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Why Midterms Will Have Little Effect On Audit Regulation

By Robert Cox (November 15, 2018)

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The 2018 midterm elections will cause a big shake-up in the leadership and membership of the House Financial Services Committee and the Senate Banking Housing and Urban Affairs Committee. However, it will likely have only a minimal impact on audit legislation and regulation. Rep. Maxine Waters, D-Calif., appears to be in line to chair the House Financial Services Committee. Waters has been a vocal opponent of the Trump administration, particularly with regard to the president's businesses, the banking industry, predatory lenders, and changes at the Consumer Financial Protection Bureau. With regard to the Senate Banking Committee, the current chairman, Sen. Mike Crapo, R-Idaho, may move on to the Senate Finance Committee depending on whether Sen. Chuck Grassley, R-Iowa, wants to chair that committee.[1] If Crapo moves on, Sen. Pat Toomey, R-Pa., may be next in line to chair the Banking Committee.[2]

The Election Will Have Little to No Effect on Audit Legislation and Regulation

Existing Legislation Under Consideration in Congress

While there will be significant changes to the committees in the House and the Senate that are responsible for audit and securities regulation, and a new speaker of the House, I do not anticipate that these changes will have much of an impact on audit legislation in the near term. There are only two pieces of legislation currently under consideration in this lame-duck Congress: (1) A Senate bill sponsored by Sens. Grassley and Jack Reed, D-R.I., to make Public Company Accounting Oversight Board disciplinary proceedings public; and (2) a House bill and a Senate bill that would exempt small broker-dealers that do not have custody of client funds from having to use a PCAOB registered auditor. Neither of these pieces of legislation have much of a chance of passing in the lame-duck session, though the legislation to exempt small broker-dealers has a better likelihood than the legislation to make PCAOB disciplinary proceedings public. The split in control between the two houses of Congress means that Democrats will block any attempts to deregulate in the auditing areas, while Republicans will block any attempts to pass new audit legislation.

New Audit Legislation and Regulation by Congress Is Unlikely

With regard to new legislation and regulation, the likely chairs of the Banking and House Financial Services Committees have shown little interest in audit regulation over their time in Congress. In the last two years Waters and Toomey have been primarily focused on banking, the Consumer Financial Protection Bureau, the Dodd-Frank Act and regulations, and predatory/payday lending. I expect that this will remain their focus barring a series of accounting scandals on par with the late '90s and early 2000s (i.e., Cendant, Enron, Tyco and WorldCom).

Auditing and accounting issues are complex and technical. The House and Senate will likely defer to the PCAOB and the U.S. Securities and Exchange Commission to take the lead on accounting regulation and enforcement. The PCAOB has shown a recent interest in making significant changes in the inspection process, including revising the format of its inspection reports, which tend to be technical, auditing standard focuses and difficult for the average investor or nonaccountant to comprehend. However, this will likely be the limit of changes in audit regulation emanating from a board that appears on the surface to be a more anti-regulatory and anti-enforcement board than the prior board led by Chairman James Doty.

I do not see the PCAOB and the SEC following the lead of the United Kingdom and Europe, where the Big Four firms have come under increased scrutiny as a result of accounting scandals, such as those including construction giant Carillion (KPMG), retailer BHS (PwC), food retailer Tesco (PwC) and telecom giant British Telecom's Italian unit, BT Italia (PwC). At the request of the U.K. secretary of state for business, energy and industrial strategy, Greg Clark, Sir John Kingman and an 11-member panel is conducting an independent review of the Financial Reporting Council, which regulates auditors in the U.K.. Critics have criticized the effectiveness of the audit, accountant and actuarial regulator and accused the FRC of regulatory capture. In addition, the U.K.'s Competition and Markets Authority is carrying out a market study of the audit industry to try to increase options in the market.

