institute of Internal Auditors;⁵⁵
- The Green Book—Standards for Internal Control in Federal Government, issued by the GAO;⁵⁶ and
- The Green Book—Principles and Standards for Offices of Inspector General, issued by the Association of Inspectors General.⁵⁷

State and Local Governments

Similar to the expectations of the federal government, state and local taxpayers expect their respective governments to provide taxpayers and the legislature a comprehensive view of how the government is managing its resources.⁵⁸ The financial statements issued by state and municipal governments communicate the state or local government's financial position and condition, its revenues and costs, assets and liabilities, and other responsibilities and commitments. The Comprehensive Annual Financial Report (CAFR) issued by each state or local jurisdiction serves the same purpose as the annual report issued by a publicly traded company to its investors. Those

⁴⁹ GAO, *Government Auditing Standards*, 2011 Revision, December 2011, p. 15, <http://www.gao.gov/products/GAO-12-331G>.

⁵⁰ GAO, *Standards for Internal Control in the Federal Government*, AIMD-00-21.3.1, November 1999, <http://www.gao.gov/products/GAO/AIMD-00-21.3.1>.

⁵¹ GAO, *Internal Control Management and Evaluation Tool*, GAO-01-131G, August 1, 2001, <http://www.gao.gov/products/GAO-01-1008G>.

⁵² GAO, *Government Auditing Standards*, 2011 Revision, December 2011, p. 179, <http://www.gao.gov/products/GAO-12-331G>.

⁵³ Accounting and auditing standards are periodically updated in response to emerging trends. GAO issued an exposure draft in April 2017. The advisory council chosen by the Comptroller General consists of representatives from federal, state, and local governments, as well as the private sector and academia. GAO, *GAO Issues New Draft Update to "Yellow Book," the Preeminent Standards for Government Auditing*, April 5, 2017, https://www.gao.gov/press/government_auditing_press_release_2017.htm.

⁵⁴ James D. Boyd and Sheila M. Roberts, *Red Book vs. Yellow Book*, January, p. 3.

⁵⁵ The Institute of Internal Auditors: North America, *Standards and Guidance: International Professional Practices Framework (IPPF)*, 2013, <https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx>.

⁵⁶ GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G, September 2014, <http://www.gao.gov/greenbook/overview>.

⁵⁷ Association of Inspectors General, *Principles and Standards for Office of Inspector General*, May 2014, <http://inspectorsgeneral.org/>.

⁵⁸ In addition to tax revenue, local governments also receive revenues from other levels of government through grants and shared revenues. They also raise revenues through other means, such as user license fees and permits.

financial statements and annual reports are a means of communicating such information to multiple stakeholders (see **Figure 5**).

Figure 5. Stakeholders in the State or Local Governments



Source: CRS.

Because the Constitution limits the power of the federal government on matters that are within the jurisdiction of states, each state or territory has flexibility to choose the accounting and auditing standards that suit its needs.⁵⁹ The underlying accounting and auditing concepts at the state and local levels are similar to those at the federal level. There is also significant overlap with private-sector accounting and auditing concepts, but the expected outcomes are different. Thus, financial reporting and auditing standards for state and local governments have a different focus than in the private sector and are more closely aligned with the federal government's objectives.

The standard-setting body for state and local governments' accounting standards is the Governmental Accounting Standards Board (GASB). While publicly traded companies are required by the SEC to follow the accounting standards created by FASB, state and municipal governments are not required to follow accounting standards promulgated by GASB. Generally, unless a local government is a recipient of federal funds through grants or shared revenue, it is not required to follow accounting or auditing standards that are applicable to the federal government.

Accounting

The accounting standards established by GASB are considered Generally Accepted Accounting Principles (GAAP) for states and municipalities. A higher-level government such as a state or a county can require all subordinate municipalities or tax authorities to follow GASB accounting standards. States and municipalities can adopt GASB accounting standards without any changes,

⁵⁹ For more information about state sovereignty, see CRS Report RL30315, *Federalism, State Sovereignty, and the Constitution: Basis and Limits of Congressional Power*, by (name redacted) .

choose not to adopt a specific standard, or modify a standard to meet their specific needs. Not adopting or changing an accounting standard might allow the entity to report a more positive outcome, especially when revising an accounting standard leads to an economic prediction that is worse than the projection under the previously used standard.⁶⁰

According to a GASB study, there were 87,575 nonfederal government entities (states and local governments and other government-created entities, such as utilities, water districts, and hospital authorities) in 2008. States have established different policies for whether they and their respective local governments will follow standards (GAAP) as promulgated by GASB. Twenty-seven states are required to follow GAAP as promulgated by GASB. Twenty-eight states require some or all of their counties to follow GAAP. Thirty-six states have laws or regulations that require at least some of their political subdivisions to follow GAAP. Thirty-four states require some or all school districts to follow GAAP. The study also noted that in some states, certain local jurisdictions are required to conform to GAAP, but they do not actually do so, and either no enforcement mechanism is available, or conformance is not enforced.⁶¹

GASB is funded by fees collected from broker-dealers by the SEC through the Financial Industry Regulatory Authority (FINRA).⁶² The accounting support fees are collected by FINRA from member firms that report trades to the Municipal Securities Rulemaking Board (MSRB). In other words, broker-dealers that transacted state and municipal securities pay the accounting support fees for GASB. Section 978 of the Dodd-Frank Act requires the SEC to collect the support fees from a national securities association that is registered under the Securities Exchange Act of 1934.⁶³ GASB incurred \$10 million in program and support expenses in 2015. The expenses were primarily paid with \$7.4 million from accounting support fees. The remainder of the expenses was paid through other revenue sources, such as sales of publications, or through subsidies from the Financial Accounting Foundation's (FAF's) excess reserve funds. GASB is a subsidiary of FAF.⁶⁴

According to GASB, financial reporting plays a major role in holding the government accountable to the taxpayer—based on a belief that taxpayers have the right to know how the government is using its resources.⁶⁵ Information that is made available may lead to debate among citizens and elected officials. GASB identifies three major objectives associated with publicly sharing financial information, and it recommends:

Accountability. Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable stakeholders to assess that accountability by

- providing information to determine whether current-year revenues are sufficient to pay for current-year services;

⁶⁰ "Public Employee Pension System Data: FY 2014 vs. FY 2013," *Governing - The States and Localities*, <http://www.governing.com/gov-data/finance/public-pensions-fiscal-2014-2013-financial-data.html>.

⁶¹ Government Accounting Standards Board (GASB), *State and Local Government Use of Generally Accepted Accounting Principles for General Purpose External Financial Reporting*, Research Brief, March 2008.

⁶² FINRA is a self-regulatory organization authorized by Congress (P.L. 75-719) to regulate the broker-dealer industry. The Securities and Exchange Commission has oversight responsibility over FINRA.

⁶³ P.L. 73-291

⁶⁴ According to FAF, the FAF, FASB, and GASB are funded by a combination of accounting support fees, subscription and publication revenue, and investment income. The largest portion is accounting support fees. FAF, *2015 Annual Report*, http://www.accountingfoundation.org/annual_reports/2015/financials.html.

⁶⁵ GASB, *GASB Concepts Statement No. 1 Summary*, <http://www.gasb.org/st/concepts/gconsum1.html>.

- demonstrating whether resources were obtained and used in accordance with the entity's legally adopted budget, and demonstrating compliance with other finance-related legal or contractual requirements; and
- providing information to assist stakeholders in assessing the service efforts, costs, and accomplishments of the governmental entity.

Evaluation by the Public. Financial reporting should assist stakeholders in evaluating the operating results of the governmental entity for the year by

- providing information about sources and uses of financial resources;
- providing information about how it financed its activities and met its cash requirements; and
- providing information necessary to determine whether its financial position improved or deteriorated as a result of the year's operation.

Current and Future Focus. Financial reporting should assist stakeholders in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they come due by

- providing information about its financial position and condition;
- providing information about its physical and other nonfinancial resources that will have useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources; and
- disclosing legal or contractual restrictions on resources and the risk of potential loss of resources.⁶⁶

State and local governments seek to meet these objectives through issuing CAFR. The below text box explains the structure and contents of a CAFR.

⁶⁶ GASB, *GASB Concepts Statement No. 1 Summary*, <http://www.gasb.org/st/concepts/gconsum1.html>.

Structure and Contents of a Comprehensive Annual Financial Report

A Comprehensive Annual Financial Report is a detailed presentation of a state's or a municipality's financial condition. Each of the three major sections—introductory, financial, and statistical—has subsections. This text box discusses some of the significant subsections.

Introductory Section. The introductory section includes basic information about the reporting entity. Elements of the introductory section include the cover, title page, table of contents, list of principal officials, organization chart, and letter of transmittal. If the entity received the Government Finance Officers Association's certificate of achievement for financial reporting, then the certificate will also be included. The letter of transmittal is considered the most important element of the introductory section. It is expected to address the accounting standards followed by the entity; provide a profile of the government; explain the local economy and long-range planning for the jurisdiction; and include the auditor's report.

Financial Section. The financial section includes the independent auditor's report, management's discussion and analysis, basic financial statements for the reporting entity and other significant subcomponents, required supplementary information (RSI), combined financial statements, and individual fund statements. RSI might focus on the funding progress of employees' pension plans and other postemployment benefit plans. Combined and individual fund financial statements and schedules present information on funds for which the reporting entity either has custodial or oversight responsibility.

