

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

January 10, 2020

Memorandum

To: Members, Committee on Financial Services

From: FSC Majority Staff

Subject: January 15, 2020, “Overseeing the Standard Setters: An Examination of the Financial Accounting Standards Board and the Public Company Accounting Oversight Board.”

On January 15, 2020 at 2:00 p.m., the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Overseeing the Standard Setters: An Examination of the Financial Accounting Standards Board and the Public Company Accounting Oversight Board.” Witnesses for the hearing are:

- **Russell G. Golden**, Chairman, Financial Accounting Standards Board
- **William D. Duhnke III**, Chairman, Public Company Accounting Oversight Board

Financial Accounting Standards Board (FASB)

Background

The Financial Accounting Standards Board (FASB) is an independent, private-sector, nonprofit organization that establishes financial accounting and reporting standards for public and private companies and nonprofit organizations that follow Generally Accepted Accounting Principles (GAAP).¹ FASB has seven members, none of which are currently minorities. FASB is recognized by the Securities and Exchange Commission as the designated accounting standard-setter for public companies, and these standards are recognized as authoritative by many other organizations, including state Boards of Accountancy and the American Institute of CPAs (AICPA). These standards govern the preparation of required financial statements and disclosures.

Given its unique structure and role, the standards issued by the FASB are not subject to the Administrative Procedure Act, even though they have the effect of law once they have been adopted.² For example, unless FASB decides to do so voluntarily, its new standards are not subject to public notice and comment before adoption. Additionally, the public is unable to utilize the Freedom of Information Act to seek information related to the FASB’s decision-making.³

¹ See generally, FASB, About FASB, <https://www.fasb.org/facts/index.shtml>

² William Isaac and Thomas Vartanian, BankThink FASB’s accountability problem, Apr. 26, 2019, <https://www.americanbanker.com/opinion/fasbs-accountability-problem>.

³ *Id.*

The Financial Accounting Foundation (FAF) is an independent, private sector, not-for-profit organization that is responsible for the oversight, administration, financing, and appointment of the FASB.⁴ The FASB is comprised of seven board members who are appointed by the FAF Board of Trustees, and generally serve 5-year terms, though they may serve for up to 10 years.⁵

Accounting Standards

CECL: In June 2016, FASB promulgated the Current Expected Credit Loss (CECL) standard in response to concerns with how banks recognize estimated credit losses under GAAP and how such practices contributed to the 2007-2009 global financial crisis. The new standard is intended to result in greater transparency of expected losses at an earlier date during the life of a loan compared to the current “incurred loss” methodology, which delays recognition until a bank determines a loss is probable. Early recognition of expected losses might not only help investors, but also improve financial stability by making the credit loss standard less procyclical.⁶ In July 2019, FASB voted to extend the implementation deadline for small, public lenders, private lenders, credit unions, and nonprofits.⁷

Liabilities v. Equities: In July 2019, FASB issued a proposed Accounting Standards Update (ASU) designed to improve guidance for certain financial instruments with characteristics of both liabilities and equities. Specifically, the proposal would reduce the number of accounting models for convertible debt instruments and convertible preferred stock from five to two; revise the derivatives scope exception guidance to reduce form-over-substance-based accounting conclusions driven by remote contingent events; and would change the related disclosure earnings-per-share guidance.⁸

Goodwill and Intangible Assets: In October 2019, the FASB issued an Invitation to Comment: “Identifiable Assets and Subsequent Accounting for Goodwill.”⁹ The request sought input on whether FASB should change the subsequent accounting for goodwill; modify the recognition of intangible assets in a business combination; or alter disclosures about goodwill and intangible assets.¹⁰ This request came after the FASB had received mixed feedback on whether the benefits of the current goodwill impairment model justified compliance and audit costs.

LIBOR: In September 2019, as global capital markets continued to move away from the London Interbank Offered Rate (LIBOR), FASB issued a proposed Accounting Standards Update (ASU) that “would provide temporary optional guidance to ease the potential burden in accounting for, or recognizing the effects of, reference rate reform on financial reporting.”¹¹ This guidance is expected only to apply to contracts or hedge accounting relationships that use LIBOR or other reference rates that are expected to be discontinued, and because the guidance is intended to help

⁴ FASB, *About the FASB*, <https://www.fasb.org/facts/index.shtml>.

