NOTICE: This is an unofficial transcript of the Public Company Accounting Oversight Board's March 6, 2024 Staff Roundtable on the Proposing Release on Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations And Other Related Amendments. The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the Roundtable can be found on the Public Company Accounting Oversight Board's website at: https://pcaobus.org/news-events/events/event-details/pcaob-staff-virtual-roundtable-on-noclar-proposal.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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ROUNDTABLE DISCUSSION OF PROPOSED AMENDMENTS TO PCAOB AUDITING STANDARDS RELATED TO A COMPANY'S NONCOMPLIANCE WITH LAWS AND REGULATIONS (NOCLAR)

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WEDNESDAY
MARCH 6, 2024

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The Roundtable convened via Videoconference, at 9:30 a.m. EST, Barbara Vanich and Martin Schmalz, Facilitators, presiding.

PCAOB BOARD MEMBERS PRESENT

ERICA Y. WILLIAMS, Chair

PCAOB STAFF PRESENT

BARBARA VANICH, Chief Auditor
MARTIN SCHMALZ, Chief Economist and Director

PANELISTS PRESENT
PANEL 1:
D. KEITH BELL, Senior Vice President, Finance, The Travelers Companies, Inc.
DOUG CARMICHAEL, Claire and Eli Mason Professor, Baruch College, CUNY
JOHN COATES, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School
BRIAN T. CROTEAU, US Chief Auditor and Auditing Services Leader, PricewaterhouseCoopers (PwC)
ROBERT J. JACKSON, JR., Professor of Law and Co-Director of the Institute
R. BRAD MARTIN, Vice Chairman, FedEx Corporation
KYLE OWENS, Partner, Auditing Standards, Crowe LLP
CHRISTIAN PEO, National Managing Partner, Audit Quality and Professional Practice, KPMG
SANDRA J. PETERS, CPA, CFA Institute Senior Head, Advocacy and Regulatory Relations, CFA Institute
LYNN TURNER, Senior Advisor, Hemming Morse

PANEL II:
DOUG CARMICHAEL, Claire and Eli Mason Professor, Baruch College, CUNY
JOHN COATES, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School
EMILY FITTS, Partner, Deloitte & Touche LLP
ROBERT J. JACKSON, JR., Professor of Law and Co-Director of the Institute for Corporate Governance and Finance, New York University School of Law
JOSH JONES, America's Director of Audit and Chief Auditor, Ernst & Young
CAROLE McNEES, CPA, Director of Quality Management, Ethics and Assurance Policy, Plante Moran
LYNN TURNER, Senior Advisor, Hemming Morse
ALAN J. WILSON, Partner, WilmerHale, Chair of the Law and Accounting Committee of the American Bar Association (ABA) Business Law Section

PANEL III:
BRIAN T. CROTEAU, U.S. Chief Auditor and Auditing Services Leader, PricewaterhouseCoopers (PwC)
COLLEEN HONIGSBERG, Professor of Law, Stanford Law School
JONATHAN KARPOFF, Washington Mutual Endowed Chair in Innovation and Professor of Finance, University of Washington
DENNIS McGOWAN, Vice President, Professional Practice, Center for Audit Quality
CAROLE McNEES, CPA, Director of Quality Management, Ethics and Assurance Policy, Plante Moran
LAURA POSNER, Partner, Cohen Milstein Sellers & Toll PLLC
TOM QUAADMAN, Executive Vice President, U.S. Chamber of Commerce Center for Capital Markets Competitiveness (CCMC), the Chamber Technology Engagement Center (C_TEC), and the Global Innovation Policy Center (GIPC)
BRANDON REES, Deputy Director of Corporations and Capital Markets, AFL-CIO
BOB TEMPLE, General Counsel & Secretary, NuScale Power Corporation
LUIGI ZINGALES, Distinguished Service Professor of Finance, University of Chicago

ALSO PRESENT

KARTHIK RAMANNA, Professor of Business and Public Policy, University of Oxford

OBSERVERS

JENNIFER BURNS, Association of International Certified Professional Accountants
COLLEEN CONRAD, National Association of State Boards of Accountancy
SUSAN COSPER, Financial Accounting Standards Board
ANGELO GIARDINA, International Accounting and Assurance Standards Board

PCAOB STAFF

BARBARA VANICH, Chief Auditor
LISA BUSEDU, Associate Chief Auditor
LISA CALANDRIELLO, Assistant Chief Auditor
DAVID ELLAM, Assistant Chief Auditor
BRIAN GOODNOUGH, Office of External Affairs
HEATHER JOSSEM, Assistant Chief Auditor
JESSICA WATTS, Senior Associate Chief Auditor

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P-R-O-C-E-E-D-I-N-G-S

9:39 a.m.

MS. WILLIAMS: Good morning. Thank you for joining us for today's roundtable regarding the proposal to amend PCAOB auditing standards related to the auditor's responsibility for considering a company's noncompliance with laws and regulations commonly referred to as NOCLAR.

The PCAOB's mission is to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Protecting investors drives everything we do including the NOCLAR proposal to be discussed today.

Noncompliance with laws and regulations can have devastating consequences for investors. When sanctions, fines, and civil settlements directly affect the company's bottom line or reputational damage causes a company's stock value to decline, investors are negatively impacted.