Some in the U.K. government, including the shadow chancellor and Labour Party politician John McDonnell, have called for breaking up the Big Four or limiting the number of companies each firm is allowed to audit to allow competition back into the market.[3] Labour is also considering banning companies from performing both auditing and consulting services for the same client. In response to recent scandals involving KPMG affiliates in the U.K., South Africa and the U.S., KPMG recently announced that it will cease undertaking nonaudit work for the FTSE-350 (London Stock Exchange) companies where it serves as the auditor.[4] However, the Big Four have pushed back against calls to break up the oligopoly of the audit market. EY's global head, Mark Weinberger, recently stated that only the Big Four could audit the largest firms in the world because of their unmatched depth and breadth of expertise for multinational audits.[5]

However, the U.K./Europe accounting scandals seem not to have created much of an impression on U.S. politicians and regulators. In recent speeches, PCAOB Chairman William Duhnke and board members Kathleen Hamm and James Kaiser made no reference to the scandals roiling the U.K.[6] Recently, Center for Audit Quality Executive Director Cindy Fornelli expressed the view that "[b]ecause auditor independence in the United States is supported by strict regulatory prohibitions, robust firm policies and procedures, and the oversight of strong, independent audit committees, I do not see the ideas being discussed in the U.K. being relevant here in the U.S."[7]

The following is a summary of the leadership changes in the Senate Banking Committee and House Financial Services Committee, the status of the two pieces of audit legislation under consideration in Congress, and potential audit regulatory changes being considered by the PCAOB.

Changes in Senate Banking Committee

Possible Leadership Change

Crapo is the current chairman of the Senate Banking Committee. To date, he has shown little interest in new audit legislation or in rolling back existing audit regulations. It is possible that Crapo may move on to chair the Finance Committee. If so, his likely replacement is Toomey. The Pennsylvania senator is currently the fourth most senior Republican on the panel. However, Sen. Richard Shelby, R-Ala., is term-limited, and Sen. Bob Corker, R-Tenn., is retiring to be replaced by Republican Sen.-elect Marsha Blackburn. During his time in the Senate, Toomey has shown a healthy skepticism toward regulation in the financial and banking sectors. Toomey has advocated for ending the conservatorship of Fannie Mae and Freddie Mac and reforms to Dodd-Frank. In addition, he has supported limiting the CFPB rules and guidance and easing regulatory burdens in the capital markets. Toomey is currently the chairman of the Banking Subcommittee on Financial Institutions and Consumer Protection. The minority will likely continue to be led by the ranking member, Sen. Sherrod Brown, D-Ohio.

Toomey's focus on legislation has been primarily in the areas of the CFPB and consumer lending. The only bill relating to audit regulation he has introduced is the Audit Integrity and Job Protection Act, which he introduced in the Senate on Sept. 19, 2013 and was referred to the Banking Committee. The legislation was never considered by the committee.

The Audit Integrity and Job Protection Act would have amended the Sarbanes-Oxley Act of 2002 to deny the PCAOB any authority to require that audits conducted for a particular issuer of securities in accordance with SOX standards be conducted by specific registered public accounting firms, or that such audits be conducted for an issuer by different registered public accounting firms on a rotating basis. In addition, it would have directed the U.S. comptroller general (at the Government Accountability Office) to update the November 2003 report, "Study on the Potential Effects of Mandatory Audit Firm Rotation," and review the potential effects (including costs and benefits) of requiring the mandatory rotation of registered public accounting firms.

The update would also have studied: (1) whether mandatory rotation of registered public accounting firms would mitigate against potential conflicts of interest between registered public accounting firms and issuers; (2) whether such a mandatory rotation would impair audit quality due to the loss of industry- or company-specific knowledge gained by a registered public accounting firm through years of experience auditing the issuer; and (3) what effect SOX has had upon registered public accounting firms' independence, and whether additional independence reforms are needed.

My belief is that Crapo or Toomey will have little interest in new audit regulation in the next Congress. In addition, the slim margin between Republicans and Democrats in the Senate, coupled with the need for 60 votes for most legislation, means that Toomey and other Republicans would need significant Democrat support. I anticipate that there will be little appetite for new audit legislation or even a roll-back in existing audit regulations.

Membership Changes

In terms of membership, there will be a number of changes in the Senate Banking Committee. As to Republicans, Corker, who is retiring, and Dean Heller, who lost the race, are leaving at the end of this Congress. Heller was chairman of the Subcommittee on Securities, Insurance, and Investment, the subcommittee that would address any new audit legislation. If Crapo moves on, this means that three new Republicans will be appointed to the committee. As to Democrats, Sens. Joe Donnelly and Heidi Heitkamp lost races and will leave the committee, leaving two vacancies to be filled. This means that five of the 25 members of the committee will likely be new.

