Evaluation of the NOCLAR Proposal's Economic Analysis

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1. Executive Summary

On June 6, 2023, the Public Company Accounting Oversight Board (PCAOB, or the Board) proposed amendments to its auditing standards related to a Company's Noncompliance with Laws and Regulations (NOCLAR).[1] The Proposal aims to significantly expand auditors' responsibilities by requiring more proactive identification, evaluation, and communication of instances where an issuer may not be complying with laws and regulations. The Proposal argues that these rules can prompt timely action by issuers to address noncompliance, ultimately reducing harm to investors and the public.[2] The Proposal posits that these changes can boost investor confidence in financial statements and capital markets.

The Proposal is expected to raise audit and potentially litigation costs for issuers and audit firms. It discusses fixed costs, such as updating audit methodologies and staff training, and variable costs associated with identifying relevant laws and regulations, assessing risks, and formulating audit responses. Issuers would likely incur costs by engaging with auditors to respond to requests and increased audit fees.

We were commissioned by the U.S. Chamber of Commerce to assess the thoroughness of the economic analysis (EA) accompanying the Proposal. As we explain below, the EA falls short of the Board's own stated criteria for conducting economic analyses in support of standard setting. While the Proposal acknowledges a significant increase in compliance costs, it fails to quantify these costs or provide empirical data to justify such extensive modifications. Moreover, as we discuss below, the PCAOB's mission is not to oversee enforcement of all laws and regulations at the federal, state, and local levels, across all jurisdictions where issuers operate.[3] Instead, they are tasked with overseeing audit reports of financial statements and internal control over financial reporting (ICFR).[4]

The Board's failure to provide a comprehensive cost-benefit analysis and quantify outcomes disregards its own guidelines for conducting economic analyses. Implementing the proposed standards is expected to generate significant costs for auditors and issuers, which will ultimately be passed on to investors. Further economic analyses are necessary to determine whether the benefits outweigh these substantial costs. Moreover, the Board's guidelines for economic analysis stipulate a post-implementation review to evaluate the effectiveness of new standards. Yet the Proposal lacks any substantive discussion regarding the Board's post-implementation review plan.

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[1] *See* Proposing release: Amendments to PCAOB Auditing standards related to a company's noncompliance with laws and regulations (PCAOB release no. 2023-003, June 6, 2023; PCAOB rulemaking docket matter No. 051, https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-051). We refer to this as the Proposal.

[2] We refer to audit firms as auditors or firms and public companies as issuers or companies.

[3] The Proposal expressly provides that NOCLAR has a broad meaning and includes violations of any law or regulation affecting the company that arise from acts or omissions by the company, management, board members, employees, independent contractors, agents of the company, or others that act in a company capacity or on the company's behalf, including personal conduct related to the business.

[4] According to its website, the PCAOB has four primary duties: (1) Register public accounting firms that prepare audit reports for issuers and SEC-registered brokers and dealers; (2) establish or adopt auditing and related attestation, quality control, ethics, and independence standards; (3) inspect registered public accounting firms' audits and quality control systems; and (4) investigate and discipline registered public accounting firms and their associated persons for violations of *specified* laws, rules, or professional standards. *See* https://pcaobus.org/about.

Notably, the EA fails to make any substantive attempt to estimate the expenses associated with the proposed amendments or to establish basic details needed to establish an economic baseline, such as current audit or attorney fees. The economic baseline lacks detailed data on current and historical audit fees, which are crucial for a comprehensive evaluation. For example, we present data from a 20-year study suggesting that more demanding audits require increasingly greater resources. Further, there is a noticeable trend of increasing audit costs over time, which the Proposal would surely exacerbate. Understanding current and expected future trends is essential for evaluating the Proposal's cost impact versus a no-action baseline.

The Board has not supplied data or statistics on the proportion of significant misstatements resulting from noncompliance, which is crucial in justifying the need for adjusting standards. Additionally, the baseline should also describe the percentage of issuers disclosing noncompliance as a material risk factor and their correlation with financial restatements.

The lack of quantification also fails to demonstrate how this broad expansion in the scope of auditor duties will benefit investors through substantial improvements in corporate compliance. It is possible that integrating compliance programs with audit processes will primarily involve documentation rather than genuine improvements in compliance, yielding few benefits. Yet issuers will likely face higher costs to broaden their compliance systems to cover all applicable laws and regulations, and they will need to invest more time and effort into overseeing these enhanced programs. Furthermore, the Board acknowledges that the Proposal's impact hinges on issuers' existing compliance activities, but it fails to offer concrete data on how many companies will see less benefit from cost impositions.

There is insufficient evidence to suggest that the proposed amendments would effectively reduce instances of noncompliance with laws and regulations compared with the current baseline. The Proposal should recognize that all issuers and shareholders will bear the costs of the proposed amendments, while the benefits will accrue only to those where material noncompliance issues arise. Moreover, many of the economic benefits of the Proposal are hypothetical or uncertain, while the costs are expected to be substantial and tangible.

The EA's cost estimates fail to provide even basic data on the estimated rise in audit expenses due to the Proposal. Such analyses are essential for the Board to consider before mandating widespread changes. The Proposal will likely necessitate significant engagement of legal experts and force issuers to allocate more internal resources for compliance.

The EA also neglected to account for all costs and impacts on markets, including the labor market consequences for auditors, attorneys, and specialists. The Proposal will exacerbate staffing issues for audit firms, especially smaller ones, due to the industry's existing talent attraction and retention challenges. Audit firms might face difficulties in obtaining specialized knowledge, especially in the fields of law and compliance. This challenge is particularly acute when the law firms possessing the most pertinent expertise are already working for the company being audited, creating a conflict of interest that bars the audit firm from hiring their services.

The EA suggests that while costs may increase, benefits could also grow, particularly for compliant issuers who may face lower variable costs. However, the EA overlooks the scalability of fixed

costs for audits, an issue that would disproportionately affect smaller, yet compliant, issuers. The rationale behind this assertion is unclear without a detailed econometric comparison of audit costs between nearly compliant companies and others while accounting for issuer-specific factors that affect costs.

The EA also fails to consider or dismisses several potential unintended consequences of the Proposal. The new standards could have a chilling effect on information flow by compelling auditors to report potential illegal acts prematurely, possibly hindering open communication between issuers and auditors and reducing the likelihood of uncovering actual issues. The new standards may also lead issuers to restrict auditors' access to essential personnel and appoint liaisons to control information flow while also obliging auditors to inform management or the audit committee of minor issues. These spillover effects raise questions about the necessity of the Proposal.

Shifting the auditor's focus toward compliance rather than financial reporting could potentially result in lower-quality audits. Similarly, requiring auditors to report potential noncompliance as soon as practicable, even before evaluating whether noncompliance occurred, would increase audit committee members' workload, which research shows is already substantial. The Proposal could potentially impair the audit committee's ability to provide effective oversight. Further, diverting management's attention to potential immaterial items or false positives of noncompliance may hinder productivity and creation of value.

The Proposal also fails to sufficiently consider the proprietary costs of disclosure. This is evident in the unclear criteria for determining when an action becomes reportable and the potential for disclosures to inadvertently reveal proprietary information to competitors. The Proposal's broad and ambiguous language may increase auditor liability concerns, thereby affecting risk management.

The Proposal disproportionately affects small and medium-sized audit firms and may potentially deter them from serving public issuers. These increased costs will ultimately be passed on to issuers, particularly smaller ones. Consequently, raising the cost of going public could restrict issuers' access to public capital, possibly forcing them to remain private longer. This effect could ultimately limit retail investors' access to investment opportunities. The impact could be especially harmful to issuers that operate in emerging technologies or industries lacking regulatory clarity. We recommend that the PCAOB thoughtfully evaluate how audits contribute to capital formation and avoid the disincentives that the present Proposal may create.

The Proposal overlooks or dismisses viable low-cost alternatives, such as issuing interpretive guidance instead of formal amendments with a follow-up plan to evaluate effectiveness. It also did not consider size-based exemptions for smaller issuers, such as applying amendments solely to large-accelerated filers or exempting emerging growth companies (EGCs), with a subsequent review to measure effectiveness and decide on potential expansion or cancellation of the amendments. We also discuss how compliance and size-based exemptions could generate a quasi-natural laboratory for researchers to examine the costs and benefits caused by new auditing standards.

The Board also misses an opportunity to learn from the more than two decades of research on the impacts of implementing sweeping new and costly auditing standards similar to those in the Sarbanes-Oxley Act (SOX). In particular, Section 404 of SOX, which mandates an assessment of ICFR, imposed a heavy financial burden on smaller issuers, as evidenced by their disproportionate compliance costs. The act led to notable negative effects on issuer value and innovation, prompting some issuers to exit public markets or take costly actions to seek regulatory exemptions. Importantly, academic and governmental studies have shown that the actual costs of complying with Section 404 were significantly higher than initial estimates, particularly for smaller issuers. Thus, the EA should consider the broad lessons of SOX, which illustrate the need to balance investor protection and the operational burdens placed on issuers.

Taken together, the EA must properly assess the proposed expansion of auditor scope, roles, and costs thoroughly and quantitatively. Without this evaluation, imposing new auditor obligations may result in adverse direct and indirect outcomes on audit firms, issuers, and ultimately investors that are contrary to the Proposal's objectives.

2. EA Guidelines at the PCAOB

2.1. Board statements on economic analysis

The Board notes it typically follows a notice-and-comment process similar to that used by other standard-setting bodies and U.S. federal agencies. Throughout the standard-setting process, the public can submit comments, and the Board notes that it might organize roundtables to collect diverse opinions. The Board notes that public feedback informs its decision-making on proposed standards before adoption. The U.S. Securities and Exchange Commission (SEC), which oversees PCAOB, holds the final authority to approve PCAOB standards and must undergo its own notice-and-comment rulemaking process before approving any new or revised standard.

The Board has published several documents on its standards for conducting EA. It maintains a website on EA at the PCAOB.[5] This website is partitioned into three parts:

1. *Spotlight:* The Board published a "Spotlight" document on economic analysis at the PCAOB, which was published in November 2020.[6] The document provides a summary of the Board's economic analysis methods and stakeholder engagement in their standard-setting process.

2. *Post-implementation review:* The EA website contains a discussion of retrospective analyses ("Post-Implementation Review"), which it notes is a vital aspect of thorough economic analysis in regulatory decisions. EAs conducted during rulemaking are typically forward-looking economic evaluations (i.e., prospective rather than retrospective).[7]

3. *Staff guidance:* The Board published staff guidance ("Staff Guidance") on the use of economic analysis in standard setting on February 14, 2014. The guidance was drafted by

[5] *See* PCAOB, *Economic analysis*, https://pcaobus.org/oversight/standards/economic-analysis.
[6] *See* PCAOB, *Spotlight: The PCAOB's use of economic analysis and stakeholder input in standard setting*, November 2020, https://assets.pcaobus.org/pcaob-dev/docs/default-source/documents/pcaob-use-economic-analysis-stakeholder-spotlight.pdf?sfvrsn=9cb7e4d0_2.
[7] *See* PCAOB, *Post-implementation review*, https://pcaobus.org/oversight/standards/pir, accessed March 2, 2024.

staff economists and the Office of General Counsel. Staff were instructed to follow the guidance by the Chairman.[8]

The Board's stated policy on analyzing economic considerations for new or revised standards focuses on four key elements, which are similar to the basic outline of the SEC's current guidance on EA:[9]

1. *Baseline:* To evaluate the economic impact of new or revised standards, the Board's EA establishes a baseline for comparison. This involves assessing current conditions without the proposed changes, including the economic characteristics of the targeted market. The board's baseline analysis examines how the new or revised standards will alter existing ones and incorporates data on broader audit activities and observed market behaviors.

2. *Need:* The Board's EA should clearly outline the necessity for setting the new or revised standard and how it addresses that need.

3. *Economic impacts:* The Board determines the expected economic outcomes, including benefits, costs, competitive impacts, and any unintended effects of the new or revised standard and its alternatives. The EA quantifies these factors when possible and supplements it with qualitative analysis.

4. *Alternatives considered:* The Board's EA evaluates different solutions to the identified issue by addressing three key topics: (1) the advantage of standard setting over other regulatory methods such as interpretive guidance or increased inspections and enforcement; (2) the reasons for selecting the Board's specific standard-setting approach over other viable options; and (3) the principal policy decisions the Board made in finalizing the standard's specifics.

2.2. Board discussions of quantification in EA

In the Spotlight, the Board outlines its approach to measuring the costs and benefits of proposed standards. This includes quantifying economic impacts, competitive effects, and any unintended consequences, alongside necessary qualitative assessments.[10] When metrics are inadequate,

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[8] *See PCAOB staff guidance on economic analysis in PCAOB standard-setting,* February 14, 2012, https://pcaobus.org/oversight/standards/economic-analysis/05152014_guidance; and PCAOB*, PCAOB releases staff guidance on economic analysis in PCAOB standard-setting,* May 15, 2014, https://pcaobus.org/news-events/news-releases/news-release-detail/pcaob-releases-staff-guidance-on-economic-analysis-in-pcaob-standard-setting_476.

[9] For example, the SEC's guidance on EA articulates, *"It is widely recognized that the basic elements of a good regulatory economic analysis are: (1) a statement of the need for the proposed action; (2) the definition of a baseline against which to measure the likely economic consequences of the proposed regulation; (3) the identification of alternative regulatory approaches; and (4) an evaluation of the benefits and costs—both quantitative and qualitative—of the proposed action and the main alternatives identified by the analysis." See* SEC, Current Guidance on Economic Analysis in SEC Rulemakings, March 12, 2012, https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

[10] *See* PCAOB Spotlight at 3: *"To the extent we can, we quantify those variables. We also provide relevant qualitative analyses."*

particularly for multifaceted measures such as audit quality, the PCAOB relies on qualitative feedback from interviews and surveys to inform its economic evaluation.[11]

The Staff Guidance notes that economic analyses should evaluate how the chosen method meets policy goals, highlighting key trade-offs among options, and that "*benefits and costs should be quantified to the extent feasible*." Pointing to publication by the Office of Management and Budget (OMB), the Staff Guidance recognizes that a cost-benefit analysis, quantified in monetary terms, helps identify the most efficient option and maximizes societal net benefits.[12] The Staff Guidance also notes that in cases where reliable or meaningful quantification is not possible, a detailed qualitative analysis, accompanied by reasons for the lack of quantification, will enhance clarity on potential policy impacts and lead to a better standard-setting process.[13]

2.3. Post-implementation review

The Board conducts post-implementation reviews (PIRs) to evaluate how effectively a rule or standard has been functioning after it has been in place for a sufficient period. These reviews aim to determine whether the rule accomplishes its intended goals; assess its costs and benefits; identify any unintended consequences; and, if necessary, conduct interim analyses to gauge the initial impacts of new requirements by Board staff.

The current Proposal does not address a plan for a PIR. Considering that the proposal is largely devoid of quantifying expected costs and benefits, such a plan becomes crucial. The Proposal should outline how its objectives will be evaluated in a subsequent PIR plan, determining whether they are achieved and if they justify the ongoing and actual compliance costs.

Further, the PIR plan should provide a discussion of the specific strategy the Board staff will use to conduct subsequent analyses; simply indicating that such an analysis will be conducted without providing details is insufficient. We suggest that the Board follow OMB's guidelines to draft standards that require the production of data for tracking actual costs and benefits.[14] Doing so

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[11] *See* PCAOB Spotlight at 3: *"While we rely on economic theory and rigorous quantitative analysis whenever possible, some concepts or phenomena (e.g., audit quality) can be challenging or impossible to fully capture on a quantitative basis. In such cases, qualitative information—such as feedback collected through interviews or surveys—also serves as a critical input for economic analysis*."

[12] *See* PCAOB Staff Guidance: *"The discussion of benefits and costs should provide insight on how the approach taken achieves the stated policy objectives as well as significant tradeoffs between alternatives considered. Benefits and costs should be quantified to the extent feasible. OMB has explained that "[w]here all benefits and costs can be quantified and expressed in monetary units, benefit-cost analysis provides decision makers with a clear indication of the most efficient alternative, that is, the alternative that generates the largest net benefits to society (ignoring distributional effects)."*

[13] *See* PCAOB Staff Guidance: "*It may not be feasible to quantify many costs and benefits of PCAOB standards. When costs and benefits cannot be quantified reliably or meaningfully, a well-developed qualitative discussion, along with an explanation of why quantification is not feasible, still allows the Board and those affected by its standards to be more clear about the potential impacts of a policy decision, and results in an improved policy-making process*."

