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Auditing and Accounting Reform Proposals: A Side-by-Side Comparison

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Summary

This report compares the major provisions of three auditor and accounting reform proposals: two versions of H.R. 3763 (as passed by the House on April 24, 2002, and by the Senate on July 15, 2002), and proposed rules that the U.S. Securities and Exchange Commission (SEC) published on June 26th under its existing authority. The appendix summarizes the two ten-point plans put forward by President Bush.

The cornerstone of U.S. securities regulation is disclosure. According to this approach, the best way to protect investors from fraud, hype, and irrational exuberance is to require companies selling stocks and bonds to the public to disclose detailed information about their financial strengths and weaknesses. Without complete and accurate information, investors cannot make rational decisions, and the market cannot allocate funds to the most productive users. Ill-informed investment choices hurt individual investors, but there are also costs to the national economy in terms of wasted resources, jobs not created, and innovations forgone. If investors decide they cannot trust corporate disclosures, they will be less likely to buy stocks and bonds, raising the cost of capital for all firms, good and bad.

Since the market's peak in January 2000, U.S. stocks have lost over $5 trillion in value. The share prices of firms that fail to meet their own profit projections, or Wall Street's expectations, are apt to plummet. The desire to avoid or postpone stock market losses creates a powerful incentive for corporate management to engage in accounting practices that conceal bad news. The cases of Enron, WorldCom, and a growing list of others suggest that this incentive is often strong enough to overwhelm the watchdog mechanisms in place to prevent deceptive financial reporting.

H.R. 3763, in its House and Senate versions, and the SEC proposal seek to restore confidence in corporate reporting by enhancing the oversight of financial accounting. All three proposals would create a new oversight body to regulate independent auditors (whose certification the law requires to be affixed to the annual reports of all publicly traded corporations). Under current practice, auditors are regulated mainly by private professional accounting groups; the new bodies would also be private, but would operate under the direct oversight of the SEC. A majority of board members would be non-accountants (or accountants a certain number of years removed from active practice). The proposals differ in the scope of authority granted to the new board; the Senate version gives the board the most sweeping powers. Among the other provisions that appear in one or more of the proposals are the following: auditors would be prohibited from providing certain non-audit consulting services to their audit clients; top corporate officials would have to personally attest to the accuracy of their firm's accounting (and face penalties if financial statements were later found to be erroneous); stock trades by corporate insiders would have to be made public within a day or two; and the oversight role of the board of directors would be strengthened. This report compares the major features of the three proposals. It will be updated as legislative developments warrant.

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The table below presents a side-by-side comparison of two versions of H.R. 3763 (as passed by the House on April 24, 2002, and by the Senate on July 15, 2002), and proposed rules that the U.S. Securities and Exchange Commission (SEC) published on June 26th under its existing authority.

The provisions are set out in eight categories:

- creation of a new auditor oversight body;
- auditor independence;
- enhanced accounting disclosure requirements;
- stock analysts;
- corporate executive accountability;
- corporate boards;
- increased penalties for securities law violations; and
- other provisions.

The Senate bill is more comprehensive than the House's, but the House has passed two separate bills that contain similar provisions to those contained in the Senate legislation. H.R. 3764 would authorize appropriations for the SEC in FY 2003 of $776 million, while H.R. 5118 contains more stringent penalties for securities fraud, particularly violations committed by corporate officers and directors. These bills are noted in the side-by-side.

The appendix to this report summarizes the two ten-point plans put forward by President Bush. Most of the President's proposals are included in the legislative and SEC initiatives.

Table 1. Comparison of Provisions of H.R. 3763 (House and Senate versions) and SEC Proposed Auditor Reform Rule

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
I. Creation of a New Auditor Oversight Board.			
Name of new regulator	Public Regulatory Organization	Public Company Accounting Oversight Board	Public Accountability Board
Number of board members	Five	Five	Nine
Board composition	Two members would be accountants with recent experience in auditing public companies; two could be CPAs, provided they had not worked in the accounting industry for two years; and at least one member must never have been a CPA	Three must never have been practicing accountants; two may be accountants who have not practiced actively for five years	Three members may be licensed CPAs, but they would not vote on disciplinary matters. The remaining six would be public members, representing public companies and investors

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Scope of board's activity	(1) to review auditors' work product, (2) to enforce (but not set) standards of competency and professional ethics, and (3) to review conflicts of interest between auditors and their clients.	(1) set auditing, quality control, and independence standards, (2) inspect the auditing operations of public accounting firms (required to register with the board and file annual reports if they audited public companies), and (3) investigate violations of securities laws, standards of ethics, competency, and conduct set by the accounting profession, and the board's own rules	(1) conduct quality control reviews of audit procedures and practices of accounting firms (annually for firms with 70+ audit clients, at least triennially for others) to ensure that auditors have and follow appropriate policies re: independence, objectivity, and integrity; personnel management; acceptance and termination of audit engagements; and audit performance, methodology, and disputes; and (2) enforce ethical and competency standards
Who must register with the board?	No registration requirements	Accounting firms that audit public companies	(1) Accountants who perform audits and (2) publicly traded companies (as adjunct members)
Standard-setting powers	None	Would set auditing, quality control, and independence standards	Would set ethics, auditing, and quality control standards, or could rely on (and oversee) private accounting groups as source of standards