Statistical Section. The statistical section typically provides stakeholders with historical perspective, context, detail, associated notes, and required supplementary information to understand and assess a government's economic condition. The statistical section is presented in five categories—financial trends information, revenue capacity information, debt capacity information, demographic and economic information, and operating information.⁶⁷

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.⁶⁸ 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.⁶⁹

While states or municipalities may have differences in their financial reporting and audit needs, the unifying theme of government accountability to its citizens creates more commonality than differences. As an example, states such as California⁷⁰ and Florida⁷¹ either utilize GAGAS for all state audits or tailor the standards to comply with state statute. Cities such as Miami, FL,⁷² and San Diego, CA,⁷³ also use GAGAS.

⁶⁷ Pete Rose, CGFM, and Wendy M. Payne, CGFM, CPA, *Governmental Accounting, Financial Reporting, and Budgeting Study Guide*, Association of Government Accountants, 2011, Section II, pp. 22-25, <https://www.agacgfm.org/CGFM-Certification/About-CGFM.aspx>.

⁶⁸ For example, see City of Denver, *About the Auditor*, <https://www.denvergov.org/content/denvergov/en/denver-auditor/about-the-auditor.html>.

⁶⁹ For example, see State of Oregon, *Audit Standards and Protocols*, <http://sos.oregon.gov/audits/Pages/standards.aspx>.

⁷⁰ California State Auditor, *Financial and Compliance Audits*, https://www.auditor.ca.gov/aboutus/financial_and_compliance_audits.

⁷¹ State of Florida, Auditor General, *Rules of the Auditor General: Florida Single Audit Act Audits Nonprofit and for Profit Organizations*, July 1, 2016.

⁷² City of Miami—Office of the Independent Auditor General, *Frequently Asked Questions*, http://www.miamigov.com/internal_audits/pages/.

⁷³ The City of San Diego—Office of the City Auditor, *Audit Handbook*, Section 3, p. 14, <https://www.sandiego.gov/>

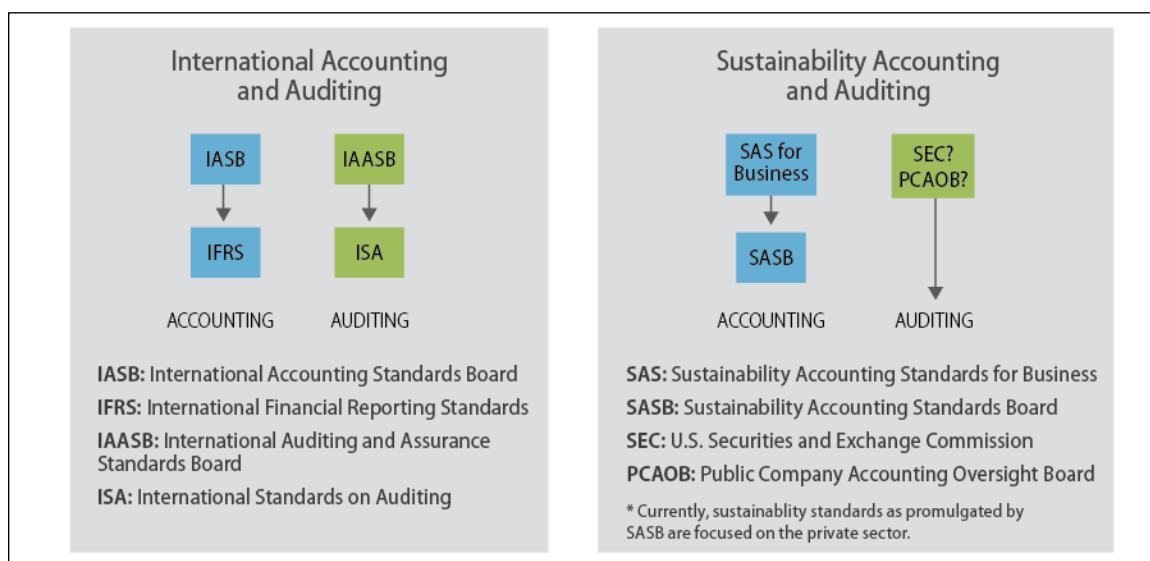
In addition to states and local governments utilizing the Yellow Book issued by the GAO, there are other organizations that influence the auditing standards for state and municipal governments.⁷⁴ The Blue Book issued by the Government Finance Officers Association, for example, provides guidance on accounting, auditing, and financial reporting standards.⁷⁵

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, whether or to what degree international accounting and auditing standards should influence U.S. GAAP and U.S. GAAS, respectively. The second is the newly emerging sustainability accounting standards for businesses, which encompass environmental, social, and governance (ESG) issues. Both of these policy issues are discussed in greater detail below.

Figure 6 provides an overview of international accounting and auditing standard-setters and for sustainability accounting and auditing.

Figure 6. International and Sustainability Standard-Setters



Source: CRS.

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.-based firms. Investors in the United States and elsewhere rely on financial statements to make informed decisions. The earlier discussion about financial statements as a means of communication with various private-sector stakeholders (see **Figure 2**) is also applicable to international accounting and auditing standards.

auditor/reports.

⁷⁴ James D. Boyd and Sheila M. Roberts, *Red Book vs. Yellow Book*, January, p. 3.

⁷⁵ Stephen J. Gauthier, *Government Accounting, Auditing, and Financial Reporting (GAAFR)*, Government Finance Officers Association, 2012, <http://www.gfoa.org/governmental-accounting-auditing-and-financial-reporting-gaafr-e-book>.

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. 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. A counterpart to U.S. GAAS is International Standards on Auditing (ISA). This section of the report provides an overview of international accounting and auditing standards and discusses some policy issues that might be of interest to Congress and investors.

Accounting

IFRS and U.S. GAAP fundamentally differ in their approach to creating accounting standards, but they share similar objectives of creating accounting and financial reporting standards that will facilitate efficient capital markets. IFRS is a principles-based accounting standard that provides broad, flexible guidelines that can be applied to a range of situations, but they can lead to inconsistent interpretation and application.⁷⁶ IFRS is subject to each jurisdiction's interpretation and institutional infrastructure. Countries with lower levels of gross domestic product or less-developed economies can realize savings by working with other countries to develop accounting standards that they can tailor to suit their jurisdictional needs. IFRS is promulgated by the International Accounting Standards Board (IASB); see **Figure 6**.

In contrast to IFRS, U.S. GAAP is generally understood to be a rules-based accounting standard that is less subject to interpretation. U.S. GAAP has evolved over 80 years within the U.S. institutional infrastructure to address the specific needs of the world's largest capital market—the United States.⁷⁷ In contrast to IFRS, rules-based accounting standards (U.S. GAAP) require specific guidelines to be followed, but they may not address unforeseen issues that may arise in the normal course of business.

Whether IFRS will eventually evolve into a rules-based standard similar to U.S. GAAP may not be known until after it has weathered significant scrutiny from practitioners and the judicial system. Despite the differences, accounting and auditing regulators in the United States and international regulators at times try to coordinate on specific standards.

IFRS has its genesis in the 1973 establishment of the predecessor organization to the International Accounting Standards Board, the International Accounting Standards Committee (IASC), by the AICPA and its counterparts in other countries.⁷⁸ The IASC, unlike FASB and IASB, was essentially a nonbinding agreement rather than a formal body. It was created to establish basic global accounting standards in response to increased economic integration and cross-border capital transactions.⁷⁹ In 2005, the EU member countries switched from their local GAAP to

⁷⁶ Rebecca Toppe Shortridge, PhD, CPA, and Mark Myring, PhD, "Defining Principles-Based Accounting Standards," *The CPA Journal Online*, 2009, <http://www.nysscpa.org/cpajournal/2004/804/essentials/p34.htm>.

⁷⁷ Linda A. MacDonald, project manager, FASB Simplification and Codification Project, "Principles-Based Approach to Standard Setting," *FASB newsletter*, November 27, 2002, http://www.fasb.org/project/principles-based_approach.shtml.

⁷⁸ The American Institute of Certified Public Accountants (AICPA) plays an integral part in creating accounting and auditing standards through its various activities, including developing and grading the Uniform CPA Examination and enforcing compliance with technical and ethical standards for its 400,000 members. AICPA, "About the AICPA," <http://www.aicpa.org/ABOUT/Pages/About.aspx>.

⁷⁹ FASB, *Comparability in International Accounting Standards—A Brief History*, <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156304264>.

IFRS. Since 2003, more than 100 countries in varying degrees have either adopted or converged with IFRS.⁸⁰ The IASB is a member of the IFRS Foundation, which is based in the United Kingdom. Unlike the designated authority granted by the SEC to FASB to set U.S. accounting standards, the IASB is an international body tasked with the responsibility, but not the authority, to promulgate the use of IFRS in member countries.⁸¹

In 2015, the IFRS Foundation's income was £30.6 million (British pounds). Contributors to the foundation from the United States include, among many others, the U.S. Federal Reserve, AICPA, Chartered Financial Analyst Institute, Oracle, Citigroup, Deloitte, and KPMG.⁸²

The IASB seeks to promote unified accounting standards through IFRS by broadly defining the principles of specific accounting concepts. Countries have two main ways of incorporating IFRS:

1. **Adoption.** Accept IFRS without any modification as set by IASB (e.g., EU member countries).
2. **Convergence.** Closely align some or all local GAAP within a jurisdiction with IFRS. Convergence can be achieved by either incorporating specific standards from IFRS or modifying the local GAAP to resemble IFRS more closely. For example, in China, IFRS is neither required nor permitted as promulgated by IASB in the original format. The Chinese Accounting Standards have substantially converged with IFRS, but they remain as a distinct standard that is suited for the Chinese governance and judicial system. To a significant degree, IFRS was customized to a more easily understandable format for Chinese markets.⁸³

Similar to FASB, the AICPA, IASB, and other nongovernmental organizations create and promote accounting and auditing rules and guidelines, but they do not have the authority to enforce these in the U.S. private sector.