[14] *See* OMB, *2015 draft report to Congress on the benefits and costs of federal regulations and agency compliance with the Unfunded Mandates Reform Act,* 2015, https://www.whitehouse.gov/wp-content/uploads/legacy_drupal_files/omb/inforeg/inforeg/2015_cb/2015-cost-benefit-report.pdf: *"Rules should be written and designed, in advance, so as to facilitate retrospective analysis of their effects, including consideration of the data that will be needed for future evaluation of the rules' ex post costs and benefits."* The OMB report cites Greenstone (2009): *"Our goal should be to rigorously evaluate every regulation in order to expand upon the ones that work and weed out*

should include a discussion of the specific metrics that will be used to determine success and how such an analysis will be conducted, including the methodologies that will be used. The proposed standards laid out by the Board make no such effort and, thus, fall short in this respect.

The obligation to discuss and then perform a PIR is essential in the context of the Proposal because the current economic analysis is largely based on conjecture and fails to include a rigorous data analysis of the market failures associated with the current standards.

3. Robustness of the Board's EA of NOCLAR

Several commentators questioned the robustness of the EA and recommended that the Board conduct additional economic analyses, particularly with respect to quantification.[15] These letters clearly note that the Board has not demonstrated that the benefits of the proposal outweigh the costs. We concur with this observation. This section critically assesses the EA provided by the Board in the Proposal.

We first evaluate the economic baseline, which includes discussions of current auditor responsibilities and academic viewpoints. We identify gaps in the economic baseline and consider the necessity of the proposed amendments. Additionally, we review the adequacy of the cost-benefit analysis, including the anticipated challenges and overall impact.

We explore the Board's rationale for its inability to quantify key impacts and consider what quantifiable aspects were neglected. We assess both addressed and unaddressed potential spillover effects in the EA. This section concludes by assessing overlooked regulatory alternatives and reviews the feedback from comment letters, offering a comprehensive perspective on the proposed changes.

3.1. Is the economic baseline accurately described?

The economic baseline provides a basis for assessing the costs and benefits of the proposed rule, as policy decisions depend on an understanding of present market conditions and any identified market failures.[16] The baseline of the EA incorporates Section II of the Proposal by reference, which describes (1) current auditor responsibilities for the identification, evaluation, and

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the ones that fail to improve our well-being (or worse, harm it)." *See* Greenstone, M. (2009). Toward a culture of persistent regulatory experimentation and evaluation. In D. Moss & J. Cisternino (Eds.), *New perspectives on regulation.* The Tobin Project). OMB updated Circular A-4 in November 2023 and included similar language: *"Agencies may consider the benefits and costs of regulatory alternatives that would facilitate data collection to support future analyses or retrospective review. These alternatives may be especially valuable if there are significant uncertainties about benefits or costs, or if benefits or costs may change over time."* *See* OMB, Circular A-4, November 9, 2023, https://www.whitehouse.gov/wp-content/uploads/2023/11/CircularA-4.pdf.

[15] *See* letters by BDO (August 7, 2023), Deloitte & Touche (August 7, 2023), Ernst & Young (August 7, 2023), Grant Thornton (August 7, 2023), KPMG (August 7, 2023), MNP (August 7, 2023), PricewaterhouseCoopers (August 7, 2023), Plante & Moran (August 7, 2023), Robert A. Conway (August 7, 2023), Committee on Capital Markets Regulation (August 7, 2023), American Council of Life Insurers (August 7, 2023), and Victor Jarosiewicz (August 4, 2023).

[16] *See* White, J. T. (2015). The evolving role of economic analysis in SEC rulemaking. *Georgia Law Review*, 50, 293–325.

communication of noncompliance; (2) the firm's current practices; and (3) observations from the Board's and the SEC's oversight activities.

The EA adds two discussions to inform the economic baseline: (1) an ad hoc staff analysis of audit firm methodologies relating to the auditor's consideration of noncompliance and (2) a summary of academic and other literature on investor harm associated with noncompliance and auditor incentives to identify, evaluate, and communicate noncompliance.

3.1.1. Current auditor responsibilities for identifying, evaluating, and communicating noncompliance

The Proposal aims to replace Auditing Standard (AS) 2405, *Illegal Acts by Clients*, and retitle the standard *A Company's Noncompliance with Laws and Regulations*. Existing AS 2405 is the current key standard outlining the auditor's duties to (1) identify, (2) evaluate, and (3) communicate and report illegal acts by an issuer.[17] It specifies the auditor's role in dealing with direct and indirect illegal activities and their impact on financial disclosures.

Identifying illegal acts: AS 2405 establishes the duties of auditors in detecting illegal acts, distinguishing those with direct material impact on financial statements from those with indirect effects. Auditors are required to ensure financial statements are free from major inaccuracies due to direct-impact acts such as tax or pension violations. They also need to obtain written representations from management, affirming there are no legal violations that could require financial disclosures or affect potential financial losses in accordance with generally accepted accounting principles (GAAP).

Evaluating illegal acts: AS 2405 requires auditors to evaluate suspected illegal acts; understand their nature, context, and financial implications; and consult with senior management at a level above those involved, when possible. Auditors must assess the materiality of confirmed or potential illegal acts and the adequacy of their accounting and disclosure in financial statements. They must also consider the impact on the other aspects of the audit and on the reliability of management's representations.

Communication and reporting illegal acts: AS 2405 mandates that the auditor be satisfied that the issuer's audit committee is informed about any illegal acts discovered, except for those deemed clearly inconsequential, detailing the act's nature, occurrence, and financial impact before releasing their report. Should an illegal act materially affect the financial statements without proper accounting or disclosure, the auditor must issue a qualified or adverse opinion. Withdrawal from the engagement may be necessary if the client fails to take appropriate corrective action, regardless of the act's materiality.

Regarding third-party disclosures, AS 2405 notes that auditors are not typically required to report illegal acts to external parties. However, exceptions occur where such reporting is mandated,

[17] *See* AS 2405, *Illegal acts by clients*, https://pcaobus.org/oversight/standards/auditing-standards/details/AS2405.

including compliance with Section 10A, federal securities law disclosures of auditor changes, communications with successor auditors as per AS 2610, and under subpoena.[18]

Under Section 10A(b)(1), auditors of public issuers must implement procedures to detect illegal acts with direct material impacts on financial statement amounts. If an auditor finds evidence of a potential illegal act, regardless of its direct or indirect effect on the financial statements, they must (1) assess the likelihood of the act's occurrence and its potential impact on the financial statements, considering possible financial consequences like fines or damages and (2) promptly notify management and the audit committee about any detected or suspected illegal acts, unless they are deemed clearly inconsequential.

Under Section 10A(b)(2), once the audit committee is informed of an illegal act, the auditor must report it to the board of directors if these conditions are met: (1) the act materially affects the financial statements, (2) senior management and the board have not taken appropriate remedial actions, and (3) the lack of action could lead to a modified audit report or auditor's resignation. If the board of directors is alerted by an auditor under specified circumstances, the issuer must inform the SEC within one business day and send a copy of this notification to the auditor. Should the auditor not receive this copy, they must, within one business day, either resign from the engagement and submit their communication with the board to the SEC or provide the SEC with a copy of their communication without resigning.

Under Exchange Act Rule 17a-5, auditors of brokers and dealers must inform the SEC (and the designated examining authority) if they discover noncompliance with financial responsibility rules or a material weakness in internal control over compliance, they have notified the broker or dealer's chief financial officer, and the broker or dealer either fails to report this to the SEC and the designated examining authority as mandated or submits a report that the auditor disagrees with.

3.1.2. Board analysis of audit firm practices

The Proposal provides a description on current practices based on the Board's analyses of firm methodologies, oversight activities, and enforcement actions. This includes examining audit deficiencies highlighted in PCAOB inspections due to noncompliance with AS 2405 as well as instances where firms failed to meet the requirements of AS 2405 or Section 10A.

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[18] Section 10A(m)(4) and Exchange Act Rule 10A-3(b)(3) require audit committees of listed issuers to set up procedures for (1) addressing complaints related to accounting, internal controls, or auditing and (2) allowing employees to report concerns confidentially and anonymously about questionable accounting or auditing practices. *See* AS 2610, *Initial audits—communications between predecessor and successor auditors*, https://pcaobus.org/oversight/standards/auditing-standards/details/AS2610. The Proposal notes that several other PCAOB auditing standards inform the auditor's consideration of an issuer's possible illegal acts. These include the following: AS 2110, *Identifying and assessing risks of material misstatement* (sections 09 and 56), https://pcaobus.org/oversight/standards/auditing-standards/details/AS2110; AS 2401, *Consideration of fraud in a financial statement audit* (part 06); AS 2505, *Inquiry of a client's lawyer concerning litigation, claims, and assessments* (section 05), https://pcaobus.org/oversight/standards/auditing-standards/details/AS2505; AS 2805, *Management representations* (section 06), https://pcaobus.org/oversight/standards/auditing-standards/details/ AS2805; and AS 2201, *An audit of internal control over financial reporting that is integrated with an audit of financial statements* (sections 09 and B8), https://pcaobus.org/oversight/standards/auditing-standards/details/ AS2201.

The Proposal notes that audit firm methodologies often extend beyond AS 2405, incorporating standards like ISA 250 (Revised) by the International Auditing and Assurance Standards Board (IAASB) and AU-C Section 250 by the Auditing Standards Board (ASB) of the AICPA, with terms "illegal act" and "noncompliance with laws and regulations" used synonymously across audits of both public and private issuers. It claims that practices vary significantly among firms. While some adhere strictly to AS 2405 and Section 10A, others implement additional procedures, such as leveraging overall risk assessment and internal control tests to detect noncompliance, understanding whistleblower and ethics programs, inspecting regulatory correspondences, making inquiries within the issuer, and issuing specific instructions in multilocation audits.

The Proposal claims, however, that there is a noticeable inconsistency in how audit firms address noncompliance with laws and regulations, especially those indirectly affecting financial statements. The Proposal aims to standardize practices across firms, which the Board claims would enhance auditor procedures for identifying noncompliance and bring greater uniformity to current methodologies.

The EA expands on the discussion of audit methodologies. It notes that Board staff examined the methodologies of selected registered firms to assess how they currently factor in auditors' consideration of an issuer's legal noncompliance and how these might need to adapt to proposed amendments. This involved comparing methodologies from global network firms (GNFs) and U.S. nonaffiliated firms (NAFs) against the existing requirements concerning legal noncompliance as well as against the proposed amendments. GNFs refer to the member firms belonging to the six major global accounting networks: BDO International Ltd., Deloitte Touche Tohmatsu Ltd., Ernst & Young Global Ltd., Grant Thornton International Ltd., KPMG International Ltd., and PricewaterhouseCoopers International Ltd. NAFs encompass U.S. and non-U.S. accounting firms registered with the Board that do not fall under the GNF category, with some belonging to various international networks. Examples include Marcum LLP, McGladrey & Pullen LLP, WithumSmith and Brown LLP, and Crowe LLP.[19]

The review of the Proposal emphasized several key changes: substituting "illegal acts" with "noncompliance with laws and regulations," requiring auditors to identify relevant laws and assess the risk of material misstatement from noncompliance and integrating this risk into the auditor's overall risk assessment. It also aimed at enhancing the detection of noncompliance through improved risk assessments and leveraging information from various audit procedures. Additionally, the amendments seek to extend the application of procedures in proposed AS 2405 to instances of potential fraud; increase communications with management, audit committees, and boards about noncompliance; and broaden the scope of audit procedures related to noncompliance, especially in engagements involving other auditors or specialists.

The EA notes the staff review of GNF methodologies showed they align with current standards addressing noncompliance with laws and regulations. Although some methodologies already include aspects of the proposed amendments, adopting these amendments would necessitate

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[19] *See* PCAOB, Firm Inspection Reports, https://pcaobus.org/oversight/inspections/firm-inspection-reports?isinternational=U.S, accessed February 29, 2024. The PCAOB discloses 3,926 reviews across all audit firm types from 2003 to 2023. These include 3,122 reports of NAFs, which represent 79.5% of all reviews during this period

significant updates. For instance, certain GNF methodologies feature definitions of "noncompliance with laws and regulations" akin to those proposed and suggest (without mandating) that engagement teams consider information from other audit activities to spot potential noncompliance.

The EA notes that, beyond this practice, GNF methodologies related to AS 2405 would require significant updates to meet the proposed amendments, particularly regarding the identification, assessment, and response to noncompliance risks that could reasonably have a material effect on financial statements and determining if there is evidence of such noncompliance. Additionally, these methodologies must be updated to include fraud considerations within AS 2405. While GNF methodologies offer guidance on risk assessment, communication with management, and the involvement of other auditors and specialists, they would need adjustments to align with the proposed changes. For instance, current methodologies suggest rather than mandate the execution of all procedures in AS 2110 (Identifying and Assessing Risks of Material Misstatement) for understanding the issuer and would need revisions to meet the proposed expanded inquiry responsibilities as outlined in AS 2110.

The EA notes that the review of NAF methodologies reveals they align with current standards in AS 2405 and AS 2110 without exceeding them. These methodologies often recommend that auditors understand laws and regulations likely affecting the risk of material misstatement. However, adopting the proposed amendments would require comprehensive updates to these methodologies.

The EA infers from this review that all audit firms would need substantial revisions to their methodologies to implement the proposed amendments to AS 2405 and enhancements to AS 2110. NAF methodologies would require significantly more changes than GNF methodologies require. However, GNF's might also have greater costs when following the Proposal's threshold of noncompliance that "could reasonably" have a material effect on financial statements.

3.1.3. Board observations from compliance activities

The Proposal also provides staff observations from inspection and enforcement activities by the PCAOB and SEC enforcement actions. It notes that staff have highlighted issues with auditors' application of AS 2405 and Section 10A's illegal acts provisions. Common inspection issues include auditors failing to recognize issuer loans to officers, prohibited under Section 13(k) of the Exchange Act, as illegal acts. Despite financial statement disclosures of these loans, the Board notes that auditors inadequately evaluated and communicated relevant information about these prohibited transactions. Enforcement actions typically stemmed from auditors not properly responding to potential securities law violations or omitting procedures to detect illegal acts materially affecting financial statements, often related to prohibited loans or financial misconduct. The Proposal claims that these findings indicate a lack of thorough auditor investigation into the impact of illegal acts on financial statements and audit execution.[20]

[20] However, in the comment letter on the NOCLAR proposal by the Center for Audit Quality, it states, "*In looking to speeches given by the SEC staff at the annual AICPA conference from 2000 to 2022, NOCLAR Section 10A was only discussed on two occasions, once in 2000 and again in 2011, one of which led to a request for the United States General Accounting Office to perform a review of reporting under Section 10A. Both the report on the original review,*

3.1.4. EA discussion of academic literature

To inform the Proposal, the EA reports that Board staff reviewed academic and other literature that highlights the risks to investors from corporate legal noncompliance, including legal penalties and reputational damage, and those that suggest auditors might lack adequate motivation to address noncompliance. The EA caveats that the literature focuses on detected cases of legal noncompliance and omits undetected or early resolved incidents. Thus, according to the EA, these studies might not capture the full extent of investor harm, auditor detection effectiveness, or the impact of AS 2405. The EA also notes in footnote 118, "***There is limited academic literature on the role of auditors in detecting noncompliance with laws and regulations by clients***."

The EA's literature review is divided into sections covering (1) investor harm and (2) auditor incentives. For *investor harm*, the EA discusses how investors are harmed by noncompliance through lower share prices. The EA primarily examines studies of legal and regulatory penalties and reputational loss. For legal and regulatory penalties, the EA points to public statistics on financial penalties for legal noncompliance that reveal varying enforcement and penalty levels across different noncompliance types and industries, and some penalties are significant. For instance, data from U.S. federal corporate prosecutions show more frequent enforcement for antifraud and environmental law violations, with higher penalties for antifraud, antitrust, and violations of the Foreign Corrupt Practices Act (FCPA). In industry, manufacturing and wholesale trade have more federal prosecutions, whereas finance, insurance, and manufacturing face heftier financial penalties. Notably, the EA states that penalties for antifraud and FCPA violations have reached considerable totals, amounting to $4.3 billion and $4.2 billion, respectively, in 2020.

For reputational losses, the EA notes that academic literature indicates that noncompliance can result in significant reputational damage, especially when it directly affects stakeholders with continual interactions with the issuer, such as customers, suppliers, employees, or investors. The EA remarks that the share price drop at the public disclosure of certain noncompliance incidents (e.g., financial restatements) often surpasses the anticipated legal penalties. It states that many academic studies attribute this excess loss to reputational damage. For instance, the EA points to studies which find that financial misrepresentations result in reputational losses that are 7.5 to 9 times higher than legal penalties in the U.S. and U.K. Conversely, noncompliance that less directly affects ongoing stakeholder relationships, like environmental violations or bribery, tends to have minimal reputational impact, with the stock price reaction more closely aligned with the expected legal penalties, according to studies cited in the EA.