Like all standards on our agenda, we are committed to getting this right and public comment is essential to that process. We want to hear from all stakeholders, and that is why we are here today.

Thank you to the panelists who will be joining us. We look forward to learning from your comments. And thank you from the public that's watching. The comment period is open until March 18th, and we want to hear from you.

Today's roundtable has been driven by our hardworking, dedicated staff. Thank you to Barbara Vanich, our chief auditor and director of professional standards at the PCAOB; Martin Schmalz, our chief economist and director of the Office of Economic and Risk Analysis; and all of their teams and colleagues who are working hard to protect investors every day.

With that, I would like to turn the roundtable over to Barb. Thank you.

MS. VANICH: Thank you, Chair Williams, and to all of our board members for joining us today. Good morning, everyone. I'm Barbara Vanich, chief auditor and director of professional standards at the PCAOB. As Erica noted, I'm joined by Martin Schmalz, chief economist and director of the Office of Economic and Risk Analysis, and it's certainly our pleasure to be with you today.

Martin and I are joined by Karthik Ramanna. Karthik is a professor of business and public policy at the University of Oxford's Blavatnik School of Government who we're very lucky to have. He's taken a partial public service leave to work with us and advise the PCAOB.

I would like to welcome you to this staff-hosted roundtable on the auditor's responsibility for a company's non-compliance with laws and regulations, which I'll just refer to after this as NOCLAR. We want to welcome our panelists, board members, and the public watching this meeting.

Before we get started, I'll give the

disclaimer for myself, Martin, and Karthik, and any PCAOB staff speaking throughout the day, our views are our own and do not necessarily reflect views of the Board, individual board members, or staff.

We would also like to remind those listening that the comment period will be open until March 18th, 2024. We welcome all comments. The staff are particularly interested in substantive comments from the public concerning the roundtable topics and any points raised during the roundtable.

On June 6th, 2023, the PCAOB proposed amendments to PCAOB auditing standards related to a company's noncompliance with laws and regulations. We received over 140 comment letters on that proposal. And from those comment letters, the staff have identified several topics for which we believe additional information will be helpful in developing our recommendation for the Board.

Today's roundtable will be organized

into three panels. From now until 11:30 a.m. we will focus on the identification of laws and regulations relevant to the audit of a company's financial statements. Then we will have a short break and reconvene from 12:30 to 2:30 to cover the assessment of non-compliance with laws and regulations. We'll, again, take a short break and reconvene from 3:00 to 5:00 to conclude our day with the economic impact of the proposed standard. Each time we break, you may rejoin using the same link.

The purpose of the roundtable, again, is for staff to obtain the perspectives of our panelists on specific aspects of the NOCLAR proposal. Additional background on the topics and questions to be covered during today's roundtable is available in the staff briefing document which is on the event page you will find linked to the homepage at the PCAOB's website for the entirety of today's meeting.

With that, let's get started on our first panel on identification. It will be organized into two topics. Topic one, the threshold for the identification of laws and regulations, and topic two, direct illegal acts versus indirect illegal acts.

We have ten distinguished panelists joining us today. D. Keith Bell, a senior vice president of finance for the Travelers Companies. Douglas Carmichael, the Claire and Eli Mason Professor, Baruch College, CUNY. John Coates from the John F. Cogan, junior professor of law and economics, Harvard Law School. Brian Croteau, the U.S. Chief Auditor and Auditing Services Leader of PricewaterhouseCoopers.

Robert J. Jackson, Junior, professor of law and co-director of the Institute for Corporate Governance and Finance, New York University School of Law. R. Brad Martin, vice chairman, FedEx Corporation who is here as a member of an audit committee. Kyle Owens, partner, auditing standards at Crowe.

Christian Peo, national managing partner of Audit Quality and Professional

Practice at KPMG. Sandra J. Peters, CFA Institute senior head advocacy and regulatory relations. And Lynn Turner, senior advisor at Hemming Morse. You can find bios for each panelist on our website.

Today, Martin, Karthik, and I are here to listen. We will direct specific questions towards panelists in order to inform our efforts as we work towards a final recommendation for the Board. We do want to hear from all panelists who wish to speak on each topic, and to encourage dialogue amongst the panelists within the time allotted.

As a reminder, if you would like to say something, please use the raise your hand function. If that's not working, just type something in the chat function. And if anyone has technical issues during the roundtable, please reach out to Brian Goodnough. In the event we run out of time, we welcome all panelists to submit additional comments to the comment file. Thank you in advance for your patience.

A note to those watching online, panelists were asked to submit any new data or analysis they plan to present here today to the comment file ahead of today's meeting, and I believe we have several submissions that are available. To ensure all panelists have time to speak, we won't be able to accommodate slide presentations from individual panelists, but nonetheless, we encourage panelists to refer to the submissions in the file.

So let's dive into topic one, the threshold for identification of laws and regulations. As part of planning and performing an audit to obtain reasonable assurance that the financial statements are free from material misstatement, the proposed standard would require auditors to identify laws and regulations with which non-compliance could reasonably have a material effect on the financial statements.