Auditing

Similar to the expectations that the financial statements of domestic firms should be free of material misstatement whether caused by error or fraud, the same set of expectations exist for financial statements of foreign firms. Foreign firms also engage an auditor to give an unbiased professional opinion on whether the financial statements and related disclosures are fairly stated in all material⁸⁴ respects for a given period of time in accordance with the established local GAAP. The International Auditing and Assurance Standards Board (IAASB) promulgates International Standards on Auditing (ISA) for adoption by each country.

⁸⁰ IFRS, "Jurisdiction Profiles," September 25, 2014, <http://www.ifrs.org/use-around-the-world/Pages/Jurisdiction-profiles.aspx>.

⁸¹ SEC, *Reaffirming the Status of the FASB as the Designated Private-Sector Standard Setter*, policy statement, April 25, 2003, <https://www.sec.gov/rules/policy/33-8221.htm>.

⁸² International Financial Reporting Standards Foundation, *Annual Report 2016*, p. 48, <https://www.iasplus.com/en/news/2017/04/ifrsf-2016-report>.

⁸³ PricewaterhouseCoopers (PwC), "China," in *IFRS Adoption by Country* (DE: PricewaterhouseCoopers, 2014), p. 159, <http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-status-country.jhtml>.

⁸⁴ 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. 17 C.F.R. §221.

Most of the previous discussion about auditing from the private sector is applicable in the context of international auditing as well. The rest of this section provides background information on IAASB and the International Federation of Accountants (IFAC) and what, if any, influence the United States has on international auditing standards. IAASB is a member organization of the IFAC.

There are other member organizations within IFAC that focus on creating international accounting standards for the public sector, international ethics standards for accountants, and international educational standards for accountants.⁸⁵ PCAOB, while not a member, has observer status with IAASB.⁸⁶

IFAC was founded in 1977 in Munich, Germany, at the 11th World Congress of Accountants. There were 63 founding members from 51 countries, and membership has since grown to include 175 members and associates from 130 countries. AICPA was a founding member of IFAC, and the U.S.-based Institute of Management Accountants is also a member.⁸⁷ Both IFAC and IAASB are funded by members. IFAC is governed by the IFAC Council and board of directors. The IFAC Council is composed of one representative from each member, and the board is composed of not more than 22 members.

IFAC is overseen by the Public Interest Oversight Board (PIOB),⁸⁸ which seeks to improve the quality of IFAC standards in the areas of audit, education, and ethics. PIOB in turn is accountable to a monitoring group composed of the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, the World Bank, the European Commission, and the Financial Stability Board. While there are no entities from the United States that are part of PIOB, the United States does have influence through the international organizations it supports, such as the Basel Committee on Banking Supervision and the World Bank.⁸⁹

The Road Ahead for U.S. Accounting and Auditing Standards and International Standards

One aspect of the powers Congress gave the SEC is the authority to establish accounting standards for the private sector in the United States.⁹⁰ Although the SEC has the Office of the

⁸⁵ The International Public Sector Accounting Standards Board (IPSASB) develops standards, guidance, and resources for use by public-sector entities. The International Ethics Standards Board for Accountants (IESBA) sets international ethics standards for professional accounting, including auditor independence requirements. The International Accounting Education Standards Board (IAESB) establishes standards in the area of professional accounting education that focus on technical competence, professional skills, values, ethics, and attitudes. International Federation of Accountants, *Independent Standard-Setting Boards*, <https://www.ifac.org/about-ifac>.

⁸⁶ International Federation of Accountants, *IAASB Welcomes US PCAOB's Efforts to Enhance the Auditor's Report*, Issues Publication Comparing IAASB and PCAOB Approaches, May 23, 2016, <https://www.ifac.org/news-events/2016-05/iaasb-welcomes-us-pcaob-s-efforts-enhance-auditor-s-report>.

⁸⁷ International Federation of Accountants (IFAC), *About IFAC*, <https://www.ifac.org/about-ifac>; IFAC, *Member Organization and Country Profiles*, Interactive Map, <https://www.ifac.org/about-ifac/membership/member-organizations-and-country-profiles?letter=U#members>.

⁸⁸ Public Interest Oversight Board (PIOB) is an independent oversight body for IFAC and other member groups. Public Interest Oversight Board, *About PIOB, What is the PIOB*, <http://www.ipiob.org/index.php/what-is-the-piob>.

⁸⁹ Public Interest Oversight Board (PIOB), *About PIOB - Origins of the PIOB*, <http://www.ipiob.org/index.php/origins-of-the-piob>.

⁹⁰ CRS In Focus IF10032, *Introduction to Financial Services: The Securities and Exchange Commission (SEC)*, by (name redacted)

Chief Accountant, whose primary mission is to establish and enforce accounting and auditing policy to ensure that financial statements improve investment decisions, the SEC has relied on the private sector to establish accounting and auditing standards in the United States. As previously discussed, FASB and its predecessor organizations have promulgated U.S. GAAP, with the SEC largely assuming an oversight role—except on the issue of establishing global accounting standards.⁹¹ The SEC since the early 2000s has at various times considered adopting IFRS or converging U.S. GAAP with IFRS. If the SEC chooses to switch from U.S. GAAP to IFRS, there may be major implications for U.S. firms and investors, which could be of interest to Congress in its oversight capacity of the SEC.

Congressional interest in accounting convergence has manifested itself in several ways, including hearings, letters to the SEC, and earlier enacted legislation. Congress expressed interest in the convergence of accounting standards at a March 2015 hearing on the SEC’s FY2016 budget request held by the House Committee on Financial Services.⁹² In June 2014, the bipartisan Joint Congressional Caucus on CPAs and Accountants wrote a letter to the SEC Chairman on the issue of convergence. In both instances, some Members of Congress voiced their concerns over “further incorporation of IFRS into the U.S. financial reporting system” and the existence of a “two-GAAP environment, enabling accounting arbitrage; investor confusion arising from differences in accounting treatments; and possible legal challenges.”⁹³ Some other Members of Congress have also expressed similar concerns publicly.⁹⁴ The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act⁹⁵ addressed many reforms to the financial industry, but did not specifically address accounting convergence issues.

Earlier congressional interest in IFRS has also manifested itself in enacted legislation that required the SEC to study the issue of adoption. For example, Section 108(d) of the Sarbanes-Oxley Act of 2002 required the SEC to “conduct a study on the adoption by the United States financial reporting system of a principles-based accounting system.”⁹⁶ The SEC concluded the study as required by SOX in 2003, recommending that U.S. standards should be more principles-based, while also recognizing the benefits and limitations of both rules-based and principles-based standards.⁹⁷

⁹¹ Since the creation of the SEC, domestic companies in the United States have used U.S. GAAP to issue financial statements. Stephen A. Zeff, “How the U.S. Accounting Profession Got Where It Is Today: Part 1,” *Accounting Horizons*, vol. 17, no. 3 (September 2003), pp. 191-193.

⁹² U.S. Congress, House Committee on Financial Services, *Examining the SEC’s Agenda, Operations, and FY2016 Budget Request*, Hearing, 114th Cong., 1st sess., March 24, 2015. On October 24, 2007, the Senate Committee on Banking, Housing and Urban Affairs (110th Congress) held a hearing on convergence of U.S. GAAP. U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs Subcommittee on Securities, Insurance, and Investment, *International Accounting Standards: Opportunities, Challenges, and Global Convergence Issues*, 110th Cong., 2nd sess., October 24, 2007, S.Hrg. 110-951 (Washington: GPO, 2007).

⁹³ Adrienne Gonzalez, “Bipartisan Congressional CPA Caucus Warns SEC Against Taking IFRS Too Fast,” *goingconcern*, July 23, 2014, <http://goingconcern.com/post/bipartisan-congressional-cpa-caucus-warns-sec-against-taking-ifrs-too-fast>.

⁹⁴ Brad Sherman and Peter King, “A Sure-Fire Way to Harm the Economy: A proposal to count leases as liabilities would cost 3.3 million jobs and add \$2 trillion to company balance sheets,” *Wall Street Journal*, November 9, 2014, <http://www.wsj.com/articles/brad-sherman-and-peter-king-a-sure-fire-way-to-harm-the-economy-1415574014>.

⁹⁵ P.L. 111-203.

⁹⁶ 15 U.S.C. §7218.

⁹⁷ SEC, *Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting*, July 25, 2003, <https://www.sec.gov/news/studies/principlesbasedstand.htm>.

Although the SEC report to Congress in 2003 stated the pursuit of a unified global accounting standard might be in the interest of the United States, a later report by the SEC in 2012 did not make any specific policy recommendations on incorporating IFRS.⁹⁸ Section 509 of the National Securities Markets Improvement Act of 1996⁹⁹ required the SEC to report to Congress on the development of international accounting standards. The study found that the international accounting standards, developed by the IASC, needed to be improved before acceptance could be considered in the United States.¹⁰⁰

The future direction of how accounting standards evolve in the United States could be decided by Congress, the SEC, or FASB. To date, Congress has not enacted legislation requiring or prohibiting the incorporation of IFRS. However, if Congress chooses to directly address the issue, it could pass legislation. Alternatively, it could continue to defer to the regulators, as it has since the creation of IFRS in 2003. Although the SEC has the statutory authority for establishing accounting standards in the United States, it has delegated the responsibility to FASB to continue to find common ground with IASB on specific standards.