For *auditor incentives*, the EA indicates that auditors encounter significant disincentives and few incentives regarding an issuer's potential legal noncompliance. These disincentives include the risk of client loss without gaining new ones, pressures related to time and fees, social pressures

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which was published in 2000, as well as a subsequent report published in 2003 based on an updated review, identified no evidence that the low number of Section 10A filings was the result of a failing by auditors. Based on a review of PCAOB inspections data downloaded from Audit Analytics for the years 2009 through 2021, there were no instances of inspection findings related to AS 2405 or illegal acts. Further, the most recent Survey of Inspection Findings for 2022 [by the International Forum of Independent Audit Regulators] provides information about those areas of inspections around the world with the highest rates of deficiencies. We note that NOCLAR and/or illegal acts does not appear in those top areas." *See* letter by Center for Audit Quality (August 7, 2023) at 21.

from client management interactions, and potential repercussions from supervisors for applying necessary professional skepticism without finding financial misstatement.

Conversely, the EA argues that incentives for auditors to tackle legal noncompliance are scarce, with regulatory responsibilities often translating into penalties rather than rewards. Despite instances of issuer noncompliance, enforcement against auditors under AS 2405 or Section 10A has been relatively infrequent. Additionally, auditor liability in shareholder litigation has decreased lately. While reputational risk could motivate auditors, studies—particularly in non-U.S. markets—show minimal reputational damage in cases of financial fraud.

The EA cites research on auditor incentives in noting that auditors have historically had a limited impact on identifying legal noncompliance. The EA cites one study that analyzes data pre- and post-SOX, revealing auditors' minor role in uncovering corporate fraud before the legislation, and a "*larger but limited role thereafter*."[21] Additionally, the EA points to recent findings by the same researchers which estimate that only a third of corporate frauds are detected normally, with such fraud annually eroding 1.6% of equity value, amounting to $830 billion in 2021.[22]

The EA also cites a study on occupational fraud.[23] However, as the U.S. Chamber of Commerce observed, "The audits of most of these entities are not under the purview of the PCAOB. In addition, the study reports that the typical fraud case causes a loss of $8,300 per month and lasts twelve months before detection—which would be immaterial to the financial statements of most issuers and broker-dealers audited by PCAOB registered firms."[24]

3.1.5. Economic baseline is incomplete

The economic baseline analysis of the Proposal fails to adequately demonstrate the relation between audit fees and the complexity and risk of an audit as well as their evolution over time. The baseline omits essential details on current audit fee figures and their historical progression. A thorough EA should at least examine how audit fees have trended over time and their correlation with audit complexity and risk. For instance, a 2022 report by Audit Analytics detailed a 20-year trend of audit fees, affirming that these fees are indicative of the complexity and risk involved in an audit, with higher-risk audits demanding more resources such as hours, personnel, and specialists.[25] Understanding these audit fee trends, particularly following major standard amendments, is vital for assessing the Proposal's cost implications.

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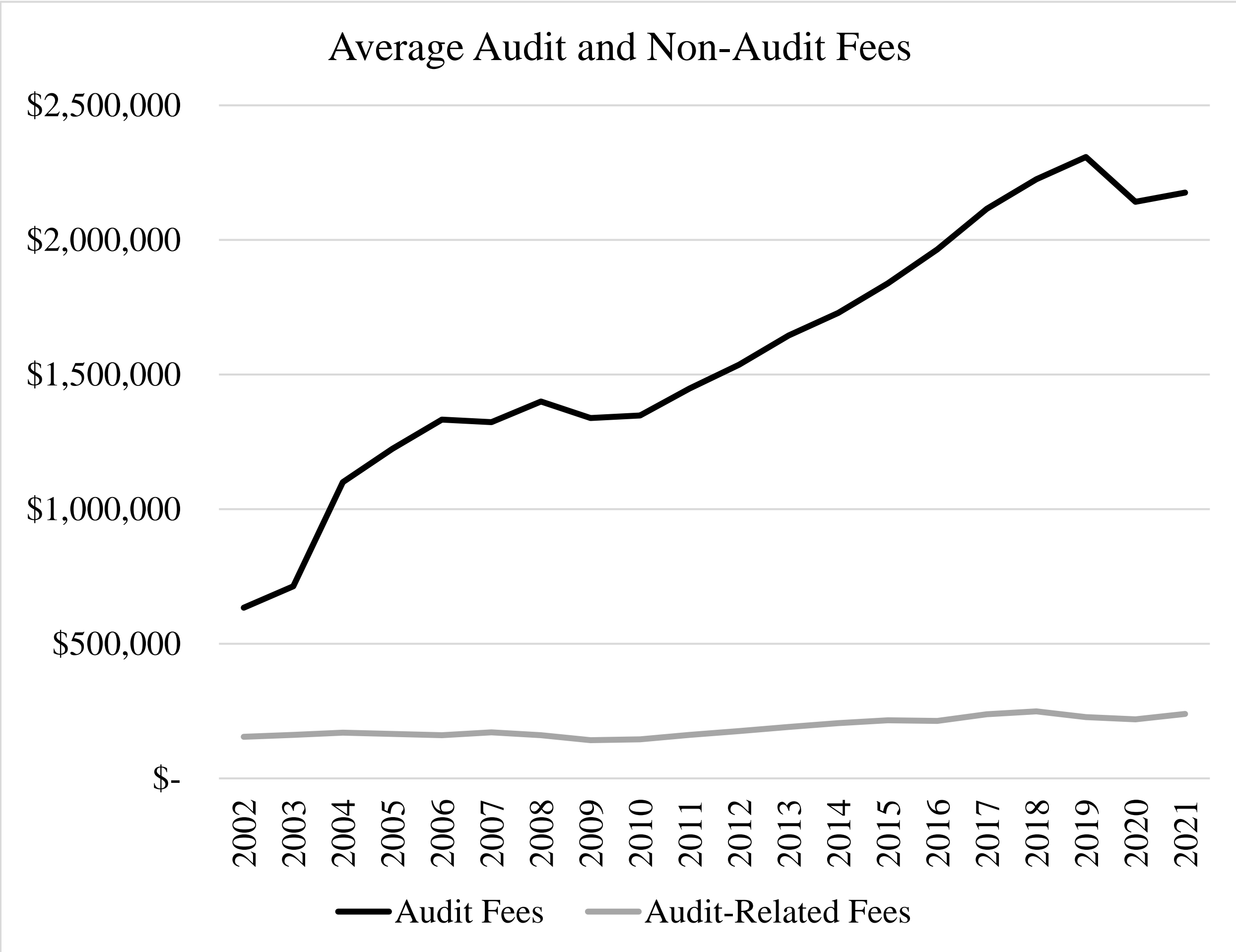
[21] *See* Proposal at 67, citing Dyck et al. (2010). *See* Dyck, A., Morse, A., & Zingales, L. (2010). Who blows the whistle on corporate fraud? *Journal of Finance*, 65(6), 2213–2253.

[22] *See* Proposal at 67, citing Dyck et al. (2023). *See* Dyck, A., Morse, A., & Zingales, L. (2023). How pervasive is corporate fraud? *Review of Accounting Studies*, 1–34.

[23] *See* Proposal at 67, citing Occupational Fraud 2022: A Report to the Nations, Association of Certified Fraud Examiners.

[24] *See* letter by U.S. Chamber of Commerce (August 2, 2023).

[25] *See* Audit Analytics, *Twenty-Year Review of Audit & Non-Audit Fee Trends*, October 2022, https://www.auditanalytics.com/doc/Twenty-Year_Review_of_Audit_and_Non-Audit_Fee_Trends.pdf.



Drawing on data and charts from the Audit Analytics report, it is evident that audit fees have risen significantly over the past two decades and are anticipated to continue increasing, regardless of the Proposal. These data or similar analysis should be included in the EA's baseline.

We also note that the SEC already mandates the disclosure of material risk factors under Regulation S-K. This includes the disclosure of the material impact of compliance with governmental regulations in annual reports and securities offering documents. Moreover, the SEC modernized risk factor disclosure in 2020 by mandating that "*to the extent material to an understanding of the business taken as a whole, disclosure of the material effects that compliance with government regulations, including environmental regulations, may have upon the capital expenditures, earnings, and competitive position of the registrant and its subsidiaries*."[26]

Given this preexisting mandate, the Board should identify which material risks are not being adequately disclosed. Such an understanding is crucial for establishing the economic baseline to justify further regulation. In fact, the EA later posits in the "costs" discussion that "*auditors may be able to make use of company-generated information. For example, issuers may already disclose*

[26] *See* SEC, Modernization of Regulation S-K Items 101, 103, and 105, Final Rule, August 26, 2020, https://www.sec.gov/files/rules/final/2020/33-10825.pdf.

certain relevant laws and regulations (e.g., as risk factors), which could serve as a starting point for the auditor's identification."[27] Yet the Board does not discuss this in the economic baseline section. Understanding the current compliance environment requires knowing what percentage of entities disclose these issues and how disclosure correlates with material financial restatements compared with those that do not disclose this information.

3.2. Is the need for proposed amendments properly discussed?

The Proposal claims that despite SOX assigning the audit committee of the issuer with the task of overseeing the auditor, there remains a risk that auditors may prioritize the issuer's interests over those of investors and users of financial statements. The Proposal asserts that, without the benefit of a rigorous data analysis, this risk emerges when an audit committee aligns more closely with the issuer or its management, possibly for compensation reasons, or when management influences the committee's oversight of the auditor, leading to a situation where the auditor acts more in the issuer's interest. The Board believes that effective auditing standards are crucial because they assign specific responsibilities to auditors that, when followed diligently, ensure audits are of high quality and meet the needs of issuers, investors, and users of financial statements. While this is an obvious benefit of an independent audit, this benefit is overly broad and fails to explain why the Proposal addresses concerns about suboptimal incentive alignment.

The EA motivates the need for regulation by citing research indicating that auditors may lack adequate motivation to detect, assess, and report an issuer's legal and regulatory violations even though such noncompliance could cause significant harm to investors through legal penalties, reputational damage, and financial loss. The EA cites studies and anecdotal evidence suggesting that auditors have not been central in uncovering legal breaches. The EA further claims that, without compelling evidence, investors seek more proactive and detailed reporting on noncompliance to make informed decisions and better oversee management.

Much of the research cited in the EA relates to problems that existing audit procedures should have uncovered (e.g., accounting fraud) or relate to illegal behavior that the auditor would not be expected to detect (e.g., fraudulent product representations).[28] For example, would an audit firm be expected to extract a confession from an issuer that has decided to falsely represent product characteristics simply because the auditor asks whether policies exist to detect such behavior or be expected to perform another type of inquiry into potential problems? From an economic perspective, once an issuer has decided to cheat, it will also seek to obfuscate the cheating, making such behavior harder to assess and detect for auditors.

Another concern is that the type of risks the proposal is designed to identify are of second-order importance or should be detectable through other regulatory mechanisms, such as enforcement by the primary regulator, who is colloquially described as the "cop on the beat." While this

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[27] *See* Proposal at 79.

[28] The Center for Audit estimates that only 2% of more than 10,000 restatements from 2003 to 2012 involved fraud. Restatement related to illegal acts would be a subset of the 2%. *See* Center for Audit Quality, Financial Restatement Trends in the United States: 2003–2012, July 24, 2014, https://thecaqprod.wpengine.com/wp-content/uploads/2019/03/financial-restatement-trends-in-the-united-states-2003-2012.pdf.

responsibility has not been the historical function of independent auditors, the Proposal effectively delegates regulatory surveillance and enforcement mandates to audit firms.

Further, the Proposal asserts that current standards may lead to a gap in information between auditors and audit committees, with AS 2405 requiring auditors only to ensure communication has occurred, often leaving the responsibility of reporting noncompliance to management. This, coupled with a lack of standards for communication between lead auditors, other auditors, and specialists, creates a potential for information asymmetries despite these parties possibly being first to recognize noncompliance issues. Unfortunately, the Proposal does not provide a compelling description of a market failure that requires significantly expanding the scope of auditor responsibilities, nor does it provide any empirical evidence of the frequency that such market failures occur. It is unclear why the existing primary regulators do not have sufficient authority to require issuers to address the potential problems the Board attempts to assign to audit firms.

3.3. Is the Proposal's cost-benefit discussion sufficient?

3.3.1. Purported benefits of the Proposal

The EA prefaces its cost-benefit discussion by stating that the impact of the proposal will depend on how closely firms' current audit practices align with the proposed changes.[29] Yet it provides no specific data on the number of audit firms already in compliance or partial compliance with the proposed amendments.

The EA describes five potential benefits of the Proposal: (1) strengthen audit and financial reporting quality, (2) reduce informational asymmetry, (3) enhance investor protection, (4) improve capital allocation efficiency, and (5) optimize the use of audit resources. We analyze the discussions of purported benefits outlined in the EA, highlighting areas potentially neglected or excluded by the Board.

Strengthen audit and financial reporting quality: The EA claims that the Proposal could lead to an improvement in audit quality by clarifying auditors' duties in identifying and evaluating noncompliance, thus making them more vigilant in detecting and assessing noncompliance. It claims the Proposal will improve the effectiveness of internal control over financial reporting, leading to better financial reporting quality. In turn, the Board argues this would enhance the reliability of financial reporting and reduce restatements. However, this conjecture does not consider the lack of expertise, the cost of training or hiring, or the potential impact of increased workloads, which we discuss below. The EA also overlooks the opportunity to measure anticipated enhancements in audit quality by contrasting audit quality indicators, such as the frequency of financial restatements and Accounting and Auditing Enforcement Releases, between audit firms that already largely adhere to the proposed amendments and those that do not.

The EA notes that this benefit of enhanced audit quality hinges on whether an issuer being audited already has strong compliance programs. The Board notes that investors in issuers with less robust

[29] *See* Proposal at 72: "*The magnitude of the benefits and costs is likely to be affected by the risk of noncompliance by audit clients and by the degree to which firms have already adopted audit practices that are similar to those the proposed amendments would require.*"

compliance, where undetected noncompliance is more probable to occur, stand to benefit more, as auditors are more likely to uncover issues using the proposed rule's enhanced procedures. Yet the EA makes no effort to quantify, survey, or describe the proportion of issuers that do and do not have robust compliance programs already in place or those that have experienced material misstatements due to noncompliance. These data are necessary for understanding the magnitude of perceived benefits that would justify the imposition of additional costs on *all* issuers. Indeed, the EA notes that for issuers with established and efficient compliance programs, where material misstatements are less likely, the new standard's benefits may be comparatively minor.[30]

The EA suggests that benefits should increase with costs and notes that variable costs may be lower for issuers with strong compliance programs.[31] However, it overlooks that fixed costs from an auditor's expanded role cannot be scaled and that smaller issuers, despite having solid compliance, may struggle to absorb these fixed costs under the new Proposal.

The EA acknowledges that many audit firms will need to incorporate specialists into their audit teams. However, as one commentator notes, it ignores academic studies that indicate that incorporating specialists affects audit quality.[32] They point to a study by Boritz et al. (2020) that finds that auditors, under regulatory pressure, may limit specialist involvement, risking audit quality to adhere to budgets and timelines and preserve client relationships.[33] Similarly, another study by Hux (2017) observes that the higher fees associated with specialists can rapidly deplete the total audit budget.[34] A third study by Zimmerman et al. (2023) finds that employing more in-house specialists raises audit team hours and lowers the audit firm's fees per hour.[35] The commentator notes that this implies auditors may not charge clients for the specialist costs, leading to budgeting and deadline challenges for larger, more specialized audit teams. Consequently, the Proposal could *reduce* audit quality due to these added pressures.

Reduce information asymmetry: The EA suggests that the Proposal will improve how auditors communicate and report noncompliance, which will reduce information asymmetry between auditors, audit committees, and specialists. AS 2405 currently requires auditors to determine that identified noncompliance is reported to the audit committee, yet typically management communicates this, not auditors. Current Board standards do not mandate that the lead auditor communicate with other auditors or specialists on noncompliance issues, which the EA notes could create an information imbalance, especially when other auditors might first detect noncompliance and could inform the lead auditor.

[30] *See* Proposal at 75: "*For companies with more developed and effective compliance programs, where the likelihood of material misstatement due to noncompliance with laws and regulations is lower, the benefit of the proposed standard would be lower.*"
[31] *See* Proposal at 75: "*As discussed below, however, these benefits are expected to generally scale with costs: while the benefits for these companies may be lower, certain variable costs would be as well, if and to the extent that auditors would be able to leverage more of the companies' efforts*."
[32] *See* letter by American Accounting Association (August 2, 2023).
[33] *See* Boritz, J. E., Kochetova, N. V., Robinson, L. A., & Wong, C. (2020). Auditors' and specialists' views about the use of specialists during an audit. *Behavioral Research in Accounting,* 32(2), 15–40.
[34] *See* Hux, C. T. (2017). Use of specialists on audit engagements: A research synthesis and directions for future research. *Journal of Accounting Literature,* 39, 23–51.
[35] *See* Zimmerman, A. A. B., Barr-Pulliam, D., Lee, J. S., & Minutti-Meza, M. (2023). Auditors' use of in-house specialists. *Journal of Accounting Research*, 61(4), 1363–1418.