⁵ *Id.*

⁶ *Gauging CECL Cyclicalities*, Moody’s Analytics (Dec. 2018), <https://www.moodyanalytics.com/-/media/article/2018/gauging-cecl-cyclicalities.pdf>

⁷ Mark Maurer, FASB Votes to Delay Credit Loss Standard for Some Lenders, Jul. 17, 2019, https://www.wsj.com/articles/fasb-votes-to-delay-credit-loss-standard-for-some-lenders-11563401755?mod=article_inline.

⁸ Thomson Reuters Checkpoint, Tax & Accounting Update, Dec. 2019, <https://www.cpajournal.com/2019/12/13/tax-accounting-update-38/>.

⁹ FASB, Invitation to Comment: Identifiable Intangible Assets and Subsequent Accounting for Goodwill, Jul. 9, 2019,

https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176172950529&acceptedDisclaimer=true

¹⁰ Luis Betancourt and James Irving, The Challenge of Accounting for Goodwill, Nov. 2019, <https://www.cpajournal.com/2019/11/27/the-challenge-of-accounting-for-goodwill/>.

¹¹ FASB, *FASB Proposes Guidance to Assist in Transition Away from Interbank Offered Rates to New Reference Rates*, Sep. 5, 2019, https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176173291628&pagename=FASB%2FFASBContent_C%2FNewsPage

stakeholders during the transition, the guidance will be effective temporarily as well.¹² The proposed ASU would “provide optional expedients and expectations for applying generally accepted accounting principles to contract modifications and hedging relationships affected by reference rate reform.”¹³

The Public Company Accounting Oversight Board (PCAOB)

Background

The Public Company Accounting Oversight Board (PCAOB) is a self-regulatory organization (SRO) that oversees the audits of public companies. It was created under the Sarbanes-Oxley Act of 2002, which required auditors of U.S. public companies to be subjected to independent, external oversight. Additionally, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 authorized the PCAOB to oversee the audits of brokers and dealers with respect to compliance reports filed pursuant to federal securities laws. The SEC, through its Office of the Chief Accountant, has oversight over the PCAOB and approves its rules, standards, and budget.

Currently, the Chinese government blocks the PCAOB’s inspection of US-related audit work and the practices of PCAOB-registered firms in mainland China and Hong Kong, citing national security and state secrecy policies. In 2019, the PCAOB debuted an online disclosure tool that lists public companies affected by this denial of access.¹⁴ The SEC and PCAOB have previously spoken on the challenges presented when regulators’ access to foreign jurisdictions is limited.¹⁵

Following a leak of confidential inspections data in December 2017, the SEC replaced the entire five-member Board, which includes no minorities and mostly white men. Under Chairman Duhnke, the PCAOB established a strategic plan for 2019-2023 in an effort to “transform the PCAOB into a trusted leader that promoted high quality auditing through forward-looking, responsive, and innovative oversight.” The Board reaffirmed that plan in a statement to the SEC this past December and provided an update to the Commission on its progress since announcing the plan in November 2018. As part of the Strategic Plan, in 2019 the PCAOB took a number of initiatives to modernize their internal processes and technologies, including hiring the board’s first Chief Data Officer and Chief Information Security Officer.¹⁶

In October 2019, it was reported that a group of former and current PCAOB employees filed a whistleblower complaint, later sent to the SEC. In response, the SEC appointed former SEC Chairman Harvey Pitt to review the PCAOB’s corporate governance.¹⁷ The complaint reported a slowed workflow amid board infighting, senior staff departures, and a “sense of fear” was created

¹² Ken Tysiac, *FASB addressing liabilities and equity complexity, goodwill*, Dec. 10, 2019, <https://www.journalofaccountancy.com/news/2019/dec/fasb-liabilities-equity-complexity-goodwill-201922621.html>.

¹³ Supra note 10.

¹⁴ PCAOB, *Public Companies that are Audit Clients of PCAOB-Registered Firms from Non-U.S. Jurisdictions where the PCAOB is Denied Access to Conduct Inspections*, Sep. 20, 2019, <https://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccess.aspx>.