To date, current and former leadership of the SEC have proposed three different approaches to incorporating IFRS within the United States, without achieving consensus. The first approach, according to then-SEC Chairman Mary Jo White at the aforementioned March 2015 hearing, was the establishment of a single set of high-quality global accounting standards.¹⁰¹

A second approach was proposed by SEC Commissioner Kara M. Stein in a March 2015 speech. In her speech, she stated that a single set of globally recognized, high-quality accounting standards is a “wonderful vision,” but with a myriad of shortcomings, and the “debate between dueling standards needs to move on.” She also stated that she was not convinced of a need to abandon U.S. GAAP in favor of IFRS. She proposed an alternate approach of developing accounting standards that are responsive to the interconnected digital world, which can minimize the differences between the two and maximize global investment and access to capital.¹⁰²

A third approach was proposed by then-SEC Chief Accountant James Schnurr that financial statements based on IFRS should be allowed as supplementary information to U.S. GAAP statements. In December 2014, he stated that international regulatory and accounting constituents continue to want clarity on what action, if any, the SEC will take regarding incorporating IFRS into U.S. GAAP.¹⁰³ In December 2016, current SEC Chief Accountant Wesley Bricker reiterated

⁹⁸ SEC, *Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers - Final Staff Report*, July 13, 2012, <https://www.sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>.

⁹⁹ P.L. 104-290.

¹⁰⁰ SEC, *Pursuant to Section 509(5) of the National Securities Markets Improvement Act of 1996 - Report on Promoting Global Preeminence of American Securities Markets*, October 1997, <http://www.sec.gov/news/studies/acctgsp.htm#sec1>.

¹⁰¹ U.S. Congress, House Committee on Financial Services, *Examining the SEC's Agenda, Operations, and FY2016 Budget Request*, Hearing, 114th Cong., 1st sess., March 24, 2015.

¹⁰² Commissioner Kara M. Stein, *International Cooperation in a New Data-Driven World*, Securities and Exchange Commission, speech, Washington, DC, March 26, 2015, <http://www.sec.gov/news/speech/2015-spch032615kms.html#.VRXQeOGAlsQ>.

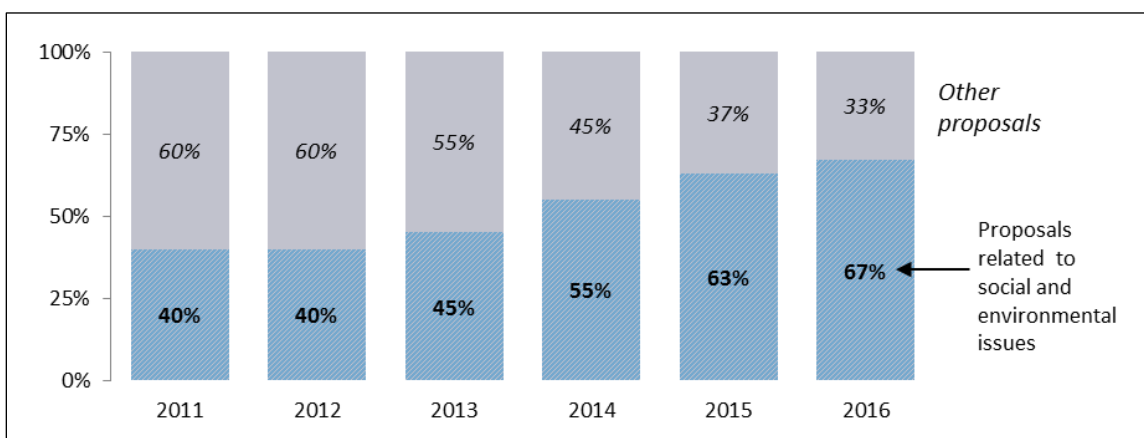
¹⁰³ Ken Tysiac, “SEC Will Seek Comments on New Possibility for Voluntary IFRS Adoption,” *Journal of Accountancy*, December 8, 2014, <http://journalofaccountancy.com/news/2014/dec/ifrs-voluntary-adoption-201411476.html>.

Schnurr's statements, adding that for the foreseeable future U.S. GAAP best serves the needs of investors and others who rely on financial reporting by U.S. issuers.¹⁰⁴

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, and shareholder expectations for corporations to address material environmental, social, and governance (ESG) issues have continued to increase. In alignment with the increasing shareholder expectations in ESG issues, the percentage of shareholder proposals related to these issues filed with SEC-registered firms increased from 40% to 67% between 2011 and 2016 (see **Figure 7**).

Figure 7. Shareholder Proposals Pertaining to Environmental, Social, and Governance (ESG) Issues



Source: Sustainability Accounting Standards Board (SASB), *2015 Annual Report*, p. 21.

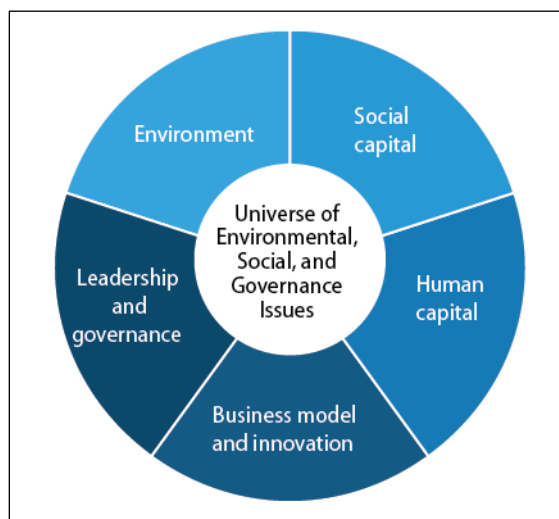
Note: SASB obtained the information from other sources. 2011-2014 information was obtained from Ernst and Young. SASB obtained 2015 and partial-year 2016 shareholder proposal information from As You Sow. SASB's 2015 annual report was issued in June 2016.

Sustainability issues include a firm's environmental and social impact as well as how a firm manages environmental and social capital to create long-term value.¹⁰⁵ Sustainability topics encompass such issues as environmental, social, and governance (ESG) topics (see **Figure 8**).

¹⁰⁴ Wesley R. Bricker, *Working Together to Advance High Quality Information in the Capital Markets*, SEC, December 5, 2016, <https://www.sec.gov/news/speech/keynote-address-2016-aicpa-conference-working-together.html>.

¹⁰⁵ A case study about United Parcel Service's (UPS's) efforts to increase profitability and reduce its environmental footprint is discussed at the end of this section.

Figure 8. Universe of Environmental, Social, and Governance Issues
(as defined by SASB)



Source: Sustainability Accounting Standards Board (SASB), *Conceptual Framework*, October 2013, p. 8.

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 Congress has enacted regulations that address many of the ESG issues. Additional disclosures and reporting requirements, they say, could be an unneeded regulatory burden for firms.¹⁰⁶ Some of the legislation and regulatory requirements that were enacted or revised in the last decade that address ESG issues include CEO pay as compared to median compensation of all other employees,¹⁰⁷ clawback provisions on incentive-based compensation,¹⁰⁸ disclosure of origins of conflict minerals,¹⁰⁹ GAAP requirements to disclose material information to the public, and Regulation S-K—an SEC requirement for firms to share nonfinancial information with investors, the public, and the SEC.

The Sustainability Accounting Standards Board (SASB), a U.S.-based non-profit, has created a set of provisional 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. As discussed below, publicly traded firms are subject to other ESG-related requirements.

¹⁰⁶ Ralph Thurm, “Reforming Sustainability Reporting: For and Against,” *The Guardian*, March 11, 2013, <https://www.theguardian.com/sustainable-business/reforming-sustainability-reporting-pros-cons>.

¹⁰⁷ For more information, see CRS Report R43262, *The “Pay Ratio Provision” in the Dodd-Frank Act: Legislation to Repeal It in the 113th Congress*, by (name redacted)

¹⁰⁸ For more information, see CRS Report R44554, *The Dodd-Frank Act: An Overview of the 2016 Incentive-Based Compensation Proposal*, by (name redacted) and (name redacted)

¹⁰⁹ For more information, see CRS Report R43639, *Conflict Minerals and Resource Extraction: Dodd-Frank, SEC Regulations, and Legal Challenges*, by (name redacted) and (name redacted)

Corporations and SASB Disclosure

The SEC does not require disclosures as specified by SASB for publicly traded firms, but there are other regulatory requirements, such as existing GAAP disclosure requirements and Regulation S-K (see text box below), that require significant sustainability issues to be disclosed by publicly traded firms. In addition, the Sarbanes-Oxley Act requires that upon the sale or disposition of property that triggers environmental remediation obligations and environmental events, a company must disclose the potential material impact to investors in its financial statements. As an example of an ESG disclosure, in the BP Deepwater Horizon oil leak in 2010,¹¹⁰ the related liability was required to be disclosed according to GAAP, as it could have materially affected the company's financial condition.¹¹¹

In addition to the SEC requirements, there may also be other federal or state requirements mandating disclosure to the public on issues related to sustainability. Similarly, in an international context, either by regulatory requirement or through stock exchanges, over 33 countries have various ESG disclosure requirements.¹¹²

Those in favor of an alternative set of requirements for disclosure of ESG issues question how useful the existing disclosure requirements are to investors. Usually, the need to disclose issues related to sustainability arises from concerns over corporate risk. Often, however, sustainability disclosures use boilerplate language meant to meet regulatory requirements or to avoid potential lawsuits. Boilerplate language, arguably, might not give any specifics of potential financial impact but might meet the basic disclosure requirements to avoid a potential lawsuit or fines from regulators.