The EA claims that enhancing communication about potential noncompliance will empower audit committees to facilitate more proactive protection of investor interests. The idea is that greater and earlier involvement in addressing compliance issues, it the Proposal will minimize the impact of noncompliance. However, this benefit ignores the downside of expanding the volume and frequency of information communicated to the audit committee about *potential* noncompliance. The Proposal would require the auditor to communicate the information to management and the audit committee "as soon as practicable" and "before the issuance of the engagement report."[36] This could overwhelm board members and management due to the principle that "a wealth of information consumes attention."[37] Like other market participants, audit committee members have limited time and would benefit more from a streamlined set of crucial information for their oversight of financial reporting.[38] Additionally, some have noted that the Proposal could increase audit committee members' workload, potentially undermining their ability to provide effective oversight—a result that contradicts the Proposal's objectives.[39]

Similarly, reporting a constant stream of information to management would require them to investigate each piece of information. Investigating clearly immaterial items will distract management from focusing on strategic initiatives and core business operations that materially affect issuer performance and value creation. This diversion of managers' time and energy away from critical issues and growth opportunities could hinder overall productivity and performance. Any misallocation of resources toward immaterial information diverts resources away from initiatives that could enhance long-term value, which ultimately harms investors.

Once again, the Board has overlooked a chance to measure how much time and effort audit committees put into dealing with potential noncompliance issues. It could have gathered this information by surveying audit firms that almost meet the Proposal's requirements already. The survey could inquire about methods for identifying risks, how much time is spent on addressing potential noncompliance, and how frequently audit firms notify the audit committee (or management, if that is the usual route of communication).

Enhance investor protection: The EA notes that the Proposal will encourage issuers to address noncompliance sooner, thereby reducing legal and regulatory penalties and reputational damage. The EA claims that the Proposal will lead to greater identification of noncompliance, which would in turn deter noncompliance by issuers, possibly leading to fewer instances of it. The EA argues

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[36] *See* Proposal at A1-7.

[37] *See* Simon, H. (1971). Designing organizations for an information-rich world. In M. Greenberger (Ed.), *Computers, communication, and the public interest* (pp. 37–52). Johns Hopkins University Press. Simon, a Nobel laureate, observes, "*What information consumes is rather obvious: it consumes the attention of its recipients. Hence, a wealth of information creates a poverty of attention and a need to allocate that attention efficiently among the overabundance of information sources that might consume it."*

[38] *See* Paredes, T. A. (2003). Blinded by the light: Information overload and its consequences for securities regulation. *Washington University Law Review Quarterly,* 81(2), 417–486. Paredes posits, *"[T]he provocative implication of information overload is that the federal mandatory disclosure system might be more effective if it were scaled back- that is to say, if less were disclosed, not more*." Paredes was an SEC commissioner from 2008 to 2013.

[39] *See* letter by American Accounting Association (August 2, 2023). The Auditing Standards Committee on Noncompliance notes that require more information to be communicated to the audit committee may cause greater busyness and reduce their oversight efficacy as many audit committees are not prepared to expand the scope of their monitoring activities (citing Cunningham et al., 2023). *See* Cunningham, L. M., Stein, S. E., Walker, K., & Wolfe, K. (2023). Insights into the evolving responsibilities of the audit committee. Working paper.

that by strengthening auditor performance and identifying noncompliance sooner or reducing instances of it, the Proposal will preserve significant shareholder value by protecting investors from legal and reputational penalties. However, commentators argue that integrating compliance programs with audit processes will primarily involve documentation rather than genuine improvements in compliance.[40] Moreover, improvements in shareholder value will largely be associated with the identification of material noncompliance. If the Proposal requires audit firms and audit committees to deal with immaterial noncompliance issues, it will consume time and issuer resources to deal with problems that, by definition, investors do not care about.

The Proposal suggests that improving noncompliance detection can help audit firms avoid significant reputational damage. It references research by Karpoff et al. (2005), among others, to support the importance of reputation, particularly highlighting environmental noncompliance as a key area needing stronger audit processes.

Despite presenting several environmental noncompliance anecdotes, the EA acknowledges that violations with less direct impact on stakeholder relations, such as environmental issues, typically result in minimal reputational harm. It references studies by Karpoff et al. (2005) and Brady et al. (2019) but indicates that this literature might not fully capture the impact. Other research by these authors suggests environmental noncompliance does not cause as significant reputational damage as financial misstatements due to accounting fraud. For example, the Board cites Karpoff et al. (2008), who state in footnote 19:

> *Reputation losses are not important for all types of misconduct, however. See Karpoff, Lott, and Wehrly (2005) for an investigation of environmental violations and Murphy, Shrieves, and Tibbs (2009) for an analysis of other types of third-party violations. Karpoff and Lott (1993) argue that reputation losses will be small or negligible for such violations because the harmed parties do not do business with the firm.*

Furthermore, with the SEC just finalizing its environmental disclosure rule, the Board's focus on environmental noncompliance seems premature.[41] It would be prudent to wait until implementation of the SEC's final rule before introducing new audit requirements. The implementation of the environmental disclosure rule could prompt issuers to disclose information related to environmental noncompliance risks voluntarily.

Improve capital allocation efficiency: The EA argues that the Proposal would result in more reliable financial statement information, which could boost investor confidence in this information. The Board posits that investors may use more reliable financial information to improve capital allocation efficiency, which would increase capital supply and reduce capital costs due to increased investor confidence and perceived market risks.

These statements overlook the expenses incurred in enhancing financial reporting and disregard the potential adverse effects on smaller issuers, particularly their capacity to launch publicly and

[40] *See*, for example, letter by Financial Executives International (August 4, 2023).
[41] *See* SEC, SEC Adopts Rules to Enhance and Standardize Climate-Related Disclosures for Investors, March 6, 2024, https://www.sec.gov/news/press-release/2024-31.

secure funding. The EA posits that better financial data could lead investors to shift their investments from less profitable to more profitable issuers. However, since market prices are determined by the expected future cash flows (essentially, profitability), the rationale behind such reallocation remains unclear and potentially unwarranted. This perspective overlooks the fact that younger, less profitable issuers, which are often in need of capital to finance growth and innovation, could be disadvantaged by this shift. Lewis and White (2023) point out that the supposed benefits of this reallocation might not extend to startups, which usually have simpler financial reports due to less accounting complexity.[42] Moreover, redirecting capital toward companies that are already profitable does not necessarily lead to societal benefits, challenging the EA's implication that such a move would be beneficial.[43]

Enhance efficiency of audit resources**:** The EA suggests that by harmonizing audit requirements with risk assessment standards, the proposed amendments will lead to a more strategic deployment of audit resources. This will result in audits being more focused on areas with greater risks of significant misstatements, possibly intensifying efforts in high-risk areas or streamlining them for efficiency. Such a reallocation could ultimately enhance the quality of both audit processes and the resulting financial reports.[44] The Board suggests that, despite audit firms and issuers expressing concerns about rising costs due to the Proposal, the new audit requirements could potentially *lower* audit costs.

This argument strikes us as disingenuous. If the potential risks were truly significant, one would expect audit procedures to have already been adapted to manage them, and any efficiencies in auditing would have been achieved by now. If the Board thinks there are audit efficiencies yet to be discovered that could reduce overall audit fees, it needs to offer concrete examples. Generally, audit costs tend to rise over time due to the growing complexity of accounting standards. We discuss these trends above in our review of the economic baseline.

3.3.2. Estimated costs and challenges of the proposal

Most commentators and third parties predict that the Proposal will lead to higher audit fees because it is expected to increase the scope and complexity of audits, potentially due to the need for more extensive procedures and possibly the use of external specialists to evaluate noncompliance with laws and regulations. Mandating that auditors comprehend operating and compliance control design and efficacy will necessitate that audit firms expand their expertise and efforts beyond traditional financial statement and ICFR auditing, further raising audit costs.[45]

The EA discusses how the Proposal would impose additional costs for auditors and issuers. It outlines how audit expenses might rise due to fixed and variable costs, which are expected to fluctuate depending on the extent to which the new requirements are integrated into existing procedures.

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[42] *See* Lewis, C. M., & White, J. T. (2023). Deregulating innovation capital: The effects of the JOBS Act on biotech startups. *Review of Corporate Finance Studies*, 12(2), 240–290.
[43] *See* Proposal at 72.
[44] *See* Proposal at 72.
[45] *See* PricewaterhouseCoopers, PCAOB Proposes Significant Expansion of Auditor Responsibilities, June 28, 2023, https://viewpoint.pwc.com/dt/us/en/pwc/in_depths/2023/in-depth-2023-05/id202305/pcaobauditorresp.html.

Fixed costs for auditors: Auditors would face fixed costs related to implementing the proposed amendments, including updating audit methodologies, preparing training materials, and conducting training. These costs would include identification of laws and information on noncompliance and an assessment of the issuer's corporate governance, including whistleblower and compliance programs. To perform this function, auditors will likely need to hire additional or external attorneys or legal experts and specialists. However, the EA does not quantify the expected cost of retaining these legal services and simply observes that *"[t]hese specialists could be costly to retain*."[46]

Commentators agree that the Proposal will require audit firms to acquire specialized expertise beyond financial auditing, which will significantly increase audit costs.[47] The EA, however, overlooks how hiring specialists affects audit budgets and efficiency. One commentator points to academic studies suggesting that the retention of specialists squeezes audit firms' profit margins (Hux, 2017) because these expenses are not always offset by increased client fees, so audit teams may find it challenging to remain on budget and schedule (Zimmerman, 2023).[48]

The EA notes that GNFs would likely use internal resources to update methodologies, while NAFs are more likely to purchase updated methodologies from external vendors. The Board postulates that the magnitude of fixed costs for updating methodologies may vary based on how extensively the new requirements are already incorporated into issuers' current methodologies. Auditors serving multiple clients in similar industries can reduce costs per client by sharing insights or centralizing efforts. The EA admits that larger audit firms will be better able to scale the fixed costs than medium and smaller audit firms.[49] An unintended consequence that has not been discussed is that higher fixed costs will make it harder for smaller audit firms to compete for engagements. This will likely result in audit services becoming more concentrated among the biggest audit firms. We discuss this further below.

The EA does provide an estimate of the use of specialists by audit firm type. The Board's analysis of 2021 data indicates that using other auditors is more prevalent in GNF audits, with 26% of all issuer audits involving them—39% in U.S. GNFs and 58% in non-U.S. GNFs, versus 7% of U.S. NAFs and 13% of non-U.S. NAFs. Additionally, GNFs more commonly use auditor specialists than do NAFs, with 95% of U.S. GNF engagements versus 54% of U.S. NAF engagements.

The EA also observes that the initial audit year costs may be highest as auditors identify relevant laws and regulations for the first time. It claims that costs in subsequent years would likely decrease, focusing on updates due to changes in laws or the business, which rests on the assumption that clients do not face significant changes in law or regulations. Thus, if the proposed amendments are adopted, the EA notes that auditors may have higher fixed costs in the years just after the Proposal than in later years.

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[46] *See* Proposal at 79.
[47] *See*, for example, letters by Ernst & Young (August 7, 2023), Illinois CPA Society (August 7, 2023), ICAEW (August 7, 2023), RSM (August 7, 2023), Center for Audit Quality (August 7, 2023), KPMG (August 7, 2023), and Mazars (August 7, 2023).
[48] *See* letter by American Accounting Association (August 2, 2023).
[49] *See* Proposal at 76–77.

Additionally, the Proposal does not explicitly discuss concerns about additional liabilities for auditors and audit committees, which could result in higher compliance and auditing costs. The Board does not attempt to quantify these costs. This omission is surprising because it is standard to provide them in SEC rulemakings. If this were an SEC proposal, estimates would be provided in the Paperwork Reduction Act (PRA), so it should be possible to quantify these costs in this context.[50]

Variable costs for auditors: The EA notes that auditors would incur engagement-level variable costs, such as increased effort in identifying applicable laws and regulations and assessing the risk of material misstatement due to noncompliance. The Board readily admits that these costs could be substantial. The EA observes that the extent of variable costs depends on existing practices and the nature of the issuer and its operations, including regulatory environments. The EA indicates that audits with greater risks or more instances of noncompliance will incur higher variable costs but provides no data on these situations.[51]

The EA also notes a variable cost component to audit firm communication under the Proposal, as auditors would need to communicate with management, the audit committee, and audit partners. However, the EA claims that *"[t]he costs associated with the expanded requirements are expected to be limited, as the communication obligations only arise when information indicating noncompliance comes to the auditor's attention*."[52] The EA does not quantify how often these communications would occur, which makes it difficult to assess this claim.

We are also concerned that the EA does not adequately discuss or quantify the challenges auditors face in assessing noncompliance with a wide range of laws and regulations, particularly those with indirect effects on financial statements. Auditors' clients must adhere to a complex web of evolving laws and regulations at federal, state, and local levels across all jurisdictions where they operate, including corporate governance, securities, trade, contracts, taxes, consumer rights, employment, health and safety, environmental protection, privacy, intellectual property, mergers, acquisitions, and foreign corrupt practices. Identifying all relevant laws and regulations would be arduous, time consuming, and costly, especially for multinational issuers operating across different legal jurisdictions and industries. This could require auditors to have or acquire legal expertise, raising concerns about the boundaries between auditing and legal advice.

There is also a concern that the Proposal could extend auditors' responsibilities beyond their core expertise, leading to a blurring of lines between audit and management or internal counsel functions and potentially affecting the auditor–client relationship.[53] Additionally, the audit procedures will likely be carried out by junior members of the audit team, who usually have limited legal knowledge. This means the audit procedures must be very detailed and straightforward to enable these less experienced team members to effectively handle issues of noncompliance. It will

[50] *See* SEC, Current Guidance on Economic Analysis in SEC Rulemakings, March 12, 2012, https://www.sec.gov/divisions/riskfin/rsfi_guidance_ econ_analy_secrulemaking.pdf.
[51] *See* Proposal at 77.
[52] *See* Proposal at 83.
[53] *See* Knight, J., & Barnes & Thornburg. The PCAOB's "NOCLAR" Proposal—Key Changes and What You Need to Know, October 4, 2023, https://btlaw.com/insights/blogs/securities/2023/the-pcaobs-noclar-proposal-key-changes-and-what-you-need-to-know.

also likely require the creation of extra review teams, possibly at the national level, tasked with evaluating whether the audit has appropriately planned and dealt with noncompliance issues.

Given that the Board clearly acknowledges that both benefits and costs of the Proposal depend heavily on the existing practices, the EA is clearly deficient in not providing cross-sectional data on current practices.[54]

Costs for issuers: The EA notes that issuers being audited may incur direct costs from the Proposal, such as producing documents and responding to additional auditor requests. Management will have to allocate resources to document their legal and regulatory risk assessment and controls more formally. The EA points out that issuers may also incur indirect costs due to the Proposal if auditors pass on increased costs through higher audit fees or if issuers take remedial actions to improve its internal controls over compliance.[55]

Despite having a detailed set of procedures to identify possible noncompliance, it remains unclear how an audit firm is supposed to handle a potential issue. The Proposal offers this example:

> *As a result of performing procedures, the auditor of a chemical company may identify information about environmental regulations related to chemical waste disposal that create a risk of material misstatement because the effect of violations of the regulations could result in material fines, penalties, or the obligation to perform environmental remediation*.

It seems that the risk of a chemical spill at such an issuer is significant enough to be mentioned in the issuer's annual report. However, if an oil spill has not occurred and there are no attendant financial statement accruals or disclosures under GAAP, then the measures taken to prevent a spill are considered an operational risk. This question arises: Is it the auditor's job to assess and give an opinion on the effectiveness of these preventive measures? It appears so, and this might necessitate bringing in specialists. If a specialist deems the measures effective, then no further action might be needed from the auditor. Yet such an evaluation appears to go beyond the scope of current audit requirements.

3.4. Quantification of costs and benefits

Numerous commentators purport that the Proposal fails to offer significant benefits to financial statement users that would justify the costs imposed on issuers.[56] These commentators often convey that the EA lacks a detailed and quantitative assessment of additional manpower and legal expenses for issuers. Further, they note that the Board should project audit costs, which could significantly exceed any proposed advantages, with implementation expenses surpassing the potential gains for investors. One commentator notes, *"The lack of a thoughtful and well-supported economic analysis of the proposed NOCLAR standard is a fatal flaw."*[57]

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[54] *See* Proposal at 77–8. Also, see Footnote 113: "*The costs associated with the proposed amendments include fixed costs to update audit methodologies and variable costs to change existing audit practice, both of which depend on how current methodologies compare to the proposed amendments*."
[55] *See* Proposal at 78.
[56] *See*, for example, letters by Dow (August 1, 2023), Mayville Engineering Company (August 4, 2023), Williams Companies (August 4, 2023), and Plante & Moran (August 7, 2023).
[57] *See* letter by Sridhar Ramamoorti (August 6, 2023).

It is evident that quantifying certain benefits and costs is more straightforward than quantifying others; indirect ones are particularly challenging to measure. In contrast, direct costs, like those for compliance, can be quantified. For example, the SEC routinely calculates and provides estimates of compliance costs to meet the PRA requirements, including detailed calculations of the hours and hourly rates for professional services such as audit engagements.