As part of the proposal, the auditor would identify such laws and regulations based on information obtained from risk assessment procedures and other procedures performed during the audit of financial statements, reviews of interim financial information, and if applicable in an audit of internal control of financial reporting.

The proposal explained that the phrase could reasonably have a material effect, would tailor the proposed requirements to include those laws and regulations that relate to the way matters are recorded or disclosed in the financial statements along with other laws and regulations that would relate to the operations of a company with which the company's non-compliance could reasonably result in material penalties, fines, or damages. These laws and regulations would necessarily be relevant to the company or its operations but would not represent every law or regulation to which the company is subject.

Our first question is are there other thresholds besides could reasonably have a material effect that would provide sufficient rigor to the auditor's identification of laws and regulations relevant to the audit of the company's financial statements.

I'd like to begin by giving the floor to the representatives from the audit firms. Let's start in the order of Mr. Croteau, Mr. Peo, and Mr. Owens.

MR. CROTEAU: Well, thanks, Barb, and to the Board and staff. I really appreciate the opportunity, first of all, to be here, and more importantly, commend the PCAOB for holding the roundtable and public outreach. I know many commenters, including my firm and myself, thought that it was important for you to do this.

And, you know, as I prepared for today and I reflected on reading many comment letters that you've received of the over 140. I had a number of conversations across kind of all constituents to try to understand where we are here relative to the threshold, and where we are relative to kind of the misunderstanding that I think might exist among constituents.

And I do think, Barb, the threshold's an important place to start the discussion. I guess what I would say as I reflect, again, on what investors are asking for, I think there may be some misunderstanding relative to what we do today, and I also think that the proposal as written can be read in a variety of ways that, you know, I can understand why there is a degree of concern, certainly from preparers, auditors, audit committees, and why investors might be reading it differently to suggest that they're just asking for something that's very reasonable.

So to try to reconcile all that, at least as I think about it, you know, Barb, I thought it might be helpful to kind of describe a little bit of how we think about or how you could think about the threshold. As you think about laws and regs today that we focus on relative to preparation of financial statements and our role as auditors, I sort of start at the center relative to those that are directly related to the preparation of financial statements and directly affect accounts and disclosures, so like tax law and pension.

I don't think anyone's suggesting today that we remove the reasonable assurance requirements relative to compliance with those laws and appropriate preparation of financial statements, and auditor's responsibilities around those. Whether you call that direct, whether you call it something else, we can all debate what the right words are around that. But I don't think you want to move away from reasonable assurance.

Then you get to the next set of laws and regs as we think about it or as I think about it, and for those, these are ones that I think about as being central to the company's operations. And this could relate to the EPA, or, you know, FDA. It could relate to, you know, from a banking perspective, anti-money laundering. There's a lot of laws and regs that we in companies spend a lot of time on today.

And I don't know that that's come through relative to an understanding of the current standard. And I also think the proposal is probably meant to focus on a lot of those laws and regs that are, in fact, central.

And, you know, when you think about the company's obligations today relative to ICFR, relative to ASC 450, or the appropriate accounting standards given their financial reporting framework, I think we've not talked enough about what's done today, and what could be done to enhance that today. But for those that think it's out of scope, if it's not direct, I think there's a misunderstanding.

These laws are not out of scope. No laws and regs are out of scope if we become aware of a violation that could have a material effect on the financial statements. So that's sort of the next set of laws and regs that I think about.

And by the way, to evidence that, we have CAMs today related to some of those laws and regs and the accruals and disclosures related to them. You'll find several related to FDA, Federal Trade Commission. And so clearly not out of scope, focused on today, a lot of time spent by auditors.

Then you think about, well, everything else. What are the rest of the laws and regs that perhaps the company doesn't have as robust compliance monitoring around, and perhaps much less likely to lead to material misstatement of the financial statements.

And I think there, certainly CFA and the Investor Advisory Group letters do suggest a different threshold relative to thinking about those and moving kind of from could to would or is likely. And I think that would help.

But I think the trouble is when you get to those kinds of laws and regs, and when you think about what those could be, you could think about, you know, and it's going to depend whether, you know, how relevant it is depending on the industry that we're speaking about. But it could be, for instance, from a banking perspective the timeliness of responding to garnishment requests or, you know, OSHA violations, potential for OSHA violations that don't have a direct material effect on the company's operations.

When you get to those types of laws and regs, and not to suggest that they're not important, but when you get to those laws and regs that are, you know, a lot less likely to have a material effect on the financial statements, I think you need to be cautious about how much you're asking management and auditors to spend time from a financial reporting perspective trying to identify the full set of those laws around the world. And then, importantly, separating that discussion from detection.

And the detection discussion to me is important to both the categories I described whether it be those you're already focused on, whether it be EPA for example. We don't sit at the river to see if the company dumps in another site if they already have a superfund site.

Certainly there are questions we may ask. But detection of laws and -- of violations of laws and regs is another important distinction that needs to be made.

So that's a bit of a long answer to your question to suggest that I think the current threshold in the standard -- in a proposal I should say, clearly is too low, and I think acknowledged by the IAG letter as well as CFA and others, and many commenters. So I think clearly too low, but also doesn't think carefully enough about detection of illegal acts and what the role is relative to detection, and how far one goes to identifying the full set of laws and regs.