¹¹⁰ National Oceanic and Atmospheric Administration (NOAA) Office of Response and Restoration, *Deepwater Horizon Oil Spill*, <http://response.restoration.noaa.gov/oil-and-chemical-spills/significant-incidents/deepwater-horizon-oil-spill>.

¹¹¹ Bernie Hawkins, Cory Manning, and Mike Bryan, *Disclosing Environmental Liabilities: Recent Developments in Legal and Accounting Standards*, American Bar Association, June 2007, http://www.americanbar.org/publications/blt/2009/07/09_hawkins.html.

¹¹² The 33 countries include Argentina, Australia, Austria, Brazil, Canada, China, Denmark, Ecuador, Egypt, Finland, France, Germany, Greece, Hungary, India, Indonesia, Ireland, Italy, Japan, Korea, Luxemburg, Malaysia, Mexico, Netherlands, Norway, Saudi Arabia, Singapore, South Africa, Spain, Turkey, and the United Kingdom. Harvard Kennedy School, The Hauser Institute for Civil Society at the Center for Public Leadership, *Corporate Social Responsibility Disclosure Efforts by National Governments and Stock Exchanges*, March 27, 2015, <http://iri.hks.harvard.edu/csr>.

Regulation S-K

Regulation S-K provides a framework for sharing nonfinancial information with investors, the public, and the SEC. The regulation was adopted under the Securities Act of 1933 and the Securities Exchange Act of 1934 to create a uniform and integrated reporting framework for SEC-registered companies. If a firm files certain Forms (S-1, 10-K, and 8-K) with the SEC, then it might be required to address issues surrounding Regulation S-K:

- Form S-1: Used by companies to register securities with the SEC.
- Form 10-K or 20-F: Required annual financial report.
- Form 8-K: Used to notify investors and the public of specific material events at a company.

Several sections of the regulation may require disclosure of sustainability issues, but some may be more relevant than others. For example:

- Item 103: Disclosure of legal proceedings requires firms to disclose information about any legal proceedings that are material, or where government sanctions exceed \$100,000.
- Item 303: Management's discussion and analysis of financial condition and results of operations requires a company to disclose any known trends, events, or uncertainties that are reasonably likely to affect the company's liquidity or capital expenditures.
- Item 503(c): Risk Factors requires a company to disclose the most significant risks that could impact the company's business, financial condition, or future results.¹¹³

Sustainability Accounting Standards Board

The Sustainability Accounting Standards Board (SASB) was founded in 2011 as an independent organization to promulgate sustainability accounting standards for the private sector.¹¹⁴ The board has not been recognized by Congress or sanctioned by the SEC as an official standard-setting body for ESG issues. Since it is not an officially sanctioned regulator, any future wholesale implementation of the standards created by SASB are voluntary. According to SASB, its definition of materiality¹¹⁵ is informed by federal securities laws. In defining industry-specific material sustainability issues, SASB considers evidence of shareholder interest, evidence of financial impact, and, in certain circumstances, forward-looking impact, but it does not purport to prescribe to any company or industry what constitutes material disclosure.¹¹⁶ The criteria for materiality under SASB might potentially consider a broader or narrower scope of information; otherwise, firms would be required to disclose material events under existing regulations.

According to SASB, immaterial sustainability issues or boilerplate disclosures have little, if any, effect on shareholder value; thus, identifying material sustainability issues within each industry

¹¹³ Bernie Hawkins, Cory Manning, and Mike Bryan, *Disclosing Environmental Liabilities: Recent Developments in Legal and Accounting Standards*, American Bar Association, June 2007, http://www.americanbar.org/publications/blt/2009/07/09_hawkins.html.

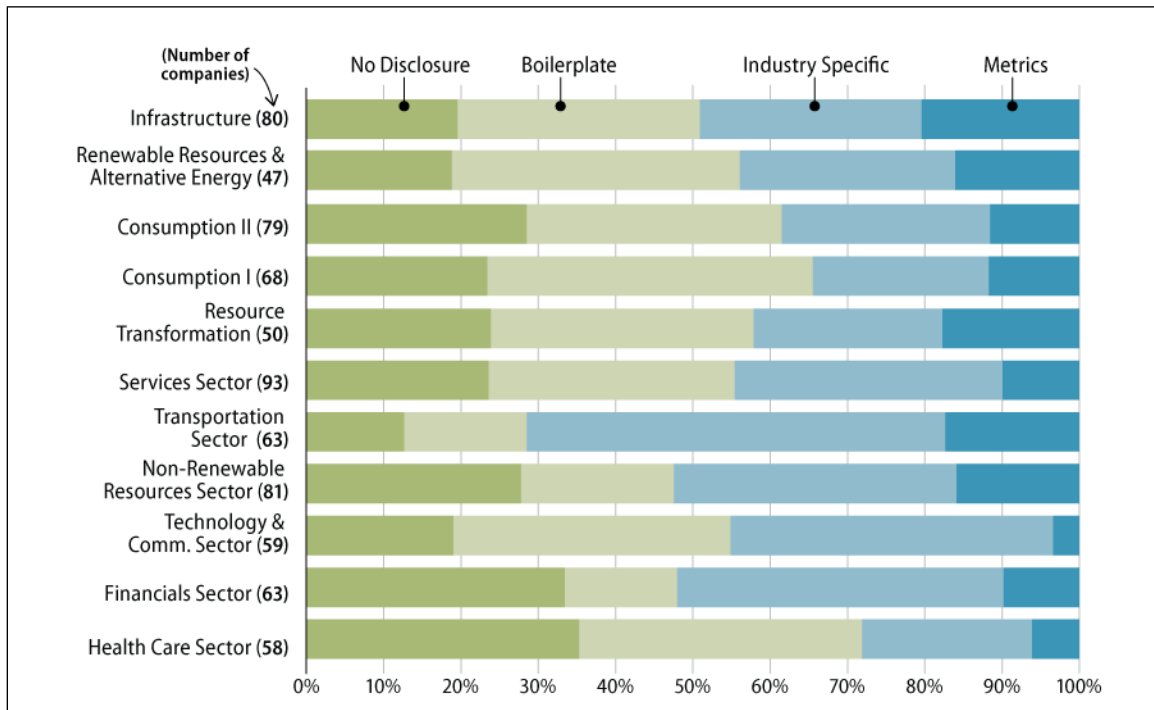
¹¹⁴ Mozaffar Khan, George Serafeim, and Aaron S. Yoon, "Corporate Sustainability: First Evidence of Materiality," *The Accounting Review*, January 5, 2016.

¹¹⁵ The definition of materiality has been a widely addressed issue by Congress, the courts, and regulators. In financial reporting the SEC has provided guidance that although certain "rules of thumb" may assist in preparation of the financial statements, such as a 5% variation in income or assets or liabilities as a threshold, the SEC suggests that any such threshold should be considered in the context of surrounding circumstances, including quantitative and qualitative factors, in assessing an item's materiality. 17 C.F.R. §211; SEC, *SEC Staff Accounting Bulletin: No. 99 Materiality*, August 22, 2009, <https://www.sec.gov/interps/account/sab99.htm>. The definition of materiality is also addressed by The Securities Exchange Act (P.L. 73-291) and by *Siracusano v. Matrixx Initiatives, Inc.*, 585 F.3d (9th Cir 2009).

¹¹⁶ SASB, *SASB's Approach to Materiality for the Purpose of Standards Development*, Staff Bulletin No. SB002-01102017, p. 1, https://library.sasb.org/materiality_bulletin/.

might provide an increased level of clarity to all stakeholders.¹¹⁷ To evaluate the type of information that is available to shareholders, SASB examined numerous companies and determined there was no consistency in how companies disclosed ESG issues. They ranged from no disclosures or standard boilerplate disclosures to industry-specific disclosures or metrics-based disclosures (see **Figure 9**).¹¹⁸ Inconsistency makes it harder to measure firm performance within each industry and across different industries. Even if a firm makes an industry-specific or metrics-based disclosure, the disclosures might not be materially relevant, or the disclosures might be a checklist that meets limited objectives without direct correlation to financial performance.

Figure 9. Disclosure of SASB Topics on Form 10-K



Source: SASB, *Industry-Based Standards for Effective Disclosure of Material Sustainability Information to Investors*, December 2016.

SASB has developed a sustainable industry classification system (SICS)¹¹⁹ to group firms by their resource intensity and by whether or not they face common sustainability opportunities and risks.¹²⁰ SICS is structured into 79 industry-specific standards in 11 sectors. To be cost-effective each industry-specific standard measures material sustainability disclosure based on 5 topics and

¹¹⁷ SASB, *The Jury is In: Materiality Matters*, March 17, 2015, <https://www.sasb.org/jury-in-materiality-matters/>.

¹¹⁸ SASB, *For Companies: Why SASB*, <http://using.sasb.org/index/for-companies/>.

¹¹⁹ SASB, *2015 Annual Report*, p. 16, <https://library.sasb.org/sasb-2015-annual-report/>.