These calculations are not only feasible; the Board also has the option to gather direct estimates from audit firms on the additional work needed to adhere to the proposed changes. Moreover, unlike the SEC, the PCAOB is not bound by the Sunshine Act, so it can conduct surveys with as many firms as necessary to accurately gauge the costs involved.

Consequently, we find the following statement at the beginning of the Proposal's EA unconvincing:

> *Due to data limitations, much of the economic analysis is qualitative in nature; however, where reasonable and feasible, the analysis incorporates quantitative information, including information from publicly available data and academic literature related to noncompliance.*[58]

While overcoming data limitations would require considerable effort, this obstacle is not insurmountable with a dedicated data collection initiative. Therefore, in this section, we review the limited data in the EA, critique the EA's justification for the difficulty in quantifying costs and benefits, and consider potential quantifications that were not pursued.

3.4.1. What data are provided in the EA?

Commentators note that because the EA does not attempt to estimate the substantial costs of the Proposal, it falls short of PCAOB standards, lacking an attempt to estimate the substantial costs of the Proposal and making it challenging to assess the Proposal's value.[59]

The EA cites statistics from an academic study on the overall cost of corporate fraud, noting that corporate fraud destroys 1.6% of shareholder equity value per year.[60] However, for most of the discussions of the cost of fraud, the EA cites "case studies" to support its justification.[61] For example, it cites statistics from an anecdote of a single issuer in a study of investor harm.[62]

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[58] *See* Proposal at 60.
[59] *See*, for example, letter by American Accounting Association (August 2, 2023).
[60] *See* Proposal at 63, where Footnote 117 reads, "*There are academic papers that estimate the undetected share of corporate noncompliance. For example, a recent study estimates that in normal times only one-third of corporate " 'frauds' are detected. The study uses the term 'fraud' loosely to refer to 'some form of misconduct or alleged fraud.' It is not limited to fraud as defined under PCAOB standards. The study also estimates that corporate 'fraud' destroys 1.6 percent of equity value each year, equal to $830 billion in 2021. Dyck, A., Morse, A., and Zingales, L. How pervasive is corporate fraud? Review of Accounting Studies 1 (2023)*."
[61] The front end of the Proposal contends, "*We have observed that investor harm from violations of laws or regulations can be significant*." To support this statement, it cites a handful of anecdotes in Footnote 4. *See* Proposal at 9.
[62] *See* Proposal at 64, where Footnote 119 states, "*For example, one study analyzes Xerox's misconduct of artificially inflating reported earnings in around 1997–1999 and estimates that the cumulated loss in market capitalization, measured over the sequence of events by which investors learned of the misconduct, was $5 billion. Out of the $5*

The EA also cites data on monetary penalties because of noncompliance with federal laws and regulations: "*Total settlement amounts for violations of antifraud laws and the FCPA have been considerable in recent years and reached $4.3 billion and $4.2 billion, respectively, in 2020*."[63] Data on noncompliance penalties from this source are further discussed in a footnote of the EA.[64] Despite these discussions, a significant shortcoming of the EA is that it fails to address the extent to which existing audit procedures would have been expected to detect these frauds and the incremental improvement in detection likelihood that the proposed amendments would offer.

The EA briefly addresses the potential reputational damage stemming from noncompliance. There is also a brief discussion in the EA of the harm from reputational penalties due to noncompliance. It notes that one study of SEC enforcement actions for financial misrepresentation "*estimates that the reputational loss is over 7.5 times the sum of all penalties imposed through the legal and regulatory system*."[65]

The only cost data presented are the fraction of audit firms that hire outside specialists. The EA estimates the utilization of other auditors and specialists across audit firm types, detailing the percentage of GNF and NAF audit firms that engage these entities based on 2021 Form AP data, with a distinction between U.S. and non-U.S. firms.[66] While estimates of this type are essential to the development of a robust baseline analysis, the absence of other more relevant cost data is inexplicable. For instance, the baseline should have incorporated an examination of historical audit fees, especially since this information is readily accessible in structured SEC annual report filings (such as eXtensible Business Reporting Language – or XBRL) and through commercial databases like Audit Analytics.

3.4.2. Is there an adequate discussion of why quantification is infeasible?

The EA acknowledges its reliance on qualitative evaluations of the Proposal's costs and benefits due to data limitations. However, the Board could have employed numerous methods to gather the necessary data but chose not to, such as a survey of audit firms. The Board's explanation for not

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billion loss, the study estimates that $1.039 billion is the reversal of the artificial share price inflation, $0.523 billion can be attributed to amounts Xerox paid in fines and to settle a class action lawsuit, and the rest of the loss—$3.44 billion—is due to impaired operations because of the revelation of misconduct, or so-called reputational loss. See Karpoff, J. M., Does reputation work to discipline corporate misconduct? The Oxford Handbook of Corporate Reputation (2012)."

[63] *See* Proposal at 65.

[64] *See* Proposal at 65, Footnote 123: *"As discussed above, violations of antifraud laws and the FCPA appear to be associated with higher financial penalties than other types of noncompliance in the database. The settlement amounts for antifraud (including accounting, healthcare, securities, tax, and general fraud) violations were $0.4 billion, $2.3 billion, and $4.3 billion in 2018, 2019, and 2020, respectively. The settlement amounts for FCPA violations were $1.7 billion, $1.9 billion, and $4.2 billion in 2018, 2019, and 2020, respectively. Data from 2021 were incomplete and, as such, not referenced herein. See The Corporate Prosecution Registry, available at https://corporate-prosecution-registry.com (accessed December 19, 2022).*"

[65] *See* Proposal at 65–6 and Footnote 125. The Proposal also cites statistics from a study of U.K. issuers.

[66] *See* Proposal at 84: "*The staff's analysis of 2021 Form AP data suggests that the use of other auditors is more common in audits performed by GNFs [referencing Footnote 150]. Overall, other auditors are involved in about 26 percent of all issuer audit engagements. About 39 percent of U.S. GNF engagements and about 58 percent of non-U.S. GNF engagements involved the use of other auditors. In comparison, only about 7 percent of U.S. NAF and 13 percent of non-U.S. NAF engagements involved other auditors*."

collecting relevant data falls short of its own standards. It should provide a more detailed justification for this shortfall rather than a generic statement attributing it to data limitations. The Staff Guidance on Economic Analysis in PCAOB Standard Settings asserts:

> *When costs and benefits cannot be quantified reliably or meaningfully, a well-developed qualitative discussion, along with an explanation of why quantification is not feasible, still allows the Board and those affected by its standards to be more clear about the potential impacts of a policy decision, and results in an improved policy-making process.*

Given that the Board faces no such restrictions on survey participation, unlike the SEC which needs Commission approval to survey more than 10 respondents, this question arises: Why has the Board not sought to obtain compliance cost estimates through surveys of audit firms or direct engagements with issuers? If the Board had tried to collect data but received too few responses to generate reliable estimates, the argument of data limitations would be more persuasive. The apparent outcome that the Board did not pursue these avenues more aggressively suggests that the claims of infeasibility to enhance the EA are unsatisfactory.

3.4.3. What quantification was feasible but not performed?

An overarching theme in received comment letters is that the Board failed to conduct sufficient quantification to study the costs and benefits of the proposal.[67] The Board does not provide data analysis or statistics that are both feasible and informative in determining whether the marginal benefits of the Proposal are expected to outweigh the burden on auditors and issuers.

Quantifying benefits: The Proposal argues that audit quality will improve because of the expanded standards. It notes that several auditors or issuers have robust compliance programs, where the imposition of costs will yield fewer benefits. However, the EA makes no attempts to measure and provide data on the fraction or total number of these entities. The SEC's guidance on cost-benefit analysis notes that an EA should do the following:

> *Identify and discuss uncertainties underlying the estimates of benefits and costs. Where particular benefits or costs cannot be monetized, the release should present any available quantitative information: for example, quantification of the size of the market(s) affected, or the number and size of market participants subject to the rule.*[68]

[67] *See* letters by American Accounting Association (August 2, 2023), Plains All American Pipeline (August 5, 2023), Committee on Capital Markets Regulation (August 7, 2023), American Council of Life Insurers (August 7, 2023), Financial Executives International (August 7, 2023), Tyler Technologies (August 7, 2023), Grant Thornton (August 7, 2023), National Venture Capital Association (August 7, 2023), Ernst & Young (August 7, 2023), Center for Audit Quality (August 7, 2023), Novanta (August 7, 2023), NuScale Power (August 7, 2023), Energy Infrastructure Council (August 7, 2023), Society for Corporate Governance (August 7, 2023), Victor Jarosiewicz (August 4, 2023), Nasdaq (August 7, 2023), and American Bar Association (August 23, 2023). For example, Grant Thornton notes, "*We believe that the economic analysis contained in the Proposal neither sufficiently acknowledges the actual costs that will be imposed on issuers and auditors nor adequately quantifies how the intended benefit to investors will exceed such costs. Such detailed, quantitative economic analysis is essential for all stakeholders—in particular, the investors who will bear such costs—to evaluate whether the benefits of the Proposal outweigh its costs*."

[68] *See* SEC, Current guidance on economic analysis in SEC rulemakings, March 12, 2012, p. 12, https://www.sec.gov/divisions/riskfin/rsfi_guidance_ econ_analy_secrulemaking.pdf.

One of the key benefits the Proposal argues is that by increasing communication between auditors and management, the audit committee, and audit partners, the proposed standards update will lead to earlier and more frequent identification of noncompliance that leads to fewer material misstatements. Following this argument, after determining the market's affected size, the EA should have evaluated expected improvements in audit quality by comparing indicators like financial restatement frequency and Accounting and Auditing Enforcement Releases between firms already nearly compliant with the proposed amendments and those that are not. The EA should have also quantified the expected frequency of these communications, perhaps by surveying firms that have more robust compliance programs than those that do not.

The Proposal rests on the assertion that noncompliance results in billions of dollars in losses each year. However, the EA does not quantify how much noncompliance could actually be prevented by the Proposal. One commentator urged the Board to quantify the incremental amount of potential losses shareholders may face due to auditors not detecting and reporting noncompliance with laws and regulations.[69]

Therefore, the EA must thoroughly examine past cases of noncompliance and estimate the potential reduction in losses. It should be noted that only investors in issuers with noncompliance concerns would benefit from these measures, while the incremental cost of the Proposal would be imposed on all firms.

One approach to tackle this issue would be to document the frequency of previous instances of noncompliance and the durations between the initial instance of noncompliance and its detection. Although the percentage of issuers with material noncompliance is small, both the frequency of noncompliance and the delays in detection would provide valuable metrics to better understand whether there is a need for updating standards.

Quantifying costs: Several commentators highlight concerns about a significant rise in audit costs, which the Board has yet to quantify. These concerns include the need to recruit additional personnel, enhance information technology and other resources, and bear extra expenses for external advisors and professional fees due to new regulations.[70]

The baseline analysis should track the trend of audit costs over time. The EA needs to forecast the rise in audit costs because of the Proposal, accounting for both the fixed costs of revising audit methodologies and the variable costs of modifying current audit practices, which hinge on the disparity between existing and proposed methods. This situation underscores the need for the Board to gain insights by surveying auditors whose methods already comply with the proposed changes and to gather cost estimates for those needing updates. These estimates could be made in a manner that is consistent with SEC rulemakings that mandate similar calculations to comply with the PRA.

The Proposal does not quantify the costs of substantially increasing issuer engagement and effort needed for auditors to fulfill the proposed audit requirements. These efforts include planning,

[69] *See* letter by Novanta (August 7, 2023).

[70] *See*, for example, letters by independent audit committee members at Microchip (August 1, 2023) and Packaging Corp of America (August 4, 2023).

performing procedures, addressing risks, identifying instances of potential noncompliance (including false positives), and communicating actions and findings.[71] Audit firms, with their history of adapting to regulatory measures such as SOX, can offer knowledgeable estimates based on their past experiences. This capability could help the Board address critiques that SEC's cost estimates often underrepresent the true costs of compliance.

Many commentators note that the Proposal extends into areas beyond traditional auditor expertise. It will require multiple specialists per audit and early engagement, further escalating expenses.[72] As noted above, the EA estimates the utilization of other auditors and specialists across different audit firm types but makes no effort to *quantify the cost* of hiring new specialists and additional auditors or attorneys to address the Proposal. It should do so.

The EA overlooked the full range of costs and market impacts, particularly the labor market effects on auditors, lawyers, and experts. If adopted, the proposed amendments would intensify recruitment and exacerbate retention difficulties for audit firms, notably smaller ones, as well as make it harder to secure specialized legal and compliance professionals due to the possible loss of attorney–client privilege. This could strain the labor market for these roles and significantly increase wages and outsourcing costs, disproportionately affecting smaller firms.[73]

Further, the Proposal overlooks the liability concerns linked to auditors depending on specialists. When audit firms hire specialists due to a lack of specific in-house expertise, the firms depend on those experts to bridge the firms' knowledge gaps. However, if the advice provided by the specialists is incorrect, the audit firms cannot evade legal responsibility. The EA should consider the potential increase in liability and insurance expenses, provided that these risks are insurable.

The Proposal is expected to raise staff training expenses significantly. The EA does not attempt to assess auditors' training requirements or evaluate if audit team members possess or will require the essential knowledge, skills, and abilities to comply with the proposal, nor does it estimate the associated costs.

The Proposal would effectively integrate a compliance audit of the issuer's legal operations. This would increase the time spent by both in-house and external legal counsel in discussions with auditors and their experts as well as in completing additional documentation required for audit evidence. Issuers will likely face higher costs to broaden their compliance systems to cover all applicable laws and regulations, along with allocating more time and resources for managing and overseeing these enhanced programs. These added time and resource requirements would incur increased costs for the public issuer, which should have been quantified.[74]

Accountants are not attorneys trained in law. Meeting the requirements of the Proposal is expected to incur substantial expenses because it will involve hiring additional lawyers. Indeed, the Proposal acknowledges that auditors may need to retain a range of legal experts to comply with the proposed

[71] *See* letter by Energy Infrastructure Council (August 7, 2023).
[72] *See* letter by American Accounting Association (August 2, 2023).
[73] See letter by U.S. Chamber of Commerce (August 2, 2023).
[74] *See* letter by Tyler Technologies (August 7, 2023).

standards but offers no projected cost beyond stating that "*these costs could be substantial*."[75] Typically, the fees charged by lawyers surpass those of accountants, and it is probable that a considerable amount of legal effort will be necessary to adhere to the suggested criteria. In estimating these fees, the calculations need to recognize that there are fixed and ongoing variable cost components. The EA does not discuss the hourly rate of attorneys and the expected increase in these fees, which shareholders will ultimately bear. Given that the SEC regularly computes comparable estimates in the PRA sections of its rulemakings, the Board could use these analyses as a template.

Audit firms, dealing with rising operational expenses such as insurance and the requirement for specialized expertise, are expected to pass these costs on to their clients and, ultimately, to investors. However, as we note above, it is important to recognize that not all these costs may be transferred. The EA did not attempt to estimate these increasing costs or the fraction that may be passed on to clients, which would affect auditor profit margins.

One commentator recommends that costs be estimated across a broad range of issuers by creating profiles of hypothetical issuers reflecting various sizes, international reach, and levels of regulatory scrutiny. They argue the analysis should encompass the diverse regulatory scrutiny encountered in various industries and geographic locations. The same commentator notes that benefits could be estimated by analyzing the largest losses over the past decade in situations where the Proposal aims to prevent or detect them earlier. They contend that the analysis should examine how effectively auditors can contribute to early detection or prevention. They caution the Board against assuming that all past losses would be avoided; instead, the Board should acknowledge that auditors' efforts might not always achieve 100% success.[76]

Netting the costs and benefits: Once the costs are measured, the appropriate comparison is to compare the incremental benefits of the proposal to the total incremental costs for all auditors and issuers.

Implementing this Proposal will necessitate significant extra resources to comply with the new standards, leading to substantial yearly costs for issuers due to potentially unnecessary additional audit procedures. We recommend the Board undertake a more detailed economic analysis of the Proposal's effects, especially to evaluate whether the quantified potential benefits to investors outweigh the significant quantified costs. Only through such an analysis can the Board decide if the incremental advantages of assessing and reporting items that may not be material are worth the definite increase in expenses and the added strain on management and auditors.

3.5. Unintended consequences of the Proposal

3.5.1. What potential unintended consequences are discussed?

[75] *See* Proposal at 77.
[76] *See* letter by Robert A. Conway (August 7, 2023).

The EA notes that the proposed amendments may lead to unintended economic effects. It discusses these possible consequences and any relevant mitigating factors as outlined below.[77] We first review the consequences discussed in the EA and offer feedback on each topic.

