Re: Comments on Docket 051: Amendments to PCAOB Auditing Standards related to a Company’s Noncompliance with Laws and Regulation


From July 2019 until recently, I was employed as a financial economist by PCAOB in its group for economic analysis of standard setting. I focus my main comments on the “economic analysis” section of the proposed rule, perhaps because having worked on them at PCAOB in the past I understand them better than almost anyone else I could envision offering public comments on the proposed rule. I also offer comments as an American investor and member of the public. I present these as a number of simple questions, easy for PCAOB’s Board and for investors and the public to understand.

Main comments about section IV. economic analysis

The proposal includes a section titled “IV. ECONOMIC ANALYSIS” spanning pages 60 to 91, not including additional comments concerning Emerging Growth Companies from page 91 to 94. On page 72, the analysis states: “Overall, we expect that the benefits of the proposed amendments would justify the costs.”

1. Where is the empirical research to estimate the costs or benefits of the proposed rule, or the effects of the proposed rule on auditors and ultimately on investors? The academic research literature is overwhelmingly empirical.
   a. The analysis cites articles such as Hobson, Mayew, Pecher, and Venkatachalam, “Improving Experienced Auditors’ Detection of Deception in CEO Narratives,” Journal of Accounting Research (2017), which “experimentally study [emphasis added] the deception detection capabilities of experienced auditors” in order to analyze a proposed effect.
   b. Where is the experimental research work applying the lessons of these prior studies to the specific proposed rule? How can the Office of Economic Research [emphasis added deliberately] and Analysis (“OERA”) conclude anything related to effects, never mind costs or benefits, related to the proposed rule with any reasonable degree of confidence without having conducted such research? The section acknowledges that such research has not previously been conducted ... which would suggest that it needs to be done.
2. What does the economic analysis actually find concerning the effect, the costs or the benefits of the proposed rule, as opposed to what it suggests may (and therefore also may not) be realized?

This “analysis” leaves everything to the reader’s imagination, and provides no evidence of actual research efforts to determine any facts related to those three essential elements (effect, costs, benefits) of the economics (i.e., by “the economics” I mean the value or utility) of the proposed rule with any degree of certainty. Instead, it confounds incentives and obligations. The following examples illustrate these concerns:

a. (pg. 64) “The staff’s review of the literature reveals that noncompliance with laws and regulations by companies may result in substantial financial damage to investors through lower share prices. In addition to sanctions and fines, civil settlements, and legal costs, share prices may also be affected by reputational consequences for the companies.” (pg. 69) “The staff’s research suggests that auditors may not have sufficient incentives to identify, evaluate, and communicate a company's noncompliance with laws and regulations, even though the harm to investors arising from such noncompliance may be significant.…. ” Beyond reviewing the literature, what actual research did the staff perform to estimate the effect, cost or benefits of the proposed rule, particularly as the cited literature hasn’t provided such estimates? What data, what evidence, did the staff collect for those analyses? What efforts did it undertake to gather such data and evidence? What preliminary, exploratory steps did the staff undertake to determine the feasibility, cost and time of such research efforts? How can a bunch of “may’s” support “we expect that the benefits of the proposed amendments would justify the costs”?

b. When discussing how the proposed amendments would “i. Strengthen Auditor Incentives”, pages 70-71 instead focus on increasing responsibilities: “… the proposed amendments significantly strengthen the auditor’s regulatory accountabilities and enhance auditor incentives by imposing requirements to identify through risk assessment and other procedures noncompliance,” and “… proposed AS 2405 would enhance incentives to consider noncompliance by requiring the auditor to use information from other audit procedures.” Clearly, this equates placing additional responsibilities and obligations on auditors as somehow strengthening the incentives of auditors. Added obligations are not incentives. In trying to make sense of this, one hypothetical alternative explanation is of a perverse view of the “carrot and the stick”: The “carrot” (incentive) for audit firms becomes avoiding “the stick” of punishment by PCAOB for not complying with these new requirements. Even so, how do these requirements provide benefits to investors—that question leads to the next section.

Additional comments, questions and observations overall

Aside from concerns over the economic analysis and the PCAOB Board’s reliance on it to propose the rule, I have some other remarks as an investor and member of the public.

1. The ultimate question is: how does this proposed change in the rules improve the situation for investors, and is it worth the change – considered on its own, and considered in light of all existing or currently contemplated other rules and rule changes, and in light of other (particularly, non-regulatory) options that may offer better trade-offs for investors?
2. As an investor, how much do I expect—from the CPAs\(^1\) who audit the financial statements of public companies in which I invest—as far as disclosing, never mind preventing, criminal activity in those public companies?

a. If those CPAs suddenly added a paragraph to their brief one-page audit report, or a footnote disclosure to the audited financials (which are issued only once a year, never mind if criminal activity happened or was detected at the beginning of the fiscal year), how much would that affect my investment decisions?

b. Wouldn’t I first ask “ Haven’t the relevant law enforcement authorities already been informed and acted according to law? How much does the newly disclosed (but possibly months-old) criminal activity affect the company and my investment now?” But, if the impact is material—meaning it reasonably would change my investment decision—wouldn’t that already be a disclosure?

c. By the time I get to see audited financial statements in the 10-K, hasn’t the company already had to put out a press release and issued an 8-K concerning the criminal/noncompliance developments? What new information am I going to obtain and have to process in addition to the already growing disclosures in 10-K filings?