¹²⁰ The North American Industry Classification System (NAICS) is the standard used by federal statistical agencies to classify businesses for the purpose of collecting, analyzing, and publishing statistical data related to the U.S. economy. NAICS groups firms into industries based on similarity of the processes used to produce goods and services. U.S. Census Bureau, North American Industry Classification System, *Frequently Asked Questions: What is NAICS and how is it used?* <https://www.census.gov/eos/www/naics/faqs/faqs.html>.

13 metrics. SASB envisions that analysts and investors will be able to compare firms based not only on financial metrics but also on sustainability metrics.

How Do You Measure Sustainability?

Sustainability issues differ across industries and require different metrics. According to SASB, even climate change manifests itself differently from one industry to the next. Standards that are material and cost-effective need to be industry-specific. As an example, material sustainability topics for the pharmaceutical industry include the following:¹²¹

- Access to Medicines
- Drug Safety and Side Effects
- Safety of Clinical Trial Participants
- Affordability for Fair Pricing
- Ethical Marketing
- Employee Recruitment, Development, and Retention
- Employee Health and Safety
- Counterfeit Drugs
- Energy, Water, and Waste Efficiency
- Corruption and Bribery
- Manufacturing and Supply Chain Quality Management

SASB's 2015 operating expenses totaled \$8.3 million. Funding was provided largely through donors such as Bloomberg Philanthropies, Deloitte, Ford Foundation, Morgan Stanley, and PWC;¹²² SASB also borrowed \$2 million.¹²³

There are other international standards and entities that promote, reinforce, or compete with SASB for disclosing ESG issues. Criticisms of some of these reporting requirements are that they are compliance focused and not focused on materiality, and they do not enhance a firm's value.¹²⁴ A compliance focus could result in firms certifying that the firm meets a specific reporting requirement without any measurement of how it affects a firm's profitability or how a firm has improved on ESG issues year over year. Those other standards and entities include the following:

- The Global Reporting Initiative (GRI) evolved in the late 1990s through two U.S.-based nonprofit organizations, the Coalition for Environmentally Responsible Economies¹²⁵ and the Tellus Institute.¹²⁶ Arguably, GRI competes with SASB in many facets of sustainability reporting. There are approximately 2,500 companies that report on sustainability issues based on GRI standards around the world.¹²⁷ As with SASB, GRI's standards are not formally incorporated as part of the financial reporting structure.
- Dow Jones Sustainability Indices measure the sustainability performance of companies. According to Dow Jones, the indices include only companies that are

¹²¹ Daniel Goelzer and David Hackett, *What Is the Sustainability Accounting Standards Board and How Does Its Work Affect Your Company?* Baker & McKenzie, September 2014, <http://bakerexchange.com/rv/ff001a08a28e6de7f538e53f6c429aa6f6d6dac5>.

¹²² For a complete list of supporting organizations, see <https://www.sasb.org/sasb/donors/>.

¹²³ SASB, *2015 Annual Report*, p. 58, <https://library.sasb.org/sasb-2015-annual-report/>.

¹²⁴ Ralph Thurm, "Reforming Sustainability Reporting: For and Against," *The Guardian*, March 11, 2013.

¹²⁵ Coalition for Environmentally Responsible Economies (CERES), *About Us*, <http://www.ceres.org/>.

¹²⁶ Tellus Institute, *The Institute*, <http://www.tellus.org/about>.

¹²⁷ W. Brinkley Dickerson, Jr., *Beware of the Self-Anointed Standard Setters - Like the SASB*, Troutman Sanders, LLP, December 19, 2013.

world leaders with long-term economic, environmental, and social criteria that account for general and industry-specific sustainability trends.¹²⁸

- International Standards Organization (ISO) 26000—Social Responsibility provides guidance on how businesses and organizations should operate in a socially responsible way that contributes to the health and welfare of society.¹²⁹
- The Organization for Economic Cooperation and Development's (OECD's) Guidelines for Multinational Enterprises provide nonbinding principles and standards in a global context for business conduct in a socially responsible way.¹³⁰
- The United Nations Global Compact seeks to engage companies to align strategies and operations with universal principles pertaining to human rights, labor, environment, and anticorruption to take actions that advance the aforementioned societal goals.¹³¹

In the arena of competing standards, which standard(s) becomes pervasive throughout the world depends on the usefulness to investors and other stakeholders.

The Road Ahead for Sustainability Accounting Standards

Over the last several years, increased interest in sustainability issues has resulted in corporations voluntarily disclosing information about ESG issues, as evidenced by a 2013 study by Ernst & Young and Boston College Center for Corporate Citizenship. According to the study, 95% of the Global 250¹³² companies issue sustainability reports; in addition, the study found that 53% of S&P 500 companies currently issue sustainability reports.¹³³ Another study found that 86% of the largest 100 companies in the United States reported on sustainability issues.¹³⁴ Without standardization and focus on materiality, measuring the effectiveness of sustainability efforts by these companies, arguably, is difficult for the investors and other stakeholders. If sustainability accounting standards continue to evolve from the development stage to be an accepted norm by the private sector, Congress may give additional scrutiny to sustainability disclosures in corporate reports.

There are several options that Congress might consider. One option is to let the markets determine what should be disclosed within the existing regulatory structure. If in the long run there is sufficient interest by investors, and SASB standards become widely accepted, then Congress could direct the SEC to require corporate disclosures in compliance with standards promulgated

¹²⁸ S&P Dow Jones Indices, *Dow Jones Sustainability Indices*, <http://www.djindexes.com/sustainability/>.

¹²⁹ International Standards Organization (ISO), ISO 26000 - Social Responsibility, <http://www.iso.org/iso/home/standards/iso26000.htm>.

¹³⁰ The Organization for Economic Cooperation and Development (OECD), *The OECD Guidelines for Multinational Enterprises*, Policy Brief, p. 2, <http://mneguidelines.oecd.org/guidelines/>.

¹³¹ United Nations, *United Nations Global Compact*, <https://www.unglobalcompact.org/what-is-gc/mission>.

¹³² Generally, Global 250 or Global 500 refers to the top 250 or 500 firms by market capitalization or revenue across all countries. Fortune, *Global 500*, 2017, <http://fortune.com/global500/>.

¹³³ Ernst & Young and Boston College Carroll School of Management - Center for Corporate Citizenship, *Value of sustainability reporting - A Study by EY and Boston College Center for Corporate Citizenship*, 2013, <http://www.ey.com/us/en/services/specialty-services/climate-change-and-sustainability-services/value-of-sustainability-reporting>.

¹³⁴ Marianne L. James, "Accounting Majors' Perception of the Advantages and Disadvantages of Sustainability and Integrated Reporting," *Journal of Legal, Ethical and Regulatory Issues*, vol. 18 (November 2, 2015), p. 111.

by SASB and standardize the reporting structure. Similarly, federal, state, and local governments might consider utilizing SASB disclosures in their annual reports.

Another option is to require the SEC to undertake a cost-benefit study and assess investor interest in sustainability disclosures in order to formalize and standardize sustainability disclosure as part of SEC filings.

Currently, firms discuss any sustainability issues in the Management Discussion and Analysis (MD&A) section of the annual report. MD&A is an SEC requirement; any sustainability issues discussed in the MD&A section are not necessarily subject to independent audit. Should SASB become a GAAP requirement or become pervasive in corporate disclosures, new auditing standards might need to be developed. As with financial accounting standards, SASB and auditing requirements would need to evolve as industries change practices or new industries emerge. In some instances, industry-specific sustainability standards might need to evolve faster than financial accounting standards, if risk factors in certain industries become more volatile or new industries emerge as legacy industries continue to become extinct.

For firms and governments that voluntarily include SASB disclosures, it could be a double-edged sword. On the one hand, additional disclosures beyond what is required by regulatory requirements could not only increase investor scrutiny and negatively affect firm stock prices, but could potentially invite lawsuits from investors and other stakeholders. On the other hand, investors might perceive a company that includes additional ESG disclosures positively and increase investor interest. Increased disclosure could potentially reduce future lawsuits since investors would have greater information to make their investing decisions than current disclosure practice. On the other hand, additional reporting can also be time-intensive, costly, and of minimal use to investors if not done correctly. As mentioned earlier, investors have signaled increased interest in additional ESG disclosures in recent years.

Additional disclosures based on standards promulgated by SASB that focus on material issues might be rewarded by investors with higher stock prices or easier access to capital. By proactively addressing material ESG issues, a firm might be able to better forecast potential business disruptions, such as price increases of essential materials. Second, it might lead to greater efficiencies, such as process improvements and innovation, and waste reduction that might contribute to firms' increased earnings. The investment community's perception of a firm's management quality and efficiency might be enhanced as a consequence of sustainability reporting, which might result in increased access to capital.¹³⁵

Case Study: Profitability and Sustainability

United Parcel Service (UPS) is an example of how a firm might satisfy the interest of the shareholders for increased profitability and improved sustainability. A UPS driver on average makes about 100 delivery stops in a day. By optimizing the delivery route UPS has reduced the distance driven, the amount of fuel consumed, and the amount of time spent on deliveries. UPS utilizes a proprietary system (ORION) that optimizes pick-up and delivery routes by creating routes that maximize right-hand turns, which save time, fuel, and reduce emissions.¹³⁶ According to UPS, ORION saves UPS about 100 million miles per year, which has resulted in reduced fuel consumption of about 10 million gallons of fuel and reduced carbon dioxide emissions of about 100,000 metric tons.¹³⁷

¹³⁵ Ernst and Young, LLP (EY), *Value of Sustainability Reporting* (a study by EY and Boston College Center for Corporate Citizenship), 2016, p. 2.