Chilling effect on information flow: The EA discusses how if auditors increase focus on noncompliance, issuers may respond by disclosing less information about ethics, compliance systems, and internal investigations to avoid extra costs. This could lead to restricted audit scopes or insufficient evidence, potentially leading to qualified opinions or disclaimers. The Board notes that subtle restrictions could affect audit quality, risking noncompliance detection. However, the EA points to the threat of SEC enforcement to help mitigate information withholding, since lying to auditors violates federal securities laws. The Board notes that the insufficient information provision may also breach these laws.

We share the Board's concerns of this potential spillover effect. The Proposal mandates that auditors report *potentially* illegal acts as soon as they become aware of their possible existence, even before fully understanding if a problem truly exists.[78] Although the Board claims this could result in reductions in information asymmetry, this mandate could backfire by deterring open communication between issuers and auditors. Such an outcome could potentially decrease the chances of uncovering actual issues.

It is conceivable that issuers might limit auditors' access to essential personnel and appoint official liaisons to control and/or limit information flow. Further, the rule casts auditors in a tattletale role, obliging them to inform issuers of problems deemed "clearly inconsequential." The benefit of this requirement remains unclear, raising questions about its justification.

Auditors might overhire experts: The EA notes that the Proposal may lead auditors to unnecessarily consult legal experts or specialists due to concerns over higher liability risks, even when it does not require judgments beyond auditors' knowledge. The Board postulates that this cautious approach could raise expenses and, in a competitive market, put audit firms that overuse specialists at a disadvantage compared to their more cost-efficient rivals.

Competitive pressures among audit firms naturally limit the tendency to overhire experts. If anything, the opposite is more likely to occur. We believe that pressure to submit competitive bids to obtain engagements will tend to result in hiring fewer specialists than might be needed.

Increasing auditors' legal risks: The EA notes that proposed changes could increase auditors' legal risks by intensifying their duty to spot legal noncompliance in issuers. Failure to detect such issues could lead to more lawsuits, despite auditors already facing increased litigation for undetected noncompliance due to insufficient incentives. The Board notes that even if such lawsuits are less likely to succeed, they still drain resources. Thus, the EA claims it is unclear if this rise in "meritorious" lawsuits will balance out but argues that the higher legal risk may boost auditors' motivation to identify significant noncompliance, which the Board notes would enhance its benefits.

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[77] *See* Proposal at 85–87.
[78] *See* Proposal at 7: *"The auditor would be required to communicate potential noncompliance, and the subsequent results of the auditor's evaluation of such potential noncompliance, to management and the audit committee."*

We note that commentators agree that the Proposal's broad and ambiguous language may increase auditor liability concerns, leading to a less effective risk management environment.[79] However, regarding the Board's second point, legal risks for noncompliance are present with or without the new amendments. Framing a drawback of greater legal risks to appear as a benefit needs to be supported by data or academic evidence. The Board should provide evidence of other standards where enhanced motivation justified the expenses incurred by such changes. Otherwise, this conjecture is just an opportunistic twisting of a cost into a benefit.

Shifting work dynamics: The EA notes that the proposed amendments might shift work dynamics between auditors and issuers, especially regarding the use of specialists. If issuers expect auditors to tackle more noncompliance issues, they may depend more on auditors and their experts, which the board notes may increase the auditors' workload and possibly affect audit quality. However, the EA claims that such shifts should be minimal because issuers will likely continue managing compliance internally to mitigate third-party liability.

We agree that the Proposal may compromise audit quality due to the heavier workload but do not share the view that this spillover effect will likely be minimal. The Proposal will increase the auditor and audit partner's workload and could impair those individuals' abilities to accomplish their tasks effectively. There is ample academic evidence that audit quality suffers when auditors experience an increased workload.[80]

In fact, the Board has previously released data noting, *"Heavy workloads could distract an engagement partner from giving adequate and focused attention to an audit engagement."*[81]

Similar concerns were expressed by the Center for Audit Quality, and the International Auditing and Assurance Standards Board has warned that excessive workloads for audit partners and staff pose substantial risks to the quality of financial reporting.[82] More recently, case study evidence showed that audit quality during the Special Purpose Acquisition Company boom resulted in lower-quality audits and deficiencies.[83]

Commentators have expressed worries that introducing additional procedures and expert consultations to audits increases both the cost and the duration of the process without offering

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[79] *See*, for example, letter by Illumina (August 4, 2023) and Marathon Oil (August 4, 2023).

[80] *See*, for example, Sundgren, S., & Svanström, T. (2014). Auditor-in-charge characteristics and going-concern reporting. *Contemporary Accounting Research*, 31(2), 531–550; and Lai, K. M., Sasmita, A., Gul, F. A., Foo, Y. B., & Hutchinson, M. (2018). Busy auditors, ethical behavior, and discretionary accruals quality in Malaysia. *Journal of Business Ethics*, 150, 1187–1198.

[81] *See* PCAOB, *Concept release on audit quality indicators.* July 2015, https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket_041/release_2015_005.pdf?sfvrsn=de838d9f_0.

[82] *See* Center for Audit Quality, *CAQ approach to audit quality indicators*, April 2014, https://www.thecaq.org/wp-content/uploads/2019/03/caq-approach-to-audit-quality-indicators-april-2014.pdf; International Auditing and Assurance Standards Board, *A framework for audit quality: Key elements that create an environment for audit quality,* February 2014, https://www.iaasb.org/publications/framework-audit-quality-key-elements-create-environment-audit-quality-3.

[83] *See* White, N., & Iacone, A. Overworked SPAC auditor's lapses lead to $2 million fine. *Bloomberg News*. February 21, 2024. https://news.bloombergtax.com/financial-accounting/spac-auditor-withum-fined-2-million-for-quality-control-flaws.

substantial benefits to investors. They note that audit costs can vary greatly depending on the issuer's industry, size, and global presence and weaken the potential advantages for investors. Critics argue that these extra measures, which may not enhance the accuracy of financial statements, result in unwarranted expenses for both issuers and investors. Moreover, the time auditors and experts spend on these additional tasks represents a significant yet hard-to-measure increase in workload that affects both parties substantially.[84]

Auditors might prioritize noncompliance over other audit areas: The EA observes that the proposed amendments could result in auditors focusing too much on legal noncompliance, possibly neglecting other critical audit areas. Under both the current and proposed AS 2405, the Board notes that auditors must address any detected noncompliance. However, it admits that materiality influences the procedures chosen. With AS 2110's changes, the EA asserts that auditors might identify more noncompliance cases, potentially at the cost of other important audit aspects, especially if these issues are not materially affecting the financial statements. This is an important concern. As we note above, increasing auditors' responsibilities and altering their focus could undermine the quality of audits. The Proposal risks hindering their effectiveness.

The Board also notes that audit committees might prioritize minor compliance issues over more significant matters. The EA suggests that certain factors could mitigate these concerns. For example, Section 10A mandates auditors to evaluate all noncompliance, emphasizing its importance. The Board notes that materiality can be hard to judge without a full understanding of the noncompliance and that many issuers' ethics programs effectively handle minor issues. Thus, the Board believes that addressing immaterial noncompliance will not unduly detract from other vital audit tasks.

The Board's assumption that addressing minor noncompliance will not burden the audit committee is unsubstantiated by data in the Proposal. Moreover, research by Cunningham et al. (2023) highlights that audit committees—already dedicating up to four hours per meeting—feel pressed for time to fulfill their agendas before the proposed amendments.[85] Imposing more duties, given their extensive responsibilities covering cybersecurity, data privacy, and risk management, could further strain their capacity, potentially diminishing their oversight effectiveness.

Positive spillover effects: The EA discusses how the proposed rules could lead to positive spillover effects. For instance, the Board speculates that improved audit committee communication may strengthen ethics and compliance programs, leading to better issuer adherence to regulations. Moreover, the Board suggests that if issuers enhance their procedures due to more rigorous auditor oversight, it could lead to wider societal benefits, like environmental improvements through better compliance with pollution regulations or increased accountability via adherence to anti-bribery laws.

While achievement of these benefits is possible, legal actions against noncompliance of this nature are viable only if noncompliance occurs and is detected. The discussion should focus instead on how the proposed amendments might increase the likelihood of detecting noncompliance earlier,

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[84] *See*, for example, letter by Dow Inc. (August 1, 2023).
[85] See Cunningham et al. (2023), stating that audit committees *"convey that their current meeting time still does not feel sufficient to cover all responsibilities outlined on the meeting agenda."*

thus preventing such incidents before they happen. The current description of these benefits is too broad and needs to be more precisely articulated to reflect the Board's actual intentions.

3.5.2. What potential unintended consequences are not discussed?

We next describe several potential unintended consequences of the Proposal, which could influence the efficiency of the audit process, competition amongst auditors, and capital formation by certain issuers.

***Proprietary costs of disclosing reportable events*:** The Proposal and EA give little consideration to the proprietary costs of disclosure. For example, the Proposal adds a new matter to the list within AS 2110.13: changes to the issuer's operating strategy. This includes information on when and how the issuer will implement such strategies and the related effect on the issuer's accounting principles and disclosures.[86]

The proposal lacks clarity on when an action becomes a reportable event, raising concerns about the potential for such disclosures to leak proprietary information to competitors. Academic research highlights the proprietary costs of disclosing such information, noting that it can give rivals a competitive edge. While managers would ideally share all private information in the absence of costs to reduce information asymmetry, full transparency is rare in capital markets due to the risk it poses to an issuer's competitive position. Seminal work by Verrecchia (1983) notes that issuers often provide less than full disclosure due to competitive harm, with the level of voluntary disclosure decreasing as proprietary costs increase.[87]

***Audit procedures*:** Second, the Proposal appears to indirectly entail possible fines for noncompliance with nonfinancial regulations, like environmental laws. It raises the question of how auditors would create procedures to verify compliance with such regulations. Efficient audit execution within strict deadlines should not incur unreasonable and unknown costs. The Proposal's broad and ambiguous language may increase auditor liability concerns, leading to a less effective risk management environment.[88]

Crowding out of smaller audit firms: The Proposal's significant costs, combined with the expertise needed, will disproportionately affect small and midsized accounting firms. These auditors may struggle with the proposed requirements due to resource limitations and lack of specialist access, which may affect client service. Navigating myriad laws and regulations across jurisdictions is impractical for them and likely beyond their capabilities. Broadening the scope

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[86] *See* Proposal at 38: "*In addition, we are proposing to add a new matter to the list within AS 2110.13—changes to the company's operating strategy, including when and how the company will implement such strategies and the related effect on the company's accounting principles and disclosures. For instance, the company may indicate a change in strategy related to halting a line of business that is contradictory to information provided by the company to the auditor regarding assumptions used in determining the value of an asset. This change may cause the auditor to question the company's intent to continue an investment in a project or the assumptions used in a goodwill impairment analysis. Information about a strategy to replace an existing product line with a new product line may provide contradictory information to the auditor about the assumptions used by the company in assessing inventory obsolescence reserves*."

[87] *See* Verrecchia, R. E. (1983). Discretionary disclosure. *Journal of Accounting and Economics*, 5, 179–194.

[88] *See* letter by Illumina (August 4, 2023).

beyond the auditor's expertise will require small and midsized audit firms to hire additional legal experts or engage external legal specialists to comply with new standards. The significant costs and expertise required will deter small to midsize accounting firms from servicing public issuers as clients or prevent them from making competitive bids, fostering greater public issuer audit concentration among a few top firms. Such a decrease in competitiveness within the audit market would not serve the public interest or improve investor protection.[89] These costs should be discussed in the quantification of the EA. Moreover, the baseline should describe the trends in smaller audit firms exiting markets given that it already has these data.

Disproportionate impact on smaller and emerging technology issuers: Audit firms will incur additional costs as they spend considerable time reviewing and documenting discussions with management and legal experts. These costs will be passed on to public issuers through higher audit fees, adding to their operating expenses and ultimately burdening shareholders. Smaller filers would face challenges bearing this financial burden, potentially restricting access to public markets for these issuers or prompting small issuers to remain private. Thus, the Proposal could significantly limit the flow of capital to smaller issuers.[90] The Proposal would also make it risky and potentially unfeasible for audit firms to engage with issuers in the digital asset or fintech sectors, due to ongoing legal uncertainties.[91] Thus, the rule could affect the development of innovative technologies and put U.S. issuers at a competitive disadvantage. The Board should consider the impact of audits on capital formation and prevent the potential negative effects of the current Proposal.[92]

3.6. Low-cost alternatives

3.6.1. What low-cost alternatives were discussed?

In exploring options, the EA highlights three points: (1) It argues that developing standards is a more effective approach compared with alternatives such as interpretive guidance or enhancing inspections and enforcement activities, (2) it reviews other methods of setting standards that were taken into account, and (3) it outlines the key policy decisions that influenced the formulation of the proposed standards.[93]

The EA notes the Board evaluated whether interpretive guidance or enhanced inspections and enforcement could effectively address auditors' duties regarding issuer noncompliance. It notes that interpretive guidance clarifies existing standards, whereas inspections and enforcement act post-audit. The EA notes that Staff Guidance could reiterate auditors' current responsibilities and elaborate on risk assessment linked to legal compliance, responsibilities under other standards, and

[89] *See*, for example, letters by Plante & Moran (August 7, 2023) and Illinois CPA Society (August 7, 2023).
[90] *See* letters by Forvis (August 7, 2023), MNP LLP (August 7, 2023), Nasdaq (August 11, 2023), and Tyler Technologies (August 7, 2023).
[91] *See* letters by Sridhar Ramamoorti (August 6, 2023) and the Cigna Group (August 7, 2023). The Cigna Group states, *"The costs may undercut management's ability to justify continued operations in certain businesses, particularly businesses that are subject to extensive evolving regulations subject to high degrees of interpretation."*
[92] *See*, for example, James R. Doty, chairman, PCAOB, *Enhancing capital formation, investor protection and our economy*, December 9, 2013, https://pcaobus.org/news-events/speeches/speech-detail/enhancing-capital-formation-investor-protection-and-our-economy_507.
[93] *See* Proposal at 88.

the connection between AS 2405 and Section 10A. However, it argues that guidance alone is insufficient because it would not offer the benefits discussed in the EA and instead focus on auditors' performance of existing standards. Similarly, it claims that greater inspection or enforcement does not enhance the standards that result in the claimed benefits of the Proposal.

The EA also notes that the Board considered making only minor updates to AS 2405, such as revising terms and omitting descriptive language and examples. While this would mean fewer adjustments to audit firm methodologies, it claims that AS 2405 is outdated and predates Section 10A and Sarbanes-Oxley. The EA claims that broader revisions are necessary and cannot be achieved through minor changes alone.

The EA lists four alternative approaches the Board considered to addressing key policy issues. We give weight to additional alternatives that could have been considered in the next section.

1. ***Meaning and use of the term "noncompliance" with laws and regulations:*** The Board considered the meaning and use of the term "noncompliance" with laws and regulations. The Board contemplated keeping the term "illegal acts" used in Section 10A but decided against it due to concerns that auditors may dismiss less significant noncompliance that the Board believes could affect financial statements. The Board also opted not to align its definition completely with the statutory language in Section 10A. The Board believes its definition of "noncompliance with laws and regulations," which includes acts by management, employees, or those acting on the issuer's behalf, provides clarity without altering the standard's scope.

2. ***Alignment with Section 10A for broker-dealers:*** The Board notes that public issuer auditors must adhere to Section 10A, but this does not apply to broker-dealer (BD) audits. Despite potential cost increases, the Board argues that the proposed amendments should extend to all PCAOB-standard audits because the benefits to BD customers are similar to those for non-BD investors. Thus, the Board believes that aligning the Proposal with Section 10A would likely reduce risk of noncompliance for BD customers.

3. ***Relationship of noncompliance with laws and regulations to the financial statements:*** The Board asserts that the impact of noncompliance on financial statements can be significant, regardless of whether it is direct, like misapplied corporate tax rates, or indirect, like unrecorded liabilities for Occupational Safety and Health Administration workplace violations. The Board maintains it chose not to maintain the existing AS 2405's direct versus indirect effects distinction, finding the concept sometimes challenging to apply and potentially misleading. The EA declares that auditors should address material misstatements from noncompliance based on their substance rather than categorization. The Board claims the proposed amendments offer better guidance for auditors to focus on material misstatement risks and their responses and how to handle and report any noncompliance discovered.

4. ***Auditor's determination of whether an act is illegal:*** The EA claims the proposed amendments aim to safeguard investors and enhance audit quality by emphasizing auditors' proactive duties rather than their limitations. It notes that current AS 2405's language downplays auditors' ability to identify legal violations, which is at odds with this goal. Instead of requiring auditors to definitively determine the legality of actions, the proposed amendments encourage them to assess

the likelihood of noncompliance. The Board argues that this shifts the focus to auditors' responsibilities to identify and evaluate potential noncompliance without implying they lack the capability to do so. Therefore, the Board viewed it as unnecessary to include language that limits auditors' perceived abilities in the new amendments.