So in my view, whether you focus on direct and indirect going forward, or something else, I think those are kind of the categories of laws and regs that I would think about. I think you could start with the threshold proposed by, for instance, IAG and CFA. But I think you need more than that relative to the concepts that I just described.

So, you know, probably can say a lot more about that, but the last thing I'll say, Barb, is that, you know, some have comingled the fraud within this discussion. And like direct affect compliance with laws and regs that I mentioned like pensions and taxes, fraud we already have reasonable assurance requirements around relative to financial statement reporting and misappropriation of assets. I wouldn't confuse that in this discussion today either. I think we're talking about incremental violations of laws and regs.

Your risk assessment standards do a great job today with all the work that you've done relative to addressing fraud throughout the audit and the auditor's responsibilities. So I wouldn't want to confuse what I'm saying here relative to the next sets of laws and regs as you get beyond those that have a direct effect relative to fraud. So that may not be the -- you may have been looking for something more succinct, but that's how I think about it, Barb.

MS. VANICH: Thank you, Brian. Thank you so much. Mr. Peo?

MR. PEO: Sure. I'll probably give an answer that's fairly similar to Brian's, but maybe expound on a few points. Maybe I'll start by also thanking the Board and OCA. I do appreciate the opportunity to be on the panel and to further explore this really important topic.

It doesn't surprise me that Brian, when he answered your question, went directly to what might be your second part of the panel which is direct versus indirect because I think that that threshold that you asked the question about really does matter if there is no more distinction between direct and indirect.

So Brian did a really nice job describing how the standards and how the profession thinks about NOCLAR today with direct and indirect. Maybe I'll just offer a couple of other thoughts on there to support what Brian's saying.

What may be a little bit misunderstood

is just because we divide between direct and indirect does not mean that as auditors we completely ignore violations related to indirect -- violations that might have an indirect impact on the financial statements.

In fact, we -- once the issues are identified, we do the exact same work for the most part. I can't think of a difference that we would do, whether we discovered a direct, an instance of noncompliance that relates to or that has a direct impact on the financial statements, or one that has an indirect impact on the financial statements.

And so the issue really that is a concern to the profession the way that the standard is written is about how much work are you supposed to do over the indirect versus the direct. The direct we already have to do a whole bunch of work. We have to provide reasonable reassurance over that. And on the indirect, to me it's a matter of at what point do the auditors get involved.

And so some of the language that is used in the standard, Paragraph 6 for example, where it says that the auditor has to understand management's process related to identifying the laws and regs, but then also preventing identifying, investigating, evaluating, communicating.

The example that Brian used, I think he said that we would have to conceivably sit at the waterfront to see if folks are -- if companies are actually violating EPA regs. That's probably not too far of an exaggeration, and I don't know if he was trying to exaggerate to make a point.

But when you start talking about we're going to have the auditors do work to prevent compliance violations that may have an indirect impact on the financial statements, that's when we start to get into things that are far outside of financial reporting, and into the other slice of the COSO cube or one of the other slices of the COSO cube and into compliance.

And that's where I think that the profession really is asking the PCAOB to be very thoughtful about whether you want us to go that far. That I think is something that we've not done. That is something that would be a very significant scope change for us.

And back to your original question, Barb, that threshold question I think on could reasonably have an impact really only comes into play if you're asking us to identify those laws and regulations that would have an indirect impact as opposed to what we do today which is we do a lot of procedures, and a lot of those procedures relate to trying to identify non-compliance whether it's direct or indirect, but it starts a little bit further downstream than where the proposal would ask us.

MS. VANICH: Thank you. Mr. Owens, in the interest of time, and I know it's hard to talk about some of these issues without getting into everything, if we could just focus, though, your remarks on the threshold in particular so I can make sure that we get to all of our panelists.

MR. OWENS: Sure, Barb. Definitely appreciate being here today. With respect directly to the threshold question here, we do appreciate the intent of the language selected here, the could reasonably language to appropriately tailor the proposed requirements that focus on the laws and regs that relate to the way the matters are presented and disclosed in the financial statements. But we do share some of the same concerns that are being highlighted in the briefing paper.

Specifically, the auditors would need to identify a complete population of laws and regulations before determining which laws and regs could reasonably have a material effect on a financial statements. We also share the same concern that the requirement is overly broad.

And a little bit of background there for those views. In the proposed -- in the proposal, Paragraph 2 of the proposed requirements states that, "With respect to all laws and regulations, and the statement of the financial statements can arise when violations occur and aren't properly presented in the financial statements."

Given that a misstatement of the financial statements can arise with the violation of any law that is not presented in the financial statements, we believe for an auditor to complete an assessment of which laws and regs could reasonably have a material effect, the auditor would need to start with that complete listing and be able to assess which laws and regs could reasonably have a material effect on a financial statements.

For example, the auditor would need to understand the nature of the potential contingent monetary effect such as the fines, the penalties, the damages, or the provisions, or the allowance for returns. And to make this assessment, an auditor may need to obtain a specialist, potentially multiple specialists to assist in understanding the nature and the range or the potential noncompliance and the range of the potential contingent monetary effects.