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Disciplinary powers	Could impose a variety of sanctions, including a determination that a firm is not qualified to audit public companies. SEC and state accountancy boards would be notified of final sanctions	Could impose a variety of sanctions, including a determination that a firm is not qualified to audit public companies. SEC and state accountancy boards would be notified of final sanctions	Could impose fines, censures, and suspend firms from auditing publicly traded corporations. SEC would be notified of final sanctions
SEC to review and possibly reduce board sanctions?	Yes	Yes	Yes
SEC oversight authority to abrogate, add to, or modify any of the board's rules?	Yes	Yes	Yes
Source of funding	Specifies that the board will not be solely dependent on the accounting profession for its funding	Funded by accountants, who would pay the cost of mandatory registration with the board, and by companies that sell securities to the public, who would be assessed a fee proportional to the value of their securities in circulation in the public market.	Funded by accounting firms and publicly traded companies

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
II. Auditor Independence.			
Bans on provision of certain non-audit services by auditors to their clients	Directs the SEC to revise its auditor independence rules to prohibit an independent auditor from designing or implementing financial information systems or from performing internal audit work for companies for which it is the outside auditor. (Under current SEC rules, auditors are barred from supervising or managing their clients' information systems, and from performing more than 40% of their clients' internal audits.)	Amends statute to ban financial system design and internal audit work. Existing SEC regulations against provision of certain other non-audit services are also incorporated into the statute. Except in certain cases, the Senate bill stipulates that auditors may provide permitted consulting services (such as tax preparation) to their audit clients only with the approval of the audit committee of the client's board of directors	No provisions. PAB would monitor auditors' internal independence rules
Who would set auditor independence standards?	The SEC	The new board	The SEC
Auditor rotation	No provision	Requires the rotation of the chief audit partner after auditing a company for five consecutive years. Calls for a study of mandatory rotation of audit firms	Would require partner rotation after seven years (the current AICPA standard)

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Auditor/client employment relationships	No provision	Bars an accountant from serving as the outside auditor for a company where a top officer had been employed by the accountant within the past year	Quality control reviews would address employees of auditors joining clients
III. Enhanced Accounting Disclosure Requirements.			
Insider transactions in corporate securities	Stock trades by corporate insiders must be reported electronically to the public on the business day following the transaction. (Under current rules, disclosure may not be required for weeks or months.)	Insider trades must be reported to the public within two business days of the transaction	No provision
Require enhanced disclosure of off-balance sheet transactions, and transactions with unconsolidated subsidiaries?	Yes	Yes	No
Require disclosure of any change in a corporation's code of ethics?	Yes	Yes	No

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Other disclosures required	Real-time disclosure of events that would be material to investors' decisions to buy or sell. The SEC would determine the kinds of events subject to real-time reporting	(1) the use of pro-forma financial statements (unaudited reports that do not follow generally accepted accounting principles) and (2) corrections or adjustments of past financial statements that were made at the insistence of a corporation's auditor	Disclosure of any sanctions imposed on a firm's auditor in the past five years
Accounting standards setting	No provisions	Directs the SEC to ensure that the Financial Accounting Standards Board, which sets accounting standards, be funded by contributions from securities issuers (rather than by the accounting industry). Also requires FASB to adopt procedures to ensure prompt consideration of needed changes to accounting rules	FASB would be funded out of the contributions of accountants and public companies to the new PAB

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
IV. Stock Analysts.			
New disclosure requirements and regulation of Wall Street analysts	Directs the SEC to study conflicts of interest that may affect analysts	Directs the SEC or the NASD (which regulates stockbrokers) to adopt rules of conduct for stock analysts. Mandates that these rules require disclosure of analysts' (and their firms') investment in, and business relationships with, the companies they cover	No provision
V. Corporate Executive Accountability.			
Requires personal certification of financial statements by CEOs and CFOs?	Yes	Yes. Also requires certification of the adequacy of a company's internal accounting controls, and establishes criminal penalties for violations	No (but a rule proposed separately by the SEC would require this)
Penalties if financial statements are found to be erroneous?	Profits from insider securities transactions would be disgorged	CEOs and CFOs would forfeit both trading profits and bonuses received before a financial report was restated	No provision
Personal loans by firms to top executives and directors	Must be disclosed	Prohibited, unless the loan is made in the normal course of business on the same terms available to public borrowers	No

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Authorizes SEC to bar violators of securities laws from serving as officers or directors of any publicly traded company?	Yes	Yes	No. (Legislation required)
Makes it a criminal offense for an officer or director of a corporation to mislead, coerce, manipulate, or fraudulently influence an independent auditor?	Yes	Yes	No. (Legislation required, although misleading an auditor could in many cases be construed as securities fraud under current law.)