¹³⁶ Marianne L. James, "Accounting Majors' Perception of the Advantages and Disadvantages of Sustainability and Integrated Reporting," *Journal of Legal, Ethical and Regulatory Issues*, vol. 18 (November 2, 2015), p. 107.

¹³⁷ United Parcel Service, "ORION Background," press release, 2017, <https://www.pressroom.ups.com/pressroom/ContentDetailsViewer.page?ConceptType=Factsheets&id=1426321616277-282>.

Appendix A. Acronyms

Table A-1. Acronyms

| Acronym | Full Name |
|----------------|--|
| AICPA | American Institute of Certified Public Accountants |
| CAFR | Comprehensive Annual Financial Report |
| COSO | Committee of Sponsoring Organizations of the Treadway Commission |
| EDGAR | Electronic Data Gathering, Analysis, and Retrieval |
| ESG | Environmental, Social, and Governance |
| FASB | Financial Accounting Standards Board |
| FASAB | Federal Accounting Standards Advisory Board |
| FAF | Financial Accounting Foundation |
| FCRA | Federal Credit Reform Act of 1990 |
| FINRA | Financial Industry Regulatory Authority |
| FPIs | Foreign Private Issuers |
| GAAP | Generally Accepted Accounting Principles |
| GAAS | Generally Accepted Auditing Standards |
| GAGAS | Generally Accepted Government Auditing Standards |
| GAO | Government Accountability Office |
| GASB | Government Accounting Standards Board |
| GRI | Global Reporting Initiative |
| GSSB | Global Sustainability Standards Board |
| IAESB | International Accounting Education Standards Board |
| IASB | International Accounting Standards Board |
| IASC | International Accounting Standards Committee |
| IAASB | International Auditing and Assurance Standards Board |
| IESBA | International Ethics Standards Board for Accountants |
| IFAC | International Federation of Accountants |
| IFRS | International Financial Reporting Standards |
| IPSASB | International Public Sector Accounting Standards Board |
| ISA | International Standards in Auditing |
| ISO | International Standards Organization |
| MSRB | Municipal Securities Rulemaking Board |
| NAICS | North American Industry Classification System |
| OECD | Organization for Economic Cooperation and Development |
| PCAOB | Public Company Accounting Oversight Board |
| PIOB | Public Interest Oversight Board |
| RSI | Required Supplementary Information |

| Acronym | Full Name |
|----------------|--|
| SASB | Sustainability Accounting Standards Board |
| SICS | Sustainable Industry Classification System |
| SEC | Securities and Exchange Commission |
| SOX | Sarbanes-Oxley Act of 2002 |
| SROs | Self-Regulatory Organizations |

Appendix B. Glossary of Financial Statements

Appendix B provides a description of the financial statements listed in **Table 1** and **Table B-1** by each sector.

Table B-1. Comparison of Financial Statements in Various Sectors

| Private Sector ^a | Federal Government ^b | State and Local Governments ^c |
|---|---|--|
| Income Statement | Statement of Operations and Changes in Net Position | Statement of Activities |
| Balance Sheet | Balance Sheet | Statement of Net Position (Assets) |
| Statement of Shareholders' Equity | Statement of Operations and Changes in Net Position | Statement of Net Position (Assets) |
| Statement of Cash Flows | Statement of Changes in Cash Balance from Unified Budget and Other Activities | Statement of Activities |
| Not Applicable | Statement of Net Cost | Required Supplementary Information |
| Not Applicable | Reconciliations of Net Operating Cost and Unified Budget Surplus (Deficit) | Required Supplementary Information |
| Not Applicable | Statement of Social Insurance | Required Supplementary Information |
| Notes to the Financial Statements | Notes to the Financial Statements | Notes to the Financial Statements |
| Management's Discussion and Analysis of Financial Condition and Results of Operation ^d | Management's Discussion and Analysis | Management's Discussion and Analysis |
| Management's Discussion and Analysis of Financial Condition and Results of Operation | Citizen's Guide to the Financial Report of the United States Government | Letter of Transmittal |
| Management's Discussion and Analysis of Financial Condition and Results of Operation | Required Supplementary Information | Required Supplementary Information |
| Management's Discussion and Analysis of Financial Condition and Results of Operation | Budget of the U.S. Government ^e | Statistical Section |

Source: CRS.

- Several of the financial statements that exist in the government sector do not exist in the private sector or are not relevant.
- The financial statements listed below are from the *Financial Report of the United States Government for Fiscal Year 2015*. The financial statements listed in **Table B-1** provide a comparison to the private sector. Individual agency financial reports may differ based on their function and purpose from what is listed for the federal government. See Department of the Treasury, *Financial Report of the United States Government - Fiscal Year 2016*, January 12, 2017, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.
- The financial statements listed below are from the Comprehensive Annual Financial Report (CAFR) of the State of Ohio and from the CAFR of the City of New York for FY2016. Other states' and territories' financial statements might differ due to their respective laws and requirements. Only government-wide financial statements are included and specific fund financial statements, such as proprietary funds, fiduciary funds, and fiduciary component units are not listed. See The State of Ohio, *Comprehensive Annual Financial Report - The State of Ohio - Fiscal Year Ended June 30, 2016*, December 22, 2016, <http://obm.ohio.gov/StateAccounting/financialreporting/cafr.aspx>.

Other cities' and local municipalities' financial statements might differ due to their respective laws and requirements. Only government-wide financial statements are included, and fund financial statements are not listed. See The City of New York, *Comprehensive Annual Financial Report of the Comptroller for the Fiscal Year Ended June 30, 2016*, October 31, 2016, <https://comptroller.nyc.gov/reports/comprehensive-annual-financial-reports/>.

- d. Some elements of the various statements and schedules in the government sector might be similar in the management's discussion and analysis of financial condition and results of operation in the private sector, but most elements are not relevant or are not presented.
- e. For the purpose of this table, Budget of the U.S. Government includes all supporting schedules. See Office of Management and Budget, *Budget of the U.S. Government*, February 9, 2016, <https://www.whitehouse.gov/omb/budget>.

Private Sector

Income Statement presents the results of a company's operations and whether it was profitable or incurred a loss during the period measured. Publicly traded companies issue the income statement quarterly and annually, along with other financial statements.

Balance Sheet presents a company's financial position at the end of a specified period. The balance sheet summarizes assets, liabilities, and sometimes owners' equity. Publicly traded companies issue the balance sheet quarterly and annually, along with other financial statements.

Statement of Shareholders' Equity presents the ownership interest of the shareholders in the company. For a sole proprietorship, a statement of owner's equity represents the owner's interest in the company after accounting for assets and liabilities. For publicly traded companies, statement of shareholders' equity will also present detailed information on the changes in each type of stockholder equity account (e.g., Preferred Stock, Common Stock, Additional Paid in Capital, and Retained Earnings) during the period measured. Publicly traded companies issue the statement of shareholders' equity quarterly and annually, along with other financial statements.

Statement of Cash Flows presents the cash generated and used during the period. Statement of cash flows is often divided into three separate components: operations, investing, and financing. Publicly traded companies issue the statement of cash flows quarterly and annually, along with other financial statements.

Notes to the Financial Statements provide additional information to the financial statements and are often longer than the financial statements. The notes are an integral part of financial statements, and they provide information about assumptions and methodologies and other critical information necessary to understand the financial statements.

Management's Discussion and Analysis of Financial Condition and Results of Operation (MD&A) provides management's overview of the company's past performance and projections of future performance. The discussion and analysis could include growth and strategy, challenges and opportunities, market conditions, and market share. MD&A is not audited by an independent auditor; it represents the thoughts and opinions of management. MD&A is included in the annual report Form 10-K that is filed with the SEC, and is also part of the annual report to shareholders.

Federal Government

Statement of Operations and Changes in Net Position presents the accrual-based¹³⁸ results of the federal government's operations. It also shows how net operating revenue affects the

¹³⁸ For a more detailed explanation of cash versus accrual basis of accounting, please see CRS Report R43811, *Cash*

government's net financial position as of a given date, usually the end of the fiscal year (September 30 for the federal government).¹³⁹

Balance Sheet presents the federal government's financial position at the end of the fiscal year (September 30). The balance sheet summarizes assets, liabilities, and net position. The net position on the balance sheet is the same as the net position reported in the Statement of Operations and Changes in Net Position.¹⁴⁰

Statement of Changes in Cash Balance from Unified Budget and Other Activities presents how the change in the balance of cash and other monetary assets affects the cash-based budget surplus or deficit. The statement begins with the cash-based budget surplus or deficit and shows the items that affected the government's budget. The statement provides an explanation of how the budget deficits were financed. A budget deficit is the result of outlays (expenditures) exceeding receipts (revenue).¹⁴¹

Statement of Net Cost presents the annual costs to operate the federal government at the agency level. Costs and earned revenue presented in the financial report is on an accrual basis, while the budget statements present costs and revenues, generally on a cash basis.¹⁴²

Reconciliation of Net Operating Cost and Unified Budget Surplus (Deficit) presents how the annual unified budget surplus (deficit) relates to the change in the government's cash and other monetary assets, as well as debt held by the public. The statement begins with the net operating result (revenue or cost) from the Statement of Operations and Changes in Net Position and presents the items that explain the difference between that amount and the federal government's annual cash-based budget or surplus.¹⁴³

Statement of Social Insurance provides estimates of the most significant social insurance programs (e.g., Social Security and Medicare). The estimates are actuarial present values of the projections and are based on the economic and demographic assumptions representing the trustees' estimates.¹⁴⁴

Notes to the Financial Statements provide information about assumptions and methodologies and other critical information necessary to understand the financial statements. In the 2016 financial report of the U.S. government, the presentation of financial statements comprised 13 pages; the 24 notes to the financial statements comprised 101 pages.¹⁴⁵

Versus Accrual Basis of Accounting: An Introduction, by (name redacted)

¹³⁹ U.S. Government Accountability Office, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-0946SP, September 25, 2009, p. 7, <http://www.gao.gov/products/GAO-09-946SP>.