So we believe that the auditor would need to identify a complete population of all the regulations, and that because of this, the proposal is going to be overly broad because we believe it's going to be challenging to eliminate any law or regulation under the could reasonably threshold.

So I guess maybe the best way, Barb, to kind of think about some of those, I thought I'd take maybe through a quick example here. As you know, we do audit a number of banking institutions, and banking institutions not only has to comply with all the laws and regs of any entity, but also with the federal and state banking laws.

And so if we just focus on those federal and state banking laws for this particular example, from a federal perspective, you can go out to your favorite law library, search for, you know, the federal finance and banking statutes, and the results are going to be numerous.

You're going to have the Bank Secrecy Act, the Community Reinvestment Act, Equal Credit Opportunity, Electronic Funds Transfer Act, Fair Credit Act, Fair Debt Collections, Fair Housing Act, and a number of other laws and regulations before you even get to the Safe Banking laws.

So in our view under the proposed standard, the auditor would need to start with this complete listing, and potentially begin an elimination process, that is make a determination of whether the law or reg could reasonably have a material effect on a financial statements.

And to be able to do so, the auditor would need to understand the law and regulation, and all the applicable requirements. But if I kind of take that one step further and focus on anti-money laundering laws --

MS. VANICH: If I could pause, I mean we're not trying to focus as much on what was in the proposal, but what it could be. Do you have any other suggestions for would a different threshold work? Do you have any suggestions there?

MR. OWENS: So I think from -- call it the recommendations on the threshold, it's more about not necessarily call it a threshold, but the factors about how you think about what laws and regulations would be in play from the overall audit perspective. So what are the additional factors of how an auditor can eliminate any potential laws or regulations, or better make that overall risk assessment that a law and regulation would not have or could not have a material effect on a financial statement. So I think it's more about the application of how you would apply any threshold for this particular analysis.

MS. VANICH: But if I can ask you, we'll come back to that because I think our last question the panel gets to that really specifically, and I want to make sure we all have something to say by the time we get there. Thank you so much, Mr. Owens.

I'd now like to call on three other panelists, maybe to react in part to what you just heard. Mr. Coates, Mr. Jackson, Ms. Peters, and Mr. Turner in that order, you know, we heard some things about the threshold including references to those suggested in comment letters from the CFA Institute and our investor advisory group. I know you're not on camera yet, we'll give you another second, but Mr. Coates, I want to see if you had any response first to what you've heard so far today.

MR. COATES: Thank you, Barbara, thank you to the Board for the invitation. I recognize I'm not an accountant or an auditor, and so come at this from a law background. So I have some sympathy for the general idea that the could reasonably standard has the potential for creating confusion, and depending on your take on it, could lead to the approach that Kyle was just sketching that the sense would be list every law, list every penalty, go through an elaborate item by item elimination. So I take the general point, but other language might be useful.

My own sense of it would be there are existing kinds of words in the SEC's MD&A framework or in 450, ASC 450 that I think could be applied. Now it's not going to be a straight apples to apples because, of course, those are settings that you're taking specific facts and specific risks, or specific contingencies. Here this is at a higher level. But the same kind of language would then lead to a more well-understood idea about what gets above reasonably possible from ASC 450.

You know, people still disagree about exactly what that is, but it's, you know, certainly more than 10 percent chance of a material impact on, et cetera. And I think with that alone, the kind of work that Kyle's sketching could be dramatically reduced in terms of the cost and challenge.

I also think it's -- let me echo the

idea that we might circle -- or the Board might circle back to this threshold question after being a little bit more clear with itself and out loud with commenters about what precisely are the on-the-ground changes in conduct that are desirable because that then might help inform how to think about the framing of the general language.

Let me say one other very general thing just to level set. No lawyer ever has known all the laws. Like no one has ever done the list that Kyle was suggesting. Like it would be a crazy list to imagine. Any full-time professional lawyer doing, even an academic, even if that was their sole job, they still would never get done because the law would change too fast to get to the end of the list, much less the list of penalties, et cetera.

So like let's maybe get a little realistic about -- on both sides of the aisle here, that is those who are wanting the proposal to change, but also those of you are proposing it, about like what meaningfully actually could be done in practice.

There's also related to that, and this will be the last thing I say, identification in a general way actually could be done very simply, that is with a relatively short list. So instead of each of the specific statutes and regulations that Kyle was beginning to list out, you could just simply frame it as laws generally applicable to banks, all right, we've now identified them. And then there are laws generally applicable to every entity.

And then there are laws -- I mean so depending on the specificity of the exercise, the threshold could be more or less easily met, even as currently written. But I want to circle back to land that. I still think drawing on existing language frameworks that are more well understood would be something I would suggest the Board consider.

MS. VANICH: Thank you so much. Mr. Jackson?

MR. JACKSON: Well, thank you, Barb, and I want to join my fellow panelists in congratulating and thanking you, the Board, and others.

You know, I agree with Brian Croteau, putting this roundtable together is exactly the kind of thing that the Board should be doing in reaching out to practitioners who are going to have to implement these standards. And I want to begin just by offering a caveat or two, and then Barb, I'm just going to make two points because I know we have a lot to cover this morning.