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
VI. Corporate Boards.			
Audit committee provisions	None	Makes the audit committee of the board of directors responsible for the hiring, compensation, and oversight of the independent auditor. Audit committee members would be prohibited from accepting consulting fees from the company, and would be required to establish procedures for receiving complaints about accounting and auditing, including anonymous "whistle blower" reports. At least one member of the audit committee would have to be a "financial expert," to be defined by the SEC	None

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Auditor report to audit committee	No provision	Requires the independent auditor to report to the audit committee on critical accounting policies followed, disagreements with management over accounting principles, and other matters	No provision
VII. Increased Penalties for Securities Law Violations.			
Securities fraud	No provision, but H.R. 5118 (passed House 7/16/02) contains provisions similar to Senate bill, except as regards jail terms (see below)	Increases penalties for altering or destroying documents, extends statute of limitations, protects whistle blowers, and prevents bankruptcy courts from discharging debts incurred through securities fraud	No provision,
White-collar crime penalties	No provision, but H.R. 5118 (passed House 7/16/02) contains provisions similar to Senate bill, except as regards jail terms (see below)	Raises fines and jail terms for several offenses, including mail and wire fraud, certification of a false financial statement, conspiracy to defraud the United States, ERISA violations, and impeding an official investigation	No provision

Provision	H.R. 3763 (House)	H.R. 3763 (Senate)	SEC Proposed Rule
Prison terms	No provision, but H.R. 5118 increases maximum sentence for above offenses from 5 to 20 (or 25) years	Increases maximum sentence for above offenses from 5 to 10 years	No provision
VIII. Other Provisions.			
SEC budget	No provision, but H.R. 3764, passed by the House on 6/26/02, authorizes $776 million for the SEC in FY 2003	Authorizes appropriations for the SEC for FY 2003 of $776 million, as opposed to $469 million in the Administration's budget request	No provision, but would not oppose a budget increase
SEC freeze authority	No provision, but H.R. 5118 (passed House 7/16/02) contains similar language	Allows the SEC to freeze extraordinary payments to corporate insiders during an investigation of securities law violations	No provision
Studies required	Calls for the SEC to study stock analysts, bond rating agencies, SEC enforcement actions, and corporate governance, and for the GAO to study the role of Wall Street investment banks in corporate accounting deceptions	Directs the SEC to study bond rating agencies and mandatory rotation of audit firms, and the GAO to study the effects of mergers in the accounting industry	No provision

APPENDIX A. President Bush's 10-Point Plans

In speeches on March 7, 2002, and July 9, 2002, President Bush set out a ten-point program on accounting and auditing reform (in March) followed by ten enforcement initiatives (in July). There is considerable overlap between the President's proposals and the legislative and regulatory initiatives compared above. Major elements of the President's speech in March included:

- the establishment of an Independent Regulatory Board to develop standards of auditing ethics and competence, under SEC oversight;
- a call for the SEC to improve corporate disclosure and to increase the number of events and kinds of news that must be disclosed immediately;
- a requirement that CEOs personally vouch for the accuracy of their firms' financial statements, and face disgorgement of bonuses if those statements were later found to be erroneous;
- authority for the SEC to bar corporate officers and directors who abuse their power from serving at other publicly traded firms;
- prompt disclosure of corporate insiders' stock transactions;
- more effective oversight of the Financial Accounting Standards Board by the SEC, to ensure that accounting rules respond to the needs of public investors; and
- a requirement that auditors compare a firm's accounting systems to a best practice standard, rather than to minimum requirements.

In July 2002, the President's speech included these elements:

- creation by Executive Order of a financial crimes "swat team" in the Department of Justice to coordinate the investigation and prosecution of securities fraud;
- proposes to increase penalties for wire and mail fraud and crimes committed by corporate officers, and calls on the Federal Sentencing Commission to ensure that corporate insiders convicted of fraud serve longer terms in prison;

- a proposal to allow the SEC to freeze payments to corporate insiders while the company is under investigation;
- proposes to prevent corporate insiders from profiting from erroneous financial statements;
- proposes to allow the SEC to bar corporate officers and directors who abuse their power from serving at other publicly traded firms;
- prompt disclosure of corporate insiders' stock transactions;
- proposes to strengthen laws that criminalize document shredding and other forms of obstruction of justice;
- calls on public companies' compensation committees to prevent corporate officers from receiving loans from their companies;
- challenges CEOs to comply with the spirit of existing disclosure rules by explaining how their compensation packages are in the best interests of their companies' shareholders, and describing in plain English in their companies' annual reports every detail of their compensation packages;
- calls on the nation's stock markets to require that a majority of a company's directors be truly independent so that they have no material relationship with the company;
- calls on the nation's stock markets to require listed companies to receive shareholder approval for all stock option plans; and
- calls for an additional $100 million (above the $469 million budget request) for the SEC in FY 2003.