¹⁴⁰ U.S. Government Accountability Office, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-0946SP, September 25, 2009, p. 7, <http://www.gao.gov/products/GAO-09-946SP>.

¹⁴¹ Department of the Treasury, *Financial Report of the U.S. Government FY 2016*, January 12, 2017, p. 48, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.

¹⁴² Department of the Treasury, *Financial Report of the U.S. Government FY 2016*, January 12, 2017, p. 45, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.

¹⁴³ U.S. Government Accountability Office, *Understanding the Primary Components of the Annual Financial Report of the United States Government*, GAO-09-0946SP, September 25, 2009, p. 7, <http://www.gao.gov/products/GAO-09-946SP>.

¹⁴⁴ Department of the Treasury, *Financial Report of the U.S. Government FY 2016*, January 12, 2017, pp. 52-165, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.

¹⁴⁵ Department of the Treasury, *Financial Report of the U.S. Government FY 2016*, January 12, 2017, pp. 52-165,

A Citizen's Guide provides a high-level summary of the U.S. government's current financial position and condition, and highlights key financial topics, including fiscal sustainability.¹⁴⁶

Management's Discussion and Analysis (MD&A) provides management's perspective and analysis of information presented in the financial report to Congress and citizens in more detail than A Citizen's Guide. The discussion and analysis include a table of the audit opinions of the respective agencies of the federal government, and an explanation of the accounting differences between the budget and the financial report.¹⁴⁷

Required Supplementary Information provides additional information to enhance understanding of the federal government's operations or financial condition. The topics discussed encompass a range of issues, such as the sustainability of Social Security and Medicare trust funds or the sustainability of fiscal policy, including the debt-to-GDP ratio.

Budget of the U.S. Government contains many of the elements contained in the Statistical Section of the CAFR. It contains financial and narrative information of past performance and future expectations for up to 10 years. It provides detailed information about the Economic Assumptions and Interactions with the Budget, Performance and Management, Budget Concepts and Budget Process, Federal Receipts, Special Topics, and Technical Budget Analyses.

State and Local Governments

Statement of Activities presents the results of the state or local government's operations. It lists revenues and expenses or expenditures and calculates the difference between them, along with other changes that are not revenues, expenses, or expenditures, and presents the net assets.¹⁴⁸

Statement of Net Assets presents the balance of the state or local government's net assets (the difference between assets and liabilities) at the end of the fiscal year. The change in net assets over time provides a measurement of how well the elected or appointed officials are managing the revenues and expenses of the government.

Required Supplementary Information provides additional information to enhance the understanding of the state or local government's operations or financial condition. The topics discussed encompass a range of issues, such as pension plans; status of highways, bridges, and public transportation; certain financial statements that either might present or reconcile the budget with expenditures; fund financial statements, including proprietary funds, fiduciary funds, and fiduciary component units; and other schedules to enhance the understanding of the CAFR.

Notes to the Financial Statements provide information about assumptions and methodologies and other critical information necessary to understand the financial statements. Notes should also provide sufficient information to distinguish between the primary government and its component units.

Letter of Transmittal provides a high-level summary of the state or local government's current financial position and condition, and highlights key financial topics, including a discussion of the

https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.

¹⁴⁶ Department of the Treasury, *Financial Report of the U.S. Government FY 2016*, January 12, 2017, p. 2, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.

¹⁴⁷ Department of the Treasury, *Financial Report of the United States Government FY 2016*, January 12, 2017, https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm.

¹⁴⁸ Governmental Accounting Standards Board, *The User's Perspective*, May 2007, http://www.gasb.org/jsp/GASB/GASBContent_C/UsersArticlePage&cid=1176156736216.

local economy; a discussion of the long-term goals and objectives of major programs and services, including capital projects; and a description of the policies and controls regarding cash and investments. It is complementary to the management's discussion and analysis.¹⁴⁹

Management's Discussion and Analysis (MD&A) provides management's perspective and analysis of information presented in the financial report to the state or local legislature and citizens. The discussion and analysis distinguishes between the primary government and its component units. In addition to state or local government's primary financial statements (government-wide financial statements), it might also include other fund financial statements, including proprietary funds, fiduciary funds, and fiduciary component units.¹⁵⁰

Statistical Section provides users of the financial statements with additional historical perspective, context, and detail to enhance the understanding of CAFR. It is usually presented in five categories: Financial Trends, Revenue Capacity, Debt Capacity, Demography and Economy, and Operating Information.¹⁵¹

¹⁴⁹ Pete Rose, CGFM and Wendy M. Payne, CGFM, CPA, *Certified Government Financial Manager Study Guide: 2 Governmental Accounting, Financial Reporting, and Budgeting*, Association of Government Accountants, 2011, pp. II-23.

¹⁵⁰ Pete Rose, CGFM and Wendy M. Payne, CGFM, CPA, *Certified Government Financial Manager Study Guide: 2 Governmental Accounting, Financial Reporting, and Budgeting*, Association of Government Accountants, 2011, pp. II-24.

¹⁵¹ Pete Rose, CGFM and Wendy M. Payne, CGFM, CPA, *Certified Government Financial Manager Study Guide: 2 Governmental Accounting, Financial Reporting, and Budgeting*, Association of Government Accountants, 2011, pp. II-25.

Appendix C. CPA Ethics

Certified public accountants (CPAs) are subject to various ethical requirements, including mandatory ethics courses to renew the CPA license every three years. They are subject to discipline by various regulatory bodies and professional organizations if they violate ethical requirements. This appendix first presents the Principles of Professional Conduct from the American Institute of Certified Public Accountants Code of Professional Conduct and then discusses some of the tools available to discipline CPAs and other accounting professionals.

AICPA Principles of Professional Conduct¹⁵²

Preamble

Membership in the American Institute of Certified Public Accountants is voluntary. By accepting membership, a *member* assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession's recognition of its responsibilities to the public, to *clients*, and to colleagues. They guide *members* in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

Responsibilities

Responsibilities principle. In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

As professionals, members perform an essential role in society. Consistent with that role, members of the American Institute of Certified Public Accountants have responsibilities to all those who use their professional services. Members also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public's confidence, and carry out the profession's special responsibilities for self-governance. The collective efforts of all members are required to maintain and enhance the traditions of the profession.

The Public Interest

The public interest principle. Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism.

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of members to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on members. The public interest is defined as the collective well-being of the community of people and institutions that the profession serves.

¹⁵² AICPA, *AICPA Code of Professional Conduct*, August 31, 2016, <http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx>.

In discharging their professional responsibilities, members may encounter conflicting pressures from each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.

Those who rely on members expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.

All who accept membership in the American Institute of Certified Public Accountants commit themselves to honor the public trust. In return for the faith that the public reposes in them, members should seek to continually demonstrate their dedication to professional excellence.

Integrity

Integrity principle. To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.

Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and honest difference of opinion; it cannot accommodate deceit or subordination of principle.

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

Integrity also requires a member to observe the principles of objectivity and independence and of due care.

Objectivity and Independence

Objectivity and independence principle. A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.

Members often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. Members in public practice render attest, tax, and management advisory services. Other members prepare financial statements in the employment of others, perform internal auditing services, and serve in financial and management capacities in industry, education, and government. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity,

members should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.

For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.

Although members not in public practice cannot maintain the appearance of independence, they nevertheless have the responsibility to maintain objectivity in rendering professional services. Members employed by others to prepare financial statements or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as members in public practice and must be scrupulous in their application of generally accepted accounting principles and candid in all their dealings with members in public practice.

Due Care

Due care principle. A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.

The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of a member's ability, with concern for the best interest of those for whom the services are performed, and consistent with the profession's responsibility to the public.

Competence is derived from a synthesis of education and experience. It begins with a mastery of the common body of knowledge required for designation as a certified public accountant. The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a member's professional life. It is a member's individual responsibility. In all engagements and in all responsibilities, each member should undertake to achieve a level of competence that will assure that the quality of the member's services meets the high level of professionalism required by these Principles.

Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a member to render services with facility and acumen. It also establishes the limitations of a member's capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a member's firm. Each member is responsible for assessing his or her own competence of evaluating whether education, experience, and judgment are adequate for the responsibility to be assumed.

Members should be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards.

Due care requires a member to plan and supervise adequately any professional activity for which he or she is responsible.

Tools Available for Discipline

The SEC may bar or suspend from practice any accountant deemed to have engaged in “unethical or improper professional conduct.”¹⁵³ States from which the accountant receives his license can fine, suspend, or bar the accountant from practice. The Professional Ethics Division within the AICPA can initiate investigations into allegations of unethical or wrongful conduct if the CPA is a member of the AICPA. If it determines guilt, it can bar the accountant from AICPA membership. The auditing profession is subject to oversight by the PCAOB, and auditors remain subject to professional discipline to ensure that they maintain compliance with auditing standards.

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¹⁵³ 17 C.F.R. §201.

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