So, first, I want to say apologies in advance. Those of you who -- or who might be familiar with my background, I was a commissioner on the SEC with board member Kara Stein a few years ago, and I stepped down to have kids. And, Barb, I succeeded. Like I hit my performance targets. I have two kids. Bonus is still in the mail.

But unfortunately, what that means is that I have a two-and-a-half-year-old who is a little under the weather. So I may have to drop off from the panel to take him to a doctor's appointment. If I have to do that, I promise it's not because I'm not dying to hear more about NOCLAR, but because I'm required to -- I'm required.

For a second, my corporate law professor was John Coates. So any mistakes I make are his fault. So if I say anything in the next three minutes that seem wrong to you, you should email John.

Okay. So two things I want to say today. First of all, I want to thank Brian and Christian for what I thought were very thoughtful comments about this proposal. And the reaction that I have is that there's really good news this morning which is that there is some agreement about the kind of work that auditors should be doing in this space.

The question is what work, and when? And that's why this conversation I think is so important, and I think will be so valuable. I hope will be so valuable to the Board and to the profession. And again, I only have two points to make about it.

The first point I want to make, and I'm directing this to Karthik and Martin in particular, and others in the field who will consider the cost and benefits of this proposal which is I want folks to be thoughtful about the baseline. So what additional work does this new standard really impose? That's the question we should be asking from a cost and benefit analysis.

And you just heard from Christian and Brian that there's existing work that happens in this space. In fact, 10 Cap A has required a great deal of -- a great deal of auditor work in this area for some time. And I want to point out that that's the appropriate baseline on which any further work would be building.

So just to give you an example, my son, as I say, he's two and a half, he thinks I'm very tall. Now those of you who have met me know he's wrong. His problem, the mistake he's making is that he doesn't have a good baseline for measurement. He doesn't know that many people, so he is persuaded that someone who's 5'7" on a good day is tall, but he's wrong because what he should do is look at the broader population, all the people and then he could see whether dad is really tall, and sadly he would discover the answer is no.

Similarly, here, when you're measuring cost and benefits, we should start from the existing baseline which is that auditors already do considerable work under 10 Cap A. It's true, I think, and clear as Brian and Christian have both suggested that what's been proposed, especially some of the ambiguity in the language adds something.

But the baseline is not zero for the same reason I'm not tall. That is, there's an existing set of work that's already happening. There are other people in the world who are taller. And for that reason the economic analysis should focus on that distinction rather than pretending as if you're building on nothing because the Board is not doing that.

Second, I want to forcefully agree with what Professor Coates has said. It may just be that he taught me the law, but I think he's right and I want to be more specific about it. My own view is that there is a lot to be gained for the Board from drawing from language from the SEC's rules governing management discussion and analysis of financial statements.

You all might remember that the year after the famous Basic versus Levinson case was decided in 1988, that's the materiality case, the very next year in 1989, the SEC put out a release and said when you're doing MD&A, that's not the standard.

When you're writing things like risk factors or doing management discussion, giving context to the financial statements, the standard for whether to say something about something in the financial statements is not the probability magnitude test of Basic because then you'd have to disclose things of very low probability.

No, no. The SEC said that the standard is reasonably likely to have a material effect. And I think that concept borrowed here could do real work in addressing some of the concerns you heard from Brian, and Christian, and others because -- for the following reason, existing disclosure committees and issuers are familiar with that standard, interact with audit committees and others about the implementation and approach of that standard, and laws that are reasonably likely to have a material effect on the issuer are going to be the subject of other conversations about disclosure elsewhere in the document.

For that reason, using that as a basis to focus and narrow auditor's work in this area, I think might be worth considering. So I want to suggest, as others have in the comment file that using that MD&A standard as a way to weed out the long list of laws that, as John Coates says, no lawyer knows, might be a path forward here that folks should talk about today because if it's one that practitioners in law and accounting feel they can apply, it might be a way to make this standard as effective as possible for investors.

Thanks again, Barb, for having me today. I'm delighted to have the chance to share my thoughts.

MS. VANICH: Thank you. And understand if you have to step away. Ms. Peters, any reaction to either what's been said or anything you wanted to share?

MS. PETERS: Well, a lot has been said. It's hard to summarize that all very quickly. I think that the second question in the second topic about what's done today, which is where Brian started and some of the others is really something that I think is very important because I think what we're trying to resolve here is an expectation gap between what investors expect of an audit and what actually happens in an audit.

And it is actually why investors think audits are very valuable, but audit reports are not necessarily valued because there's a lack of transparency with respect to what's actually communicated, right? Investors don't read auditing standards, and they don't know that there's a distinction between direct and indirect that was written into the profession some 35 years ago that scopes things out that they might -- that they might care about.

And our members told us in a survey maybe five years ago that NOCLAR was one of the top three things that they wanted the standard centers to consider because noncompliance with laws and regulations and the resulting consequences on the reputation and financial statements can be quite significant.

But I think that there is a very -- in thinking about this panel, there's what's management's responsibility. And under 302, they need to make sure that there is not a material omission in the financial statements. There is auditors -- and they need to comply with the accounting for contingencies under ASC 450.