¹⁵ Jay Clayton and William Duhnke, *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China*, Dec. 7, 2018, <https://pcaobus.org/News/Speech/Pages/statement-vital-role-audit-quality-regulatory-access-audit-information-internationally.aspx>.

¹⁶ PCAOB, *Spotlight: Highlights of Key Changes & Enhancements in 2019*, <https://pcaobus.org/News/Speech/Documents/Highlights-Key-Changes-Enhancements-2019.pdf#search=spotlight>.

¹⁷ <https://www.wsj.com/articles/audit-watchdog-plagued-by-internal-strife-whistleblower-claims-11571152206>

by Chairman Duhnke due to “numerous terminations,” some of which were reportedly “driven by retaliation.”¹⁸

Inspections

As part of the PCAOB’s Strategic Plan, the Board is working to transform its inspections program. Specifically, as part of its 2019 Outlook, the PCAOB “identified recurring deficiencies related to auditor independence.”¹⁹ In May, the Board released Staff Guidance on Rule 3526(b) Communications with Audit Committees Concerning Independence, which requires an accounting firm to communicate to clients any relationship between the firm and the audit client that may create a conflict.²⁰ The guidance granted firms a large amount of discretion to conclude that despite violations of independence rules, the firm’s objectivity and impartiality were not impaired. The Board emphasized the importance that firms communicate to audit clients any violations and analysis undergone to determine the firm was nonetheless an impartial and objective auditor. The guidance was criticized for assuming audits were not compromised instead of addressing questions of independence.²¹

On December 30, 2019, the SEC announced a proposal to modernize certain aspects of the auditor independence framework which would further narrow the types of relationships that are understood to compromise an audit’s independence.²² These changes include exempting student loans from relationships that would trigger a question of independence, and adjusting the definition of beneficial ownership for the purposes of identifying conflicts that compromise an auditor’s independence.

In 2019, the PCAOB increased its engagement with audit committee chairs during the inspection process and worked to better understand how the largest audit firms define their quality control objectives and manage the associated risks. The PCAOB appointed its first Stakeholder Liaison in 2019 to serve as a “direct point of contact for investors, audit committees, and preparers.”²³ In 2019 the PCAOB also formed an “Inspections Quality Group” tasked with ensuring the “consistency, quality, and effectiveness” of the PCAOB’s inspections activities.

In 2020, the PCAOB intends to “further transform” their inspections and reporting. As part of this effort, in December 2019, the Board issued a concept release soliciting public comment on a proposal to revise the PCAOB’s quality control standards.²⁴ The proposal is based on the proposed international standard for firms’ quality management and is designed to reflect a shift towards risk-based approaches and recent developments in corporate governance and leadership. The new standards would require firms to take proactive steps to address risks before they adversely affect

¹⁸ *Audit Watchdog Plagued by Internal Strife, Whistleblower Claims*, The Wall Street Journal (Oct. 15, 2019), <https://www.wsj.com/articles/audit-watchdog-plagued-by-internal-strife-whistleblower-claims-11571152206>.

¹⁹ PCAOB, *Inspections Outlook for 2019*, Dec. 6, 2018, <https://pcaobus.org/News/Speech/Documents/Highlights-Key-Changes-Enhancements-2019.pdf#search=spotlight>.

²⁰ PCAOB, *Staff Guidance: Rule 3526(b) Communications with Audit Committees Concerning Independence*, May 31, 2019, [https://pcaobus.org/Standards/Documents/Staff-Guidance-Rule-3526\(b\)-Communications-Audit-Committee-Concerning-Independence.pdf](https://pcaobus.org/Standards/Documents/Staff-Guidance-Rule-3526(b)-Communications-Audit-Committee-Concerning-Independence.pdf).

²¹ Consumer Federation of America, et al., *Joint letter to the SEC regarding PCAOB staff guidance on Rule 3526(b)*, November 21, 2019 (sic), <http://ourfinancialsecurity.org/wp-content/uploads/2019/12/Letter-to-SEC-on-PCAOB-aud-ind-guidance-11.21.19.pdf>.

²² SEC, *Release No. 33-10738: Amendments to Rule 2-01, Qualifications of Accountants*, Dec. 30, 2019, <https://www.sec.gov/rules/proposed/2019/33-10738.pdf>.

