

Stanford Law School

Potential Costs & Benefits of NOCLAR

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Agenda

- It is difficult, if not impossible, to reliably quantify the set of potential costs and benefits associated with NOCLAR.
- Therefore, I focus on the theoretical set of potential costs and benefits.
 - To identify the set of costs and benefits, I reviewed the 140 comment letters filed as of February 20th, 2024 in addition to academic literature.
 - There is significant relevant academic work on the consequences of misconduct, SOX 404(b), and corporate litigation.
- I conclude with figures that can help us to anchor the costs and benefits.

Potential Costs of NOCLAR, Part I

Direct & Indirect Costs

- Increased internal and external labor costs (audit, legal, compliance, IT, etc.)
- Greater liability exposure, particularly for audit firms, resulting in higher insurance premiums and more litigation
- Higher software costs to expand existing compliance systems

Potential Costs of NOCLAR, Part II

Unintended Consequences (hypothesized in comment letters)

- Greater demand for those with specialized expertise, making it difficult (and expensive) to recruit and retain qualified personnel
- Reduction in audit quality
- Risk of violating PCAOB and SEC auditor independence rules
- Increased time to perform an audit
- Reduction in number of public companies
- Increased risk of market concentration for audit firms
- Weakened attorney client privilege protections
- Increased information overload
- Real effects on business operations (e.g., inability to justify continued operations in certain areas)
- Greater tension between auditor and management
- Increased “stickiness” between audit firm and issuer

Potential Benefits of NOCLAR

- Reduction in the frequency of detected and undetected corporate misconduct
- Reduction in information asymmetries
- Improved compliance environment within the firm, allowing for improved decision-making and more efficient capital allocation
- Improved audit quality
- Better alignment of investor expectations and auditor behavior

Consequences of Misconduct

- Stock prices decline significantly when markets learn of corporate misconduct. Depending on the severity of the infraction, estimates range from declines of over 25% to just under 5% (e.g., Dechow et al. 1996; Beneish 1999; Palmrose et al. 2004; Burns & Kedia 2006; Karpoff et al. 2008; Gande & Lewis 2009).
- Misconduct increases the cost of capital (Hribar & Jenkins 2004; Graham et al. 2008; Chava et al. 2010, 2018; Kravet & Shevlin 2010; Yuan & Zhang 2015).
- Victims of financial misconduct experience a series of psychological and financial harms and are less willing to participate in capital markets going forward (Button et al. 2014; Giannetti & Wang 2016; DeLiema et al. 2020).
- Employees at firms that commit fraud suffer significant wage declines and high rates of separation (Choi & Gipper 2023). The effects are most pronounced for workers in the bottom of the wage distribution.
- Misconduct impedes efficient capital allocation (Kedia & Philippon, 2009).

Anchoring the Costs of NOCLAR

Commentators suggested the costs would be comparable to SOX 404(b), but it's not obvious to me that this is the proper benchmark.

Further, there is wide variation in the estimated cost of SOX 404(b), perhaps because direct costs have declined over time.

- “Between FY 2003 and FY 2004, total audit fees increased by nearly 59%”. *Comment Letter, Members of the Audit Committee Council, citing Audit Analytics Report, (July 2023), 20-Year Review of Audit Fee Trends (2002-2022).*
- “Direct costs have also been steadily falling over time for all firms. ... By the second year ... surveys estimated total direct costs had fallen by between 15 percent and 40 percent ... Subsequent surveys show further drops of about 25 percent following [2007] ... with the result that by 2012, firms with less than \$10 billion of market capitalization were paying an average of \$350,000”. *Coates & Srinivasan 2014.*
- The “mean (median) total cost of compliance is \$1.21 (\$0.45) million” for 2007/2008. *Alexander et al. 2013.*
- An “issuer no longer subject to the ICFR ... requirement would save approximately \$210,000 per year comprised of approximately \$110,000 per year reduction in audit fees and an additional reduction in non-audit costs of approximately \$100,000”. *SEC 2020.*

Anchoring the Costs of NOCLAR

Assuming 7,279 companies, as reported in Audit Analytics (July 2023)*, estimates of audit costs and non-audit costs using the prior estimates for SOX 404(b) are below:

| | Mean Increase Per Firm | Total Audit Fees | Mean Audit + Non-Audit Fees Per Firm | Total Audit + Non- Audit Fees |
|---|---------------------------|---------------------|--|----------------------------------|
| SEC, 2020 | \$110,000 | \$800.7M | \$210,000 | \$1.53B |
| Alexander et al., (2013) | \$443,000 | \$3.22B | \$1.2M | \$8.73B |
| Members of the Audit Committee Council (59% increase in audit fees) | \$1.32M* | \$9.6B | | |

* This figure is based on the number of public companies that disclose audit fees.

** Assumes a 59% increase from mean audit fees of \$2.24M in 2022 (Audit Analytics, July 2023).

Anchoring the Benefits of NOCLAR

The extent to which NOCLAR would reduce misconduct is unknown, but the costs of corporate misconduct are substantial.

- From 2000 to 2023, *Good Jobs First* shows that public companies paid \$830 billion in penalties.
- The effect on market capitalization is even more pronounced; the decline in market capitalization is typically greater than the legal penalty itself (*Karpoff, 2013*).
- On average, firm stock prices decline when lawsuits are filed (see *Billings et al. 2024*, examining over 200,000 lawsuits filed in federal court).
- As noted earlier, estimates for the decline in market capitalization upon restatements and other indicators of financial irregularities range from just under 5% to over 25%.

Anchoring the Benefits of NOCLAR

Attempting to value the decline in total market capitalization resulting from restatements and litigation leads to a substantial number.

The decline in market capitalization is due to several factors (e.g., change in expected cash flow/discount rate, loss of reputation, etc.). I cannot reliably estimate the portion of the decline that we might consider a correction as opposed to that caused by the misconduct.

Restatements

- In 2022, there were 454 restatements (Audit Analytics, Nov. 2023)
- To estimate the decline in market capitalization associated with these restatements:
 - Assume a 5% abnormal decline in market capitalization (lower range of estimates) and mean market capitalization of \$6.8B (mean of firms listed in Compustat).
 - Multiplying $454 \times 5\% \times \$6.8B$ suggests a decline of over \$156B.

Litigation

- From 2006-2021, Billings et al., 2024 find an annual average of 13,932 lawsuits brought in federal court against public companies with abnormal returns of -0.001 to -0.015 upon filing.
 - Assume a 0.1% abnormal decline in market capitalization (lower range of estimates) and mean market capitalization of \$6.8B.
 - Multiplying $13,932 \times 0.1\% \times \$6.8B$ suggests a decline of over \$95.8B.

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