Auditors have responsibilities under Sarbanes-Oxley, they have responsibilities under the auditing standards. They have responsibilities under Section 10A. They are quite so clear in what -- from an investor perspective on making sure there's no gap on the omission of a material misstatement in the financial statements related to a noncompliance with regulations. That's the gap we're trying to as investors solve, right?

And so we, in our comment letter, we said, well, maybe it could be is reasonably expected, or I forget exactly the exact word we used. But in reflecting on that, you know, if you look at AS 2110, it uses -- and AS 2110 is identifying and assessing risks of material misstatement, uses could -- uses the exact same language, right?

So how do we use different language here than in the statement with respect to material misstatements. And we have sympathy with respect to the fact that investors don't want auditors to, one, build a list of all the laws. And they don't want -- I mean investors have to pay for all of this, right? So they don't want auditors to do things that management isn't responsible for doing first.

They want to review what management has done -- investors want auditors to look at what management's done in a skeptical way and assess whether or not management has actually made a reasonable assessment of that there's no material misstatement of the financial statements from a noncompliance with laws and regulations.

If management doesn't have a complete list, but has a process that's reasonable, I think that's something that we want auditors to look at. And it may require they use legal expertise. They do it already when they have to -- if they come upon something, they already have to evaluate it. We're just asking in using -- and they'll need to use legal expertise in doing that.

We're saying are you looking at the process for identifying these items, and the potential misstatement that may occur, and maybe you need to use legal expertise on that. But we're not coming to -- we're not coming to this issue saying you need to look at every law and regulation, and you need to do it before management does it or separate and apart from management. We look at Paragraph 6 and say it says you should use the work of management.

I think it's the language in Paragraph 4 that says identify laws and regulations. It's really the identify even more so than the could, and maybe some merging of the language in Paragraph 4A and 4B could be a possible way, and I won't do that here, of saying we as investors want auditors to ensure there's no material misstatement from the -- of the financial statements from non-compliance with laws and regulations, but that doesn't include looking at every single law.

MS. VANICH: Thank you, Ms. Peters. Mr. Turner? I think you're on mute.

MR. TURNER: Apologize for that. So it's actually been 45 years ago when the profession adopted this notion of indirect and direct. Since that time we've had the FCPA passed. We've had Section 10A, of which I had a role in drafting, adopted. We've had SOX passed including the whistleblower provisions and ethics. And we've had a federal court ruling from the bench that auditors are responsible for detecting fraud. So there's a real basis here for -- and it's most appropriate that the PCAOB would at this point in time come back and revisit that which is a very outdated standard.

I do think that the notion of could reasonably have a material effect is a proper standard. John, you mentioned you're not an auditor, and Rob, I don't think you are either in all due respect. But the notion of could possible is a well understood auditing notion. It is the exact language that's already used for auditors in the standard that says you have to go out and assess risk of a potential material misstatement.

So that language is well understood by the auditing profession, you know, probably as well understood as Basic and TSC is by the attorneys. And so it's not this confusing language for auditors at all. In fact, if auditors don't understand that, we've actually got a much bigger problem than in this instance.

Now the IAG, in reading the comment letters from the various firms, saw the concern that they felt that perhaps people wouldn't understand it, and I don't think there's any question auditors can understand that. On the other hand, given their concern, we had a great discussion at the IAG about this, and the IAG, and I certainly don't speak for the group as a whole, but they agreed we'd insert the reasonably likely language that, John, you and Rob mentioned, that came out of the 1989 releases by the commission. I was actually at the commission when that came out.

But when you look at the guidance that the commission gave as to language reasonably likely, and it's in the footnote of our comment letter, and it was incorrect for Brian to categorize the IAG letter as setting a higher standard than could reasonably possible. That's just not true.

In fact, if you look at the comment letter, it says -- and quotes the commission, it says, note that reasonably likely is a lower threshold than more likely than not, but higher than remote, which means it ain't going to happen. So reasonably likely is someplace in between it ain't going to happen and it's less than 50/50. And that is nothing short of could reasonably have a material effect. It's the same thing.

And personally, I don't care if you write in the word glad or you write in the word happy, and that's what we're talking about here. Do you put in could possibly have a material impact using language that auditors already use every day of the year, and clearly understand, or to help others out, do we turn around and use language reasonably likely. They're the both -- they are both the same threshold.

Anyone that can pull out a Websters will see that they're both the same. So what we're talking about here and what we're arguing about is do we write glad or do we write happy. And, quite frankly, I think there's more important things to spend our time on than that.

So, certainly, I agree with Sandy that there's a role here for the auditors. There's a role here for management. Any final standards should highlight the importance of the controls and processes of management including the GC and CFO and CEO have in place. And the auditors to the extent that they contest those processes and controls, then certainly, they don't have to do everything all over again. They can rely upon that information.

Of course, if management doesn't have

any process for identifying these noncompliance situations that could have a material impact, then the auditor's going to have to do more because they're providing reasonable, a high level of assurance to investors that there is no material misstatement.

They're also saying in their audit report, in every audit report that goes out they say we have performed an audit that was designed to ensure that there's no material misstatements whether from errors or fraud. Fraud is an illegal act the last time I looked. And there's no footnote hanging off that saying except for indirect.