²³ Supra note 15.

²⁴ PCAOB, *Concept Release: Potential Approach to Revisions to PCAOB Quality Control Standards*, Dec. 17, 2019, <https://pcaobus.org/Rulemaking/Docket046/2019-003-Quality-Control-Concept-Release.pdf>.

the quality of the audit firm's engagements. In 2020, the PCAOB also plans to publish a proposed rule addressing a permanent program for broker-dealer inspections.

The PCAOB has also garnered criticism for the inaccessibility of its inspection reports,²⁵ and the Board anticipates it will release a new inspection report format in the first quarter of 2020. The most significant recent change to the auditor's report is the additional requirement for auditors to report critical audit matters (CAMs). The rule took effect this summer and requires auditors to identify aspects of the audit of the financial statements that were communicated or required to be communicated to the audit committee, that were related or material to the financial statements, and that "involved especially challenging, subjective, or complex auditor judgment." CAM requirements were effective for large accelerated filers as of June 30, 2019 and for all other companies as of December 15, 2020.

Enforcement

Since its reorganization in 2018, PCAOB enforcement actions have declined. A Cornerstone Research report released in December found that the PCAOB took 13 enforcement actions in 2018, down 63% from the 35 enforcement actions taken in 2017.²⁶ This low level of enforcement was also mentioned in the whistleblower complaint filed in May as a result of the internal dysfunction.²⁷ According to the PCAOB, in 2019 there were 30 Enforcement Orders published, including 13 orders involving the six largest global accounting firm networks.²⁸

Additionally, a report issued by the Project On Government Oversight found that in its over 16 year existence, the PCAOB found 808 instances in which the four largest auditing firms in the U.S. which audit 99% of companies in the S&P 500 index, performed defective audits, but the PCAOB has only brought 18 enforcement actions against those firms or their employees.²⁹ While the PCAOB could have fined these audit firms \$1.6 billion, the PCAOB issued only \$6.5 million in fines. Moreover, the PCAOB has only fined individuals at the four largest audit firms \$410,000.

Enforcement actions focused largely on Quality Control and Independence concerns, both of which the PCAOB and SEC have started to address. In May, the PCAOB released guidance regarding auditor independence and in December, the SEC released its own proposed amendments to the treatment of auditor conflicts. In December, the PCAOB published a Concept Release addressing Quality Control Standards.³⁰ Notably, unlike the SEC, PCAOB investigations and disciplinary proceedings are confidential and nonpublic until published.³¹

²⁵ Mark Maurer, *U.S. Regulator to Put the Spotlight on Audit Quality in 2020*, Dec. 27, 2019, <https://www.wsj.com/articles/u-s-regulator-to-put-the-spotlight-on-audit-quality-in-2020-11577444401>.

²⁶ Cornerstone Research, *The SEC and PCAOB finalized 45 enforcement actions involving accountants in 2018. Monetary settlements totaled less than \$3.3 million*, Dec. 27, 2019, <https://www.cornerstone.com/Publications/Reports/Regulatory-Actions-Involving-Accountants-2018>.

²⁷ *Supra* note 23.

²⁸ PCAOB, *Enforcement*, <https://pcaobus.org/Enforcement/Pages/default.aspx>.

²⁹ *How an Agency You've Never Heard of Is Leaving the Economy at Risk*, Project on Government Oversight (Sep. 5, 2019), <https://www.pogo.org/investigation/2019/09/how-an-agency-youve-never-heard-of-is-leaving-the-economy-at-risk/>.

³⁰ PCAOB, *Concept Release: Potential Approach to Revisions to PCAOB Quality Control Standards*, Dec. 17, 2019, <https://pcaobus.org/Rulemaking/Docket046/2019-003-Quality-Control-Concept-Release.pdf>.

³¹ To address this issue, The PCAOB Enforcement Transparency Act, sponsored by Rep. Pressley, was proposed at a June 2019 hearing before the Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets entitled, "Putting Investors First: Examining Proposals to Strengthen Enforcement Against Securities Law Violators." The discussion draft would make PCAOB hearings and all related notices, orders, and motions, open and available to the public unless otherwise ordered by the Board.