3.6.2. Were any low-cost alternatives overlooked?

At least five feasible alternatives either were not considered or were dismissed without giving them due consideration:

1. Mandate that the issuer's general counsel establish methods for spotting noncompliance and promptly report these issues to both the audit committee and the auditing firm. This approach enables the auditing firm to assess if there are sufficient internal controls to detect noncompliance and whether prompt reporting occurred. While the auditing firm might still require a specialist's help to ensure comprehensive identification of possible noncompliance, this approach significantly reduces their burden compared to developing all these procedures independently. If the Board lacks the authority to mandate such behavior, it could issue interpretative guidance as a substitute or possibly work with the SEC to accomplish this.

2. Consider implementing the proposed amendment in phases, depending on the size of the company. Initially, mandate that only "large accelerated filers" adopt the amendments. Once sufficient data are collected, the Board could conduct a preplanned post-implementation review with specific indicia of success to evaluate the Proposal's impact. If it proves effective in meeting its set objectives, the requirement could then be extended to other issuers (e.g., accelerated and nonaccelerated filers) and broker-dealers.

3. Alternatively, the Board might consider permanently exempting smaller issuers, such as EGCs, from these requirements. This exemption could be particularly pertinent since the fixed costs associated with the amendments could be disproportionately high for these companies. Yet, because of their simpler business models, the likelihood of noncompliance issues could be relatively lower.

4. The Board has claimed that interpretative guidance alone is not adequate to fully tackle the issue of potential noncompliance. It appears that a key goal of the Proposal is to standardize audit practices and ensure more consistency in how audit firms identify noncompliance. However, we find this argument unconvincing. First, standardization is not necessarily a benefit if it reduces the incentive for an auditor to exceed the minimal standards for audit quality. Second, the Proposal often mentions that many firms are already meeting its intended goals. If so, the existing standards must effectively communicate the Board's intentions. The reluctance of some audit firms to rigorously detect noncompliance might stem from cost concerns or a lack of expertise. Nonetheless, whatever the reason, interpretative guidance could serve to clearly outline the Board's expectations. An alternative approach could then involve issuing interpretative guidance coupled with a strategy to assess its effectiveness in meeting the Board's goals after a predefined period. Should it become evident that audit firms are not aligning with these expectations, this could justify reconsidering the amendments.

5. If the Board implements any portion of the NOCLAR proposal, it could do so with staggered compliance dates or exemptive size-based thresholds. The advantage of this approach is twofold. The first benefit is that it allows audit firms and larger issuers to absorb the startup and learning costs of new systems and processes. While the total cost of compliance can be higher for large issuers—given their size and complexity—these issuers can often achieve economies of scale and spread the fixed costs of auditing over a larger base of assets or revenue. Although they require more extensive and complex audits, the incremental cost of auditing additional transactions or business units could be relatively lower compared to the fixed costs, making the average cost per dollar of revenue or assets lower for larger issuers. It is also possible that the learning from these audits could result in savings for smaller issuers.

   A second advantage of this approach is that it creates a quasi-natural experiment, enabling the study of the Proposal's economic effects by comparing issuers slightly above and below the size threshold. Such comparisons can provide causal estimates of the costs and benefits of expanding auditor responsibilities. This method was previously applied to study the size-based exemptions under SOX. We discuss some of these studies in the next section.

4. Estimates of Audit Costs for SOX Were Grossly Underestimated

To further understand the consequences of the Proposal and the real effects of its costs, we believe it is relevant to look at a past example of implementing new auditing standards by the accounting industry that is on par with the magnitude of the changes in the Proposal. Similar to the concerns we outline above, the implementation of SOX posed significant difficulties for smaller issuers and had negative spillover effects on their value and innovation.

We first provide an overview of the SOX, with an emphasis on Section 404, which pertains to assessment of ICFR. We discuss the initial cost estimates for SOX compliance at the time of its enactment and examine studies indicating that these costs were significantly underestimated. Special attention is given to the disproportionate financial burden SOX placed on smaller issuers.

Additionally, we explore the negative spillover effects on issuer value, including instances of companies withdrawing from public markets and engaging in costly measures to avail themselves of regulatory exemptions. For instance, during a recent address to the Small Business Capital Formation Advisory Committee, SEC Commissioner Hester Peirce remarked:

> *The number of listed companies in the United States dropped from around 8,000 in 1996 to roughly 4,200 in mid-2022. During the 1990s, the U.S. saw around 412 IPOs annually, compared to only 248 during the last ten years. I hope that the Committee will help us identify the causes for this decline and suggest productive solutions. Some causes, of course, are outside the Commission's control, but we have a role in others—such as the rising costs of being a public company and the newly adopted special purpose acquisition company (SPAC) rules. External reporting costs for public companies have increased by*

150% since the start of the century, far outstripping inflation of 71%, and could rise more if we move forward with the climate rule.[94]

4.1. Section 404 under SOX

SOX became law on July 30, 2002.[95] It introduced several measures to increase the transparency and accountability of public issuers. One of the key components, Title I, created the PCAOB to supervise the audits of public issuers. Title IV includes several requirements for enhanced financial disclosures, transactions by key issuers personnel and major shareholders, and guidelines for ICFR.

Specifically, Title IV's Section 404 places a strong emphasis on evaluating the effectiveness of an issuer's internal controls. Under Section 404(a), issuers are required to disclose in their annual reports the responsibility of management in establishing and maintaining a solid internal control structure for financial reporting. They must also assess the effectiveness of these controls. Section 404(b) extends this requirement by mandating that the issuer's external auditors independently verify and report on the accuracy of management's assessment of ICFR.

The SEC proposed regulations for implementing Section 404 and other parts of SOX on October 22, 2002, and received over 200 comments in response, with 61 specifically discussing the Section 404 proposals.[96] Some of the feedback pointed out that the SEC's regulations were stricter than the requirements of SOX itself, leading to predictions that audit costs would be higher than expected. Nevertheless, the final rule for Section 404 was issued on June 5, 2003, and became effective on August 14, 2003.[97] Subsequently, on June 17, 2004, the SEC approved the Public Company Accounting Oversight Board's Audit Standard No. 2 (AS2). This standard established the guidelines and procedures that auditors must follow when assessing an issuer's compliance with Section 404(b) of SOX.[98]

4.2. Cost estimates of Section 404

In the final rule, the SEC estimated the annual costs for implementing Section 404(a) at approximately $1.24 billion, or $91,000 per issuer, but did not provide an estimate for the costlier Section 404(b) auditor attestation of ICFR.

In 2009, the SEC published a study examining how the costs associated with complying with Section 404(b) of SOX changed before and after the implementation of the Auditing Standard No.

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[94] *See* SEC Commissioner Hester Peirce, *Angels and IPOs: Remarks before the Small Business Capital Formation Advisory Committee*, February 27, 2024, https://www.sec.gov/news/speech/peirce-remarks-sbcfac-022724, citing data from the World Bank.

[95] *See* Sarbanes-Oxley Act of 2002, July 30, 2002, https://www.govinfo.gov/content/pkg/PLAW-107publ204/html/PLAW-107publ204.htm.

[96] *See* SEC, *Disclosure required by Sections 404, 406, and 407 of the Sarbanes-Oxley Act of 2002*, https://www.sec.gov/rules/proposed/33-8138.htm.

[97] *See* SEC, *Management's report on internal control over financial reporting and certification of disclosure in Exchange Act periodic reports*, https://www.sec.gov/rules/final/33-8238.htm.

[98] *See* PCAOB, *An audit of internal control over financial reporting performed in conjunction with an audit of financial statements*, https://pcaobus.org/oversight/standards/archived-standards/details/Auditing_Standard_2.

5 (AS5) reforms in 2007. The AS5 reforms were introduced to make the audit process more efficient and less costly for issuers, particularly focusing on the assessment of ICFR. These reforms aimed to streamline the audit requirements, emphasize risk assessment, and reduce unnecessary burdens on issuers while maintaining the effectiveness of the audits. The study categorized these costs into four main types: (1) audit, (2) outside vendor, (3) internal labor, and (4) nonlabor.

The table below shows that the initial cost estimates provided by the SEC were significantly lower than the actual figures. Before the AS5 reforms were implemented, the real costs were 4.67 times higher than the SEC's original predictions. Even after the AS5 reforms took effect, the actual costs remained 3.67 times higher than the initial estimates.

	Initial estimate	Updated estimate pre-reform	Difference versus initial estimate	Updated estimate post-reform	Difference versus initial estimate
404(a)	91,000	425,080	+367%	335,768	+269%
404(b)					
Audit		820,864		652,095	
Outside vendor		437,787		311,323	
Internal labor		1,532,521		1,346,855	
Nonlabor		161,563		137,702	
Total		2,865,708		2,329,618	

Several studies have highlighted that the actual costs of compliance with Section 404(b) are higher than initially estimated by the SEC. Ge et al. (2017) identified a 35.7% increase in audit fees directly attributable to Section 404(b) compliance.[99] Furthermore, a survey conducted by Charles River Associates on Fortune 1000 issuers revealed that the average cost for these issuers to meet the ICFR requirements, excluding audit fees, amounted to $5.9 million. Additionally, the incremental audit costs related to Section 404 compliance were found to be another $1.9 million.

Alexander et al. (2013), which included economists from the SEC, conducted an analysis on the impact of Section 404 compliance by surveying nearly 3,000 executives between December 2008 and January 2009.[100] They discovered that most of these executives, particularly those from smaller issuers who faced relatively high initial costs for compliance, believed that the costs associated with compliance were greater than the benefits derived from it. Only about 10.2% of the executives surveyed felt that the benefits of compliance had exceeded its costs in the preceding year. With an average estimated compliance cost of $1.21 million, the study concluded that executives generally perceive that the burden of compliance significantly outweighs its benefits.

[99] *See* Ge, W., Koester, A., & McVay, S. (2017). Benefits and costs of Sarbanes-Oxley Section 404(b) exemption: Evidence from small firms' internal control disclosures. *Journal of Accounting and Economics*, 63(2-3), 358–384.
[100] *See* Alexander, C. R., Bauguess, S. W., Bernile, G., Lee, Y. H. A., & Marietta-Westberg, J. (2013). Economic effects of SOX Section 404 compliance: A corporate insider perspective. *Journal of Accounting and Economics*, 56(2-3), 267–290.

These findings demonstrate the challenges associated with accurately estimating compliance costs and indicate that the SEC significantly underestimated the actual expenses of compliance.

Lewis and White (2023) considered the effect of the 2012 JOBS Act, which aimed to boost small businesses by easing regulatory burdens, especially benefiting biotech and tech startups with limited revenue.[101] It introduced the concept of EGCs, offering them a five-year relief from stringent SOX Section 404(b) compliance, which requires auditor attestation of internal controls. This exemption was crucial for biotech EGCs (bio-EGCs), which, due to long research and development (R&D) cycles, often operate without revenue for extended periods. As discussed above, prior academic research suggests that compliance costs outweigh the benefits for these issuers, as the financial complexities they face are relatively straightforward. The 404(b) exemption allowed bio-EGCs to allocate resources toward innovation rather than compliance. This reallocation provided greater opportunities for R&D efforts and employment growth, aligning with the JOBS Act's goal of facilitating capital formation and job creation in innovative sectors. On April 20, 2020, the SEC made the 404(b) exemption for EGCs permanent, allowing small innovative companies to prioritize scientific progress over burdensome financial reporting requirements.

4.3. Disproportionate costs of Section 404 for smaller issuers

Sections 404(a) and 404(b) of SOX came into force in 2004 for issuers with a public float of at least $75 million. The significant impact of Section 404 on smaller issuers prompted concerns from market participants, which lead to a delay or complete exemption from Section 404 requirements for these issuers. Specifically, the SEC postponed the implementation of Section 404(a) for nonaccelerated filers until 2007.

Studies by academics and government bodies have consistently found that small public issuers face disproportionately high fixed costs, including audit fees and expenses related to hiring additional staff or consulting with external experts to comply with Section 404. The U.S. Government Accountability Office (GAO) highlighted in 2006 that *"for smaller public companies, the cost of compliance has been disproportionately higher (as a percentage of revenues) than for large public companies, particularly with respect to the internal control reporting provisions in section 404 and related audit fees."*[102]

Further research, including a study by the SEC on the compliance costs of 404(b) for smaller issuers,[103] supports these findings. Zhang (2007) employed an event study methodology to examine the economic impact of SOX, discovering that delaying Section 404 compliance by a year resulted in considerable savings for issuers, around 1.26% of their market cap, with small issuers

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[101] *See* Lewis, C. M., & White, J. T. (2023). Deregulating innovation capital: The effects of the JOBS Act on biotech startups. *Review of Corporate Finance Studies*, 12(2), 240–290.
[102] *See* GAO, *Sarbanes-Oxley Act: Consideration of key principles needed in addressing implementation for smaller public companies,* April 2006, https://www.gao.gov/assets/250/249736.pdf.
[103] *See* SEC, *SEC study of the Sarbanes-Oxley Act of 2002 Section 404 internal control over financial reporting requirements,* September 2009, Table 8, http://www.sec.gov/news/studies/2009/sox-404_study.pdf.

benefiting the most.[104] Iliev (2010) also investigated the market reaction to delaying Section 404 compliance, finding that compliance led to a decrease in market value for smaller issuers.[105]

Ettredge et al. (2018) explored the effect of Section 404(b) on audit fees among different categories of filers and observed fee increases across the board. Accelerated filers saw a more significant relative increase in fees (107.8%) compared with those of large accelerated filers (84.6%), underscoring the heavier financial burden on smaller issuers. This rise in fees was attributed to increased demand for audit services without a corresponding increase in supply. Even nonaccelerated filers, who are exempt from Section 404(b), experienced a 42.7% increase in audit fees. The study also found no evidence of improved audit quality, as measured by discretionary accruals and the likelihood of restatements, despite the higher fees. The conclusion was that while audit firms benefit financially from Section 404(b), it does not enhance investor protection, and the brunt of the costs falls disproportionately on smaller issuers.[106]

4.4. Negative spillover effects of SOX

SOX, particularly Section 404(b), has been associated with a range of adverse outcomes for issuers, including diminished innovation, exits from public markets, and strategic behaviors to meet regulatory exemptions. Studies by Gao and Zhang (2018) have revealed that issuers just above the $75 million public float threshold for accelerated filers exhibit lower levels of patents and citations compared with smaller, exempt nonaccelerated filers. This suggests that the compliance costs required by 404(b) deter innovation by imposing disproportionately high expenses on smaller issuers.

Leuz et al. (2008) explored the phenomenon of issuers deregistering from the SEC but continuing to trade in markets not regulated by the SEC, a strategy known as "going dark." This trend, more prevalent among smaller issuers post-SOX, underscores the financial motivations for avoiding the compliance burdens of Section 404, indicating a significant financial strain, particularly on smaller issuers.

Dharmapala (2022) observed a strategic behavior post-SOX where issuers deliberately kept their public float below $75 million to benefit from exemptions from Section 404(b), resulting in significant cost savings. This manipulation led to a decrease in public float, increased reliance on debt financing, and heightened financial constraints; these actions underscore the lengths to which issuers would go to sidestep the burdens of compliance.[107]

The credibility of these findings was initially challenged by SEC commissioner Robert Jackson, who, during a discussion on extending 404(b) exemptions, claimed that a replication of Iliev using one year of data showed no evidence of regulatory avoidance behaviors such as bunching.

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[104] *See* Zhang, I. X. (2007). Economic consequences of the Sarbanes–Oxley Act of 2002. *Journal of Accounting and Economics*, 44(1-2), 74–115.

[105] *See* Iliev, P. (2010). The effect of SOX Section 404: Costs, earnings quality, and stock prices. *Journal of Finance*, 65(3), 1163–1196.

[106] *See* Ettredge, M., Sherwood, M. G., & Sun, L. (2018). Effects of SOX 404 (b) implementation on audit fees by SEC filer size category. *Journal of Accounting and Public Policy*, 37(1), 21–38.

[107] *See* Dharmapala, D. (2022). Estimating firms' responses to securities regulation using a bunching approach. *American Law and Economics Review*, 24(2), 449–494

However, this claim was later refuted by the research of Ewens et al. (2024), which, through a comprehensive 14-year analysis, demonstrated that issuers indeed cluster just below the SOX compliance thresholds. Their study, employing sophisticated econometric techniques, showed that issuers adjust their financial strategies, notably increasing debt over equity, to remain below these thresholds without changing their operational or ownership structures.[108]

These findings collectively suggest that the compliance costs associated with SOX, especially for smaller issuers, outweigh any potential benefits such as reduced capital costs. The persistence of strategic behaviors to avoid compliance highlights the need for a careful reevaluation of the regulations to balance the goals of investor protection with the economic and innovative vitality of public issuers.

