

March 8, 2024

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: 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)

Dear Ms. Brown:

On March 6, 2024, I participated in the two first two panels in the PCAOB's Roundtable on its proposed revisions to standard relating to Noncompliance with Laws and Regulations or "NOCLAR." My comments on aspects of the proposed revisions discussed on those panels are reflected in the record of that roundtable.

Let me thank Tom Quaadman for inspiring me to write. His comments at the roundtable, which drew on a comment letter from the U.S. Chamber of Commerce (Aug. 2, 2023), were more than adequately countered by comments from top researchers from Stanford and the University of Chicago, among others, but his testimony made me think it might be useful to add more to the file on the economics of the proposal.

Mr. Quaadman reports the Chamber believes the NOCLAR proposed revisions would cause audit firms to increase audit fees by at least \$36.4 billion. It achieves this estimate by simply multiplying current fees by three. It derives its multiple of three by comparing NOCLAR to Section 404 of the Sarbanes-Oxley Act and claiming that audit "[f]ees more than doubled from 2002 to 2004 with the implementation of SOX Section 404." That claim is based on annual numbers in a report from Audit Analytics.¹ The Chamber seems to believe no one would benefit from improving legal compliance, as its letter and Mr. Quaadman's testimony did not mention any benefits, apparently believing that the cost of capital (which the Chamber's members pay whenever they raise capital) is unaffected by fraud and other forms of lawbreaking.

The Chamber's cost estimates are based on objectively mistaken inputs.

First, any simple comparison of audit fees in 2002 to 2004 reflects not only SOX 404 but other forces:

- market expectations of improved and more reliable financial reporting by public companies,
- increased attention to controls and auditing by shareholders, analysts and public companies, and
- increased potential liability for auditors owing to the wave of accounting and auditing scandals that created the need for SOX.

Changes from 2002 to 2003 could not have been the result of SOX 404, which was only required for reports filed after November 2004, and audit fees were rising prior to SOX's adoption in mid-2002, stimulated by Enron, Worldcom and the long list of other companies making major financial restatements prior to 2002. Any before-and-after analysis of anything has to get the relevant dates right, has to be objective about the baseline, and has to take account of pre-event trends. More serious surveys and analyses by the SEC and

¹ Twenty-Year Review of Audit & Non-Audit Fee Trends by Audit Analytics (Oct. 2022) at 6.

others found SOX 404 costs that declined over time, and were on average closer to 10% than to 100%.² The Chamber presents no reason to take its estimate of the effects of SOX 404 seriously.

Second, any fair estimate of the permanent actual effect of SOX 404 on audit fees also has to take into account the PCAOB's own updating of AS2 in AS5 in 2007. As the Board well knows, and the Chamber and well-informed corporate manager should know, AS5 expressly permitted:

- top-down risk-based approaches that permit audit firms to focus on key control risks under 404;
- use of “scaled” approaches to take account of firm or internal control system component size;
- reliance on the work of others in the attestation process, so that less expensive employees or third party vendors can directly perform some of the work required; and
- replacement of time-consuming and elaborate “walk-throughs” with other methods of testing internal control systems.

Any fair long-term assessment of SOX 404 needs to reflect these changes. Audit and audit-related fees fell after AS5. Any fair estimate of the permanent compliance cost impact has to reflect learning over time by audit firms and issuers, and adaptation by the PCAOB. The Chamber's estimate does not do so.

Third, and most fundamentally, the Chamber presents no reason to think the changes required by the proposed NOCLAR revisions are even roughly analogous to changes required by SOX 404. Internal controls are essential to production of reliable financial statements, and all companies rely on financial controls. Nothing in the NOCLAR proposal suggests it would require the same degree of involvement of audit firms in the design, implementation or even assessment of compliance programs as what is appropriately desirable under SOX 404 for control systems. In short, the Chamber's analogy is off. One cannot predict goals to be scored even by the great Lionel Messi by tripling the average Boston Celtics score for the season.

Beyond these fairly basic points about compliance costs, I bring to your attention two published papers relevant to the overall economic analysis for any change in standards that could reduce fraud.

- The first, a peer-reviewed article that is among the most frequently cited survey of research on SOX, co-authored by Harvard Business School's Suraj Srinivasan and myself, covers both the above points about compliance costs in more detail, and also reviews research relevant to the costs of fraud, the benefits of fraud reduction, and the challenges in developing economic estimates of changes in regulation designed to accomplish fraud reduction. The article can be found here: <http://nrs.harvard.edu/urn-3:HUL.InstRepos:12175242>
- The second, published in the Yale Law Journal, consists of six case studies of economic analyses of major financial regulations, including SOX 404. It reviews available research bearing on the kinds of questions an attempted quantified cost-benefit analysis of those rules would entail. In the article, from pages 927 to 947, I lay out in detail the theoretical components of an analysis of that kind, and present calibrated ranges of estimates for both the costs and benefits of SOX 404. While I believe (as stated above) that SOX 404 is not a good analogy for the proposed NOCLAR revisions, many of the inputs to an economic analysis of the two overlap, such as the costs and incidence of corporate fraud. The article can be found here: <https://www.yalelawjournal.org/collection/cost-benefit-analysis-of-financial-regulation>.

² E.g., Alexander, C. R., S. W. Bauguess, G. Bernile, Y. A. Lee, and J. Marietta-Westberg, Economic effects of SOX Section 404 compliance: A corporate insider perspective, 56 J. Acct'g and Econ. 267–290 (2013); see also Securities and Exchange Commission, Study and Recommendations on Sections 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between \$75 and \$250 Million (2009).

The bottom line of the two publications is straightforward. It is not feasible to develop precise, reliable, quantified estimates of the costs and benefits of major financial regulations, particularly those that are designed to reduce fraud. Most of the major inputs to such analyses remain insufficiently studied and subject to substantial discretionary assumptions. The demand by the Chamber and others for such estimates before rules can be changed in any way is a not-so-disguised attempt to stall changes in regulation altogether.

This of course does not mean that informed and reasoned judgments cannot be reached about the value of regulatory changes, such as the proposed NOCLAR revisions. Nor does it mean that no rules designed to reduce fraud should be adopted. The Board's own reasoned judgment – based on qualitative assessments from a range of constituents, precisely as the Board is receiving through the public comment process – is both sufficient and necessary to decide what the likely economic effects of changes will be, and the uncertainties involved are simply a reason for the Board to continue to monitor the effects of any change after it is adopted, and adapt as it learns, just as it did with SOX 404.

Very truly yours,

John C. Coates

For identification only: John F. Cogan Professor of Law and Economics, Harvard Law School