3. Am I going to make better decisions, or just suffer from more information overload?

a. Presuming that public company managers, now aware that CPAs will pay closer attention to hints of criminal activity, react by diverting part of their attention and corporate resources to better monitoring such activity themselves, do I want that as an investor, or would I instead want a stronger law enforcement intervention so that managers remain focused?

b. What happens when auditors discover something where law enforcement needs time to investigate and the CPAs are forced to keep it undisclosed past year-end, even though the stock price is affected when disclosed later? At whom do I get upset? Do I have a claim, either against the company or the auditors? Hasn’t this dilemma already been addressed with CPA compliance with law enforcement investigations, just more narrowly applied? Is this just one more reason for me to be unhappy with auditors, either that they missed another thing in their audit activities (and criminal activity would be a broad thing for them to monitor, given overlapping and sometimes conflicting criminal laws, such as state vs. Federal) or that they’re the whistleblowers on something that could have been and likely should have been left to law enforcement?

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\(^1\) I use the term CPAs and auditors interchangeably, not to imply that all CPAs are auditors or vice versa, but to emphasize that auditors tend to have what might be said to be a “CPA background” and the training expected with such a background, as opposed to, say, a criminal investigator’s background. Indeed, the engagement partner for a public company audit must be a “licensed CPA” but audit teams may consist of any number of other professionals. Will I, as an investor, now want to know the extent of their experience dealing with criminal investigations? Will PCAOB offer guidance on the minimum level of such experience per audit team? Will audit firms be assessed deficiencies on their audits for failure to have enough of such experience? How else will PCAOB decide whether an audit firm and a specific audit engagement team have substantially complied with this proposed rule?
4. Because they directly shoulder the burden of additional work scope (even if compensated for it), how reasonable are the new requirements imposed on auditors? What exactly do I expect auditors to now learn to do, or do I expect audit firms to hire criminal investigators, in order to provide investors the appropriate assurance under this new rule? How will accounting programs teach criminal investigation to future CPAs? Will that be a new part of the CPA exam and continuing professional education? As an investor, do I really think that is going to make auditors better and lead me to rely more on their audit reports in my investment decisions? Do the proposed changes help investors (and auditors) determine when an audit “did enough”, or do they simply open the door to further interpretation and ex-post (litigation) claims by investors against auditors?

5. What happens to my investment choices when more public companies say “enough” and agree to be taken private, or not go public at all, to not deal with this burden?
   a. Am I, or do I at least believe that I am, better off overall as an investor, or as a member of the public, as a result of such a change?
   b. What happens when more accounting students and auditors say “enough” to careers in public auditing? Will the ones who are left be the better ones, and better how, and will there be enough left of those to do the job of public auditing properly, or will this change now affect the future of auditing, and thus the future reliability of audited public company disclosures, negatively?
   c. For larger public companies, the added costs of the expanded audit work scope shouldn’t affect their distributable free cash flows much, but I see significant added fixed costs for all audit firms thanks to this rule change, never mind the impact on a smaller public company workforce (who wants to work with big brother watching over your back all the time?), so suddenly the effect on smaller companies and smaller audit firms is magnified. So much for capital formation – but that’s the SEC’s mission, not PCAOB’s, so perhaps the SEC’s Commissioners might take a different perspective than PCAOB’s Board?

**In closing**

The questions I have posed are simple and could just as easily be asked by anyone else in America, from the most marginal investor to the most powerful member of government. Though my critique could go much further, the points I have made are already sufficient to support my belief that the authors of the economic analysis know, or reasonably should know, that their analytical efforts cannot reasonably determine whether benefits of the proposed rule justify its costs. Further, the points I make are enough to support my belief that PCAOB’s Board cannot reasonably rely on that economic analysis as part of their justifications to propose the rule, and if they were to choose to do so nonetheless, Board members would mislead investors and the American public, thus failing in their basic duty to protect investors and the public.

As an investor, I don’t see how this proposed rule is worth it for me, other investors, or for the public, and the analysis contained in the proposed rule does not convince me otherwise. I don’t even see how it is clearly going to have the expressly intended effect, even if I ignore how much I fear it is going to cost or how little benefit it might provide. Accordingly, I close with my opinion that the proposed rule should
not be adopted but withdrawn, as it is not clear how it will help protect investors and the public interest via the preparation of informative, accurate, and independent audit reports.

Sincerely,

/x/ Victor Jarosiewicz

Victor Jarosiewicz, PhD, ASA, CFA, CAIA