The committee is often a destination for freshman senators because its connection to Wall Street and banking provides numerous fundraising targets. There is some speculation that on the Republican side, Sen.-elect Mitt Romney from Utah and Sen. Shelley Moore Capito from West Virginia (and former chairwoman of the financial institutions subcommittee on the House Financial Services Committee) may be added.[8] With Democrat Kyrsten Sinema's victory in Arizona to the Senate, she is a likely candidate for the committee. Sinema was a member of the House Financial Services Committee and has a reputation as a moderate. In the House, Sinema supported the legislation to ease some of Dodd-Frank's regulations that passed in May 2018. She also received a number of campaign contributions from commercial banks ($170,507 as of Oct. 16, according to the Center for Responsive Politics).[9]

Change in Leadership of House Financial Services Committee

Rep. Maxine Waters appears to be next in line to chair the House Financial Services Committee. In the last year, Waters has been a forceful critic of President Donald Trump's businesses, pushed for more information on Trump's and Deutsche Bank's lending relationship, and have criticized the administration's rollback of enforcement and regulation by the CFPB and changes to the Dodd-Frank Act. While she appears to be out of step with Democrat leadership with regard to her calls for impeachment of the president and has a high media profile, these do not appear to stand in her way of chairing the committee.

Audit-related legislation would likely not be a priority of a Waters-led committee. Her primary focus will be consumer protection, investigations of the administration regarding the president's businesses, challenging the administration's deregulatory agenda, investigating banks (particularly regarding such scandals as Wells Fargo and predatory lending practices), the Community Reinvestment Act and the encouragement of lending in low- to moderate-income communities, and opposition to any weakening of the CFPB.

As a committee member, her focus has been on housing and community reinvestment issues. In June, she introduced a bill that would reverse or reform recent policies by the Department of Housing and Urban Development that she called discriminatory, and a bill that would increase protections for homeowners facing possible foreclosure.

Expect a Waters-led committee to have a strong focus on consumer issues, particularly measures to protect lower-income and minority families. The committee may even propose and pass bills in the banking area. However, even with Democrats controlling the House, it is unlikely that the committee and the House as a whole will take up major legislative action in regulation of auditors.

Pending Audit Legislation

Small Business Audit Correction Act

This year, small broker-dealers have been pushing for an amendment to exempt private brokers that do not have custody of client funds and are in good standing with securities regulators from having to use an auditor registered with the PCAOB. The 2010 Dodd-Frank Act expanded the PCAOB's inspection authority to include broker-dealer audits. In a July 9, 2018, letter to the House Financial Services Committee, 803 small broker-dealers urged the committee to change the requirement, asserting that the requirement to have a PCAOB audit has raised annual broker audit fees from $9,000 to $17,000.[10]

In the House, on June 6, 2018, Rep. J. French Hill, R-Ark., and Rep. Vicente Gonzalez, D-Texas, introduced a bill for the Small Business Audit Correction Act of 2018, H.R.6021, to amend the Sarbanes-Oxley Act of 2002 and exclude privately held, noncustody brokers and dealers that are in good standing from the requirement to have a PCAOB-registered auditor perform an annual audit. Also, on June 6, 2018, Sen. Tom Cotton, R-Ark., introduced the same bill in the Senate, S.3004.

In the House, the House Financial Services Committee considered and marked up the bill on Sept. 13, 2018, and the committee ordered the bill to be reported to the full House by a vote of 36-16. Interestingly, Waters voted against the bill and criticized the proposed amendment. The House has not yet voted on the legislation.

In the Senate, hearings were held by the Banking Committee on June 26 and 28 and an amendment to the bill, S.Amdt.4020, was referred to the Banking Committee on Sept. 17, 2018. To date, no further action has been taken on the bill.

It is unclear whether this bill will pass in the lame-duck session. My opinion is that the bill will likely die with the end of this Congress, and given Waters' opposition, will not be considered in the next Congress.