4.5. Actions to remediate burdens of 404(b)

To mitigate the costs of Section 404(b) compliance, the SEC provided Section 404 compliance guidance in June 2007 and endorsed the PCAOB's Audit Standard 5 (AS5), which eased the auditor attestation requirements established by AS2 in 2004. The PCAOB acknowledged that issuers had incurred unexpectedly high costs from 404(b) and sometimes excessive effort from auditors: *"Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting."* [109]

Despite efforts to attenuate the compliance burdens of Section 404(b) on small issuers, government agencies, such as the U.S. Department of Treasury and GAO, readily admit that Section 404(b) continues to generate disproportionate costs on smaller, low-revenue issuers.[110]

Ge et al. (2017) analyzed shareholder gains from the permanent Section 404(b) exemption for nonaccelerated filers. Their findings indicate that nonexempt issuers incur 35.7% higher audit fees than exempt nonaccelerated filers. These findings suggest substantial cost differences.[111]

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[108] *See* Ewens, M., Xiao, K., & Xu, T. (2024). Regulatory costs of being public: Evidence from bunching estimation. *Journal of Financial Economics*, 153, 103775.
[109] *See* PCAOB, *Auditing Standard No. 5: An audit of internal control over financial reporting that is integrated with an audit of financial statements*, June 12, 2007, https://pcaobus.org/Standards/Auditing/pages/auditing_standard_5.aspx.
[110] *See* U.S. Department of the Treasury, *A financial system that creates economic opportunities: Capital markets*. October 2017, https://home.treasury.gov/system/files/136/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf; and U.S. Government Accountability Office, *Internal controls: SEC should consider requiring companies to disclose whether they obtained an auditor attestation,* July 2013. https://www.gao.gov/assets/660/655710.pdf.
[111] *See* Ge, W., Koester, A., & McVay, S. (2017). Benefits and costs of Sarbanes-Oxley Section 404(b) exemption: Evidence from small firms' internal control disclosures. *Journal of Accounting and Economics*, 63(2–3), 358–384.

Appendix A. Studies Cited in Proposal

Topic number	Citation topic in proposal	Study number	Study	Location (footnote, or FN)	Proposal section
1	Investor Harm from Noncompliance	1	Dyck, A., Morse, A., & Zingales, L. (2010). Who blows the whistle on corporate fraud? *Journal of Finance*, 65(6), 2213–2253.	FN 3, FN 130, FN 137	I.A. IV.A.
1	Investor Harm from Noncompliance	2	Dyck, A., Morse, A., & Zingales, L. (2023). How pervasive is corporate fraud? *Review of Accounting Studies*, 1–34.	FN 117, FN 138	IV.A
1	Investor Harm from Noncompliance	3	Karpoff, J. M. (2012). Does reputation work to discipline corporate misconduct? In M. L. Barnett and T. G. Pollock (Eds.), *The Oxford Handbook of Corporate Reputation* (pp.). Oxford University Press.	FN 119, FN 124	IV.A.
1	Investor Harm from Noncompliance	4	Karpoff, J. M., Lee, D. S., & Martin, G. S. (2008). The cost to firms of cooking the books. *Journal of Financial and Quantitative Analysis*, 43(3), 581–611.	FN 125	IV.A.
1	Investor Harm from Noncompliance	5	Karpoff, J. M., Lee, D. S., & Martin, G. S. (2017). Foreign bribery: Incentives and enforcement. Unpublished working paper.	FN 125	IV.A.
1	Investor Harm from Noncompliance	6	Armour, J., Mayer, C., & Polo, A. (2017). Regulatory sanctions and reputational damage in financial markets. *Journal of Financial and Quantitative Analysis*, 52(4), 1429–1448.	FN 126	IV.A.
1	Investor Harm from Noncompliance	7	Amiram, D., Bozanic, Z., Cox, J. D., Dupont, Q., Karpoff, J. M., & Sloan, R. (2018). Financial reporting fraud and other forms of misconduct: a multidisciplinary review of the literature. *Review of Accounting Studies*, 23, 732–783.	FN 127	IV.A.
1	Investor Harm from Noncompliance	8	Karpoff, J. M., Lott, J. R., & Wehrly, E. W. (2005). The reputational penalties for environmental violations: Empirical evidence. *Journal of Law and Economics*, 48(2), 653–675.	FN 128	IV.A.
1	Investor Harm from Noncompliance	9	Brady, J., Evans, M. F., & Wehrly, E. W. (2019). Reputational penalties for environmental violations: A pure and scientific replication study. *International Review of Law and Economics*, 57, 60–72.	FN 128	IV.A.
2	Auditor Incentives	10	Asare, S. K., Wright, A., & Zimbelman, M. F. (2015). Challenges facing auditors in detecting financial statement fraud: Insights from fraud investigations. *Journal of Forensic and Investigative Accounting*, 7(2), 63–111.	FN 129	IV.A.
2	Auditor Incentives	11	Hobson, J. L., Mayew, W. J., Peecher, M. E., & Venkatachalam, M. (2017). Improving experienced auditors' detection of deception in CEO narratives. *Journal of Accounting Research*, 55(5), 1137–1166.	FN 131, FN 134	IV.A.

2	Auditor Incentives	12	Nelson, M. W. (2009). A model and literature review of professional skepticism in auditing. *Auditing: A Journal of Practice Theory*, 28(2), 1–34.	FN 132	IV.A.
2	Auditor Incentives	13	Bennett, G. B., & Hatfield, R. C. (2013). The effect of the social mismatch between staff auditors and client management on the collection of audit evidence. *The Accounting Review*, 88(1), 31–50.	FN 132	IV.A.
2	Auditor Incentives	14	Brazel, J. F., Jackson, S. B., Schaefer, T. J., & Stewart, B. W. (2016). The outcome effect and professional skepticism. *The Accounting Review*, 91(6), 1577–1599.	FN 133	IV.A.
2	Auditor Incentives	15	Peecher, M. E., Solomon, I., & Trotman, K. T. (2013). An accountability framework for financial statement auditors and related research questions. *Accounting, Organizations and Society*, 38(8), 596–620.	FN 134	IV.A.
2	Auditor Incentives	16	Honigsberg, C., Rajgopal, S., & Srinivasan, S. (2020). The changing landscape of auditors' liability. *Journal of Law and Economics*, 63(2), 367–410.	FN 135	IV.A.
2	Auditor Incentives	17	Weber, J., Willenborg, M., & Zhang, J. (2008). Does auditor reputation matter? The case of KPMG Germany and ComROAD AG. *Journal of Accounting Research*, 46(4), 941–972.	FN 136	IV.A.
2	Auditor Incentives	18	Skinner, D. J., & Srinivasan, S. (2012). Audit quality and auditor reputation: Evidence from Japan. *The Accounting Review*, 87(5), 1737–1765.	FN 136	IV.A.
2	Auditor Incentives	19	Frendy, & Hu, D. (2014). Japanese stock market reaction to announcements of news affecting auditors' reputation: The case of the Olympus fraud. *Journal of Contemporary Accounting Economics*, 10(3), 206–224.	FN 136	IV.A.
2	Auditor Incentives	20	Causholli, M., & Knechel, W. R. (2012). An examination of the credence attributes of an audit. *Accounting Horizons*, 26(4), 631–656.	FN 139	IV.B.
2	Auditor Incentives	21	Ronen, J. (2010). Corporate audits and how to fix them. *Journal of Economic Perspectives*, 24(2), 189–210.	FN 141	IV.B.
3	Audit Committee	22	Bruynseels, L., & Cardinaels, E. (2014). The audit committee: Management watchdog or personal friend of the CEO? *The Accounting Review*, 89(1), 113–145.	FN 142	IV.B.
3	Audit Committee	23	Cassell, C. A., Myers, L. A., Schmardebeck, R., & Zhou, J. (2018). The monitoring effectiveness of co-opted audit committees. *Contemporary Accounting Research*, 35(4), 1732–1765.	FN 142	IV.B.
3	Audit Committee	24	Berglund, N. R., Draeger, M., & Sterin, M. (2022). Management's undue influence over audit committee members: Evidence from auditor reporting	FN 142	IV.B.

			and opinion shopping. *Auditing: A Journal of Practice & Theory*, 41(1), 49–74.		
4	Audit Quality	25	Chen, H., Chen, J. Z., Lobo, G. J., & Wang, Y. (2011). Effects of audit quality on earnings management and cost of equity capital: Evidence from China. *Contemporary Accounting Research*, 28(3), 892–925.	FN 145	IV.C.
4	Audit Quality	26	Lambert, R., Leuz, C., & Verrecchia, R. E. (2007). Accounting information, disclosure, and the cost of capital. *Journal of Accounting Research*, 45(2), 385–420.	FN 145	IV.C.
4	Audit Quality	27	Scott, W. R., & O'Brien, P. C. (2003). *Financial Accounting Theory* (Vol. 3). Prentice Hall.	FN 145	IV.C.
4	Audit Quality	28	DeFond, M., & Zhang, J. (2014). A review of archival auditing research. *Journal of Accounting and Economics*, 58(2–3), 275–326.	FN 147	IV.C.
5	Issuer Disclosure	29	Dennis, S. A., & Sharpe, I. G. (2005). Firm size dependence in the determinants of bank term loan maturity. *Journal of Business Finance & Accounting*, 32(1–2), 31–64.	FN 157	IV.D.
5	Issuer Disclosure	30	Brennan, M. J., & Subrahmanyam, A. (1995). Investment analysis and price formation in securities markets. *Journal of Financial Economics*, 38(3), 361–381.	FN 157	IV.D.
5	Issuer Disclosure	31	Aboody, D., & Lev, B. (2000). Information asymmetry, R&D, and insider gains. *Journal of Finance*, 55(6), 2747–2766.	FN 157	IV.D.
5	Issuer Disclosure	32	Chiang, R., & Venkatesh, P. C. (1988). Insider holdings and perceptions of information asymmetry: A note. *Journal of Finance*, 43(4), 1041–1048.	FN 157	IV.D.
5	Issuer Disclosure	33	Mercer, M. (2004). How do investors assess the credibility of management disclosures? *Accounting Horizons*, 18(3), 185–196.	FN 157	IV.D.
6	Information Asymmetry	34	Easley, D., & O'Hara, M. (2004). Information and the cost of capital. *Journal of Finance*, 59(4), 1553–1583.	FN 158	IV.D.

Appendix B. Referenced Studies Not Cited in Proposal

Topic number	Topic in comment letter	Study number	Omitted study	Letter section
1	Quantification	1	Greenstone, M. (2009). Toward a culture of persistent regulatory experimentation and evaluation. In D. Moss & J. Cisternino (Eds.), *New Perspectives on Regulation*. The Tobin Project.	2.3
2	Economic Baseline	2	White, J. T. (2015). The evolving role of economic analysis in SEC rulemaking. *Georgia Law Review*, 50, 293–325	3.1
2	Economic Baseline	3	Audit Analytics. (2022). *Twenty-year review of audit & non-audit fee trends*. https://www.auditanalytics.com/doc/Twenty-Year_Review_of_Audit_and_Non-Audit_Fee_Trends.pdf	3.1
3	Specialist Costs	4	Boritz, J. E., Kochetova, N. V., Robinson, L. A., & Wong, C. (2020). Auditors' and specialists' views about the use of specialists during an audit. *Behavioral Research in Accounting* 32(2), 15–40.	3.3
3	Specialist Costs	5	Hux, C. T. (2017). Use of specialists on audit engagements: A research synthesis and directions for future research. *Journal of Accounting Literature* 39, 23–51.	3.3
3	Specialist Costs	6	Zimmerman, A. A. B., Barr-Pulliam, D., Lee, J. S., & Minutti-Meza, M. (2023). Auditors' use of in-house specialists. *Journal of Accounting Research*, 61(4), 1363–1418.	3.3
4	Audit Committees	7	Simon, H. (1971). Designing organizations for an information-rich world. In M. Greenberger (Ed.), *Computers, Communication, and the Public Interest* (pp. 37–52). Johns Hopkins University Press.	3.3
4	Audit Committees	8	Paredes, T. A. (2003). Blinded by the light: Information overload and its consequences for securities regulation. *Washington University Law Review Quarterly*, 81(2), 417–486	3.3
4	Audit Committees	9	Cunningham, L. M., Stein, S. E., Walker, K., & Wolfe, K. (2023). Insights into the evolving responsibilities of the audit committee. Working paper.	3.3
5	Proprietary Disclosure	10	Verrecchia, R. E. (1983). Discretionary disclosure. *Journal of Accounting and Economics*, 5, 179–194.	3.5
5	Auditor Workload	11	Sundgren, S., & Svanström, T. (2014). Auditor-in-charge characteristics and going-concern reporting. *Contemporary Accounting Research*, 31(2), 531–550.	3.5
5	Auditor Workload	12	Lai, K. M., Sasmita, A., Gul, F. A., Foo, Y. B., & Hutchinson, M. (2018). Busy auditors, ethical behavior, and discretionary accruals quality in Malaysia. *Journal of Business Ethics*, 150, 1187–1198.	3.5
6	SOX	13	Ge, W., Koester, A., & McVay, S. (2017). Benefits and costs of Sarbanes-Oxley Section 404(b) exemption: Evidence	4.2 4.5

			from small firms' internal control disclosures. *Journal of Accounting and Economics*, 63(2–3), 358–384.	
6	SOX	14	Alexander, C. R., Bauguess, S. W., Bernile, G., Lee, Y. H. A., & Marietta-Westberg, J. (2013). Economic effects of SOX Section 404 compliance: A corporate insider perspective. *Journal of Accounting and Economics*, 56(2–3), 267–290.	4.2
6	SOX	15	Lewis, C. M., & White, J. T. (2023). Deregulating innovation capital: The effects of the JOBS Act on biotech startups. *Review of Corporate Finance Studies*, 12(2), 240–290.	3.3 4.2
6	SOX	16	Zhang, I. X. (2007). Economic consequences of the Sarbanes–Oxley Act of 2002. *Journal of Accounting and Economics*, 44(1–2), 74–115.	4.4
6	SOX	17	Iliev, P. (2010). The effect of SOX Section 404: Costs, earnings quality, and stock prices. *Journal of Finance*, 65(3), 1163–1196.	4.4
6	SOX	18	Ewens, M., Xiao, K, & Ting, X. (2024). Regulatory costs of being public: Evidence from bunching estimation. *Journal of Financial Economics,* 153: 103775.	4.4
6	SOX	19	Dharmapala, D. (2022). Estimating firms' responses to securities regulation using a bunching approach. *American Law and Economics Review*, 24(2), 449–494.	4.4
6	SOX	20	Ettredge, M., Sherwood, M. G., & Sun, L. (2018). Effects of SOX 404 (b) implementation on audit fees by SEC filer size category. *Journal of Accounting and Public Policy*, 37(1), 21–38.	4.4

Appendix C. Referenced Comment Letters

This appendix lists the comment letters referenced in this document. For a list of all comment letters, *see* PCAOB Docket 51, https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-051/comment-letters. The Center for Audit Quality (CAQ) provides an analysis of 139 NOCLAR-related comment letters received by the PCAOB during 2023. *See* CAQ, CAQ Analysis of PCAOB Proposed Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations (NOCLAR) and Other Related Amendments, November 2023, https://thecaqprod.wpenginepowered.com/wp-content/uploads/2023/11/caq_comment-letter-analysis-noclar_2023-11.pdf.

PCAOB letter number	Date	Commentator
19	August 1, 2023	Dow
21	August 2, 2023	American Accounting Association
22	August 2, 2023	U.S. Chamber of Commerce
35	August 4, 2023	Packaging Corp of America
37	August 1, 2023	Microchip
40	August 4, 2023	Mayville Engineering Company
43	August 4, 2023	Williams Companies
45	August 4, 2023	Marathon Oil
46	August 7, 2023	American Council of Life Insurers
49	August 6, 2023	Sridhar Ramamoorti
53	August 7, 2023	Plante & Moran
55	August 7, 2023	Cigna Group
56	August 7, 2023	Deloitte & Touche
58	August 7, 2023	Financial Executives International
59	August 5, 2023	Plains All American Pipeline
61	August 7, 2023	Tyler Technologies
64	August 7, 2023	Grant Thornton
65	August 4, 2023	Victor Jarosiewicz
67	August 7, 2023	Illinois CPA Society
68	August 7, 2023	ICAEW

70	August 7, 2023	NuScale Power
75	August 4, 2023	Illumina
76	August 7, 2023	PricewaterhouseCoopers
77	August 7, 2023	RSM
81	August 7, 2023	National Venture Capital Association
84	August 7, 2023	BDO
86	August 7, 2023	Ernst & Young
87	August 7, 2023	Forvis
88	August 7, 2023	Novanta
91	August 7, 2023	Center for Audit Quality
92	August 7, 2023	KPMG
104	August 7, 2023	Mazars
109	August 7, 2023	Committee on Capital Markets Regulation
113	August 7, 2023	Energy Infrastructure Council
116	August 7, 2023	Robert A. Conway
118	August 7, 2023	MNP
122	August 7, 2023	Society for Corporate Governance
126	August 7, 2023	Nasdaq
134	August 23, 2023	American Bar Association