PCAOB Enforcement Transparency Act of 2017

In March 2017, Sens. Reed and Grassley reintroduced legislation to make the PCAOB's disciplinary proceedings against auditing firms and auditors public. The same senators originally introduced the bill in 2011. Supporters of the bill have argued that the confidential disciplinary process encourages accounting firms and auditors to drag out investigations and disciplinary proceedings for years and consume unnecessary PCAOB staff time while the public remains unaware of problems with the accounting firms or the companies they have audited. For the same reasons, accounting firms have little interest in public PCAOB proceedings. The bill went nowhere when it was introduced in 2011 and has gone nowhere since its introduction in March 2017. Absent significant accounting scandals and pressure on the accounting firms, I believe this legislation will never pass Congress.

PCAOB Changes

As I discussed in an article for Law360 on June 14, 2018, "What to Expect from PCAOB's Ongoing Transition," there will be some changes brought by the PCAOB in audit inspections, regulation and enforcement in the coming year.[11] These changes will be driven by the SEC's wholesale replacement of the five members of the PCAOB at the end of 2017, and in turn, the board's replacement of all of the senior staff of the PCAOB. These changes are as follows:

- The board is conducting a 360-degree review, similar to FINRA in 2017, that will ultimately lead to significant changes in organizational leadership, the inspections process, standard setting and enforcement;

- The board is replacing most of the long-tenured heads of divisions and offices and has already named a new director of the Division of Registration and Inspections (George Botic), a new director of the Office of International Affairs (Liza McAndrew Moberg), and a director of the new Office of External Affairs (Torrie Miller Matous);
- In recent speeches, Chairman William Duhnke and board member James Kaiser have stated that the board's goal is to have entirely new leadership in place by the end of 2018, which will provide additional insight into the future direction of the PCAOB;
- Expect significant changes in the PCAOB inspection process and form and content of inspection reports in the next year or two; and
- Expect continuity in standard setting and enforcement in the near term, but changes in 2019.

In recent speeches, board members have signaled that they are well on their way in considering changes to the inspection process. In terms of new audit standards now in effect, the most significant change coming next year will be the requirement that audit opinions contain a discussion of critical audit matters, or CAMs. For more information regarding these changes, I refer the reader to my June 14 Law360 article.

Conclusion

The midterm election will have little to no effect on audit regulation. I do not anticipate that the lame-duck Congress or the new Congress will introduce new legislation regarding audits, even though the U.K. seems to be actively considering new regulations of the Big Four audit firms. Any new audit regulations will be driven principally by the PCAOB and current announced changes under consideration by the new board.

Notes

[1] *"How midterms could shake up Senate Banking Committee," American Banker (Oct. 25, 2018).*

[2] *Id.*

[3] *"British politician pledges to break up 'cartel' of big four accounting firms in radical overhaul," Business Insider (Sept. 21, 2018).*

[4] *"Accounting scandals prompt KPMG ban on non-audit work," Mark Kleinman, Sky News (Nov. 8, 2018)*

[5] *"EY hits back at calls to break up Big Four accounting firms," Madison Marriage, Financial Times (Sept. 13, 2018).*

[6] *Kathleen M. Hamm, "Mexican Mangos, Diamonds, Cargo Shipping Containers, Oh My! What Auditors Need to Know about Blockchain and Other Emerging Technologies: A Regulator's Perspective," 43rd World Continuous Auditing & Reporting Symposium (Nov. 2, 2018); James G. Kaiser, "A Board Member's Perspective: PCAOB's 5-Year Strategic Plan, Transformation Initiatives, and Current Developments," Saint Joseph's University (Nov. 1, 2018); William D. Duhnke, "Keynote Speech to ALI's Accountants' Liability 2018 Conference," ALI Accountants' Liability 2018 Conference (Oct. 18, 2018).*

[7] *"New PCAOB board members plan big changes," Accounting Today (Nov. 13, 2018).*

[8] *"How midterms could shake up Senate Banking Committee," American Banker (Oct. 25, 2018).*

[9] *Id.*

[10] *"803 small broker-dealers push for legislation to ease audits," Mark Schoeff Jr., Investment News (July 13, 2018).*

[11] *"What To Expect From PCAOB's Ongoing Transition," Robert H. Cox, Law360 (June 14, 2018), https://www.law360.com/articles/1053727.*

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