So the notion of indirect and direct is outdated, needs to go by the wayside. We need to get everyone focused on singularly on insisting having a material impact because if it's having a material impact, even if you might have called it indirect in the past, say OSHA or say account openings like what transpired at Wells Fargo, even if you were trying to say that's not material and it turns out to be, you got a problem. And that is an issue that the PCAOB is rightfully trying to address here.

So stay focused where you are, I'd say. If it's material, it doesn't matter whether it's direct or indirect, to argue that, oh, because it's indirect I don't have to worry about it. No. That's not the issue. You're an auditor and you're telling everyone there's no material misstatement in those financial statements. So if it's indirect but still has some material impact, and you haven't done your job assessing the risk and testing and identifying that, you got a problem. Thank you.

MS. VANICH: Thank you, Mr. Turner. I see two hands up, but I want to make sure we hear everyone speak, and so I'll come back to you. But, Mr. Bell and Mr. Martin, I mean as an issuer and an audit committee member, you grapple with threshold issues, and you grapple with when instances of noncompliance need to be recorded or disclosed. Any response or views on this? And then I'll circle back to Doug Carmichael after you. Mr. Bell.

MR. BELL: Sure. In dissecting this question, my first reaction was there's a couple issues. This question is based on the premise that the auditor should have a broader responsibility in identifying the applicable laws and regulations. I don't necessarily agree with that premise as it's really management's responsibility to identify the laws and regulations which it must comply. And then to put in place appropriate procedures and controls to fulfill that responsibility.

It's really the auditor's responsibility to assess the effectiveness and completeness of those process and controls. It's not to duplicate them. And I think my biggest concern here is that auditors really shouldn't be placed in the position of performing management's responsibilities, which in this case would require skills outside of their training and professional credentials.

Also, I think that this proposal could require auditors or other specialists to replicate management's efforts, and at a level that's not likely to be at the same depth as management's to obtain evidentiary matter to review internal documentation and communications to do legal research and interview management.

This approach gets pretty close to impairing the auditor's independence, and we believe that imposing these responsibilities creates a high risk of misleading investors that the auditors provided a greater level of assurance. It also implies that the auditor has a shared responsibility in the preparation of financial statements, which is not true. And it significantly increases the costs and risk of delay of an audit. On the issue --

MS. VANICH: Sorry.

MR. BELL: I was going to say on the issue of the threshold, I was listening to the comments on reasonably likely versus reasonably possible. I think they are different thresholds.

Reasonably possible to me implies that a higher -- or excuse me, a lower possibility of occurring than reasonably likely. The word likely implies that it's going to happen. So I think there is a distinction there.

But I think a better approach would be to go back and look at the TSC Industries case where it uses the term substantial likelihood that a reasonable shareholder would consider an important fact. I think that's a better threshold.

MS. VANICH: Thank you. Thank you for that. And I know people may want to respond to some things. We do have a question specifically on how the auditor might be able to use the work of the company, so if we could maybe table comments on that. Mr. Martin, and then Mr. Carmichael.

MR. MARTIN: Thank you very much. I'll add just two or three things. I am neither an attorney or an accountant, so I can add very little value to the specific issues that are being discussed today, but will comment two or three perspectives.

Number one as chairman of an audit committee that is an issuer and vice chairman of its board, we're going to play by whatever rules that it is the PCAOB outlines, and work with our audit firms. I've been on 11 public company boards, I've shared four audit committees, and have had a significant interaction when our audits have been audited by the PCAOB. So I have enormous respect for the process.

But I would say to Mr. Coates' comment and Mr. Bell's comment, what's going on on the ground for my perspective at an audit committee and at a board, it is a very serious focus of the tone at the top of corporation, the resources and processes in place and controls in place to assure compliance with laws and regulations, and a transparent communication among management, board, and the auditors when there are issues arising associated with that.

That's the standard by which we've

operated everywhere that I've been involved with a company. I've signed 302s as a CEO of a big enterprise, and on the ground that's my perspective of what happens day in, day out.

I don't speak for FedEx, but I will tell you that FedEx has 500 staff attorneys focused on complying with the laws and regulations of a company that operates in 220 different jurisdictions.

I will tell you we have a compliance function that is intensely focused on compliance. Our board, our audit committee, we meet regularly with all of the constituents that are involved in compliance, and oversight, and financial reporting transparency.

So whatever it is we are trying to solve for here, I'm not really familiar with being neither an attorney or an accountant. I interact with and have interacted with as chairman, or CEO, or a lead director hundreds of investors, not once has it been raised to me this is a very important gap if you will on the ability to assess how a company is performing for those who own it.

It will cost money from those who own it. It will slow certain processes down. Not sure what value it will add, but I do respect the important mission of the PCAOB and its work with the audit firm to try and get to the right place to ensure even more confidence in everything that we're trying to do. Thanks.

MS. VANICH: Thank you so much, Mr. Martin. Mr. Carmichael?

MR. CARMICHAEL: Yes. I've been thinking about this subject since 1973, so I have a lot of comments. But I'll confine them here to the issue we're supposed to address.

Words I think are extremely important. I think it would be better to bring the language closer to what auditors are familiar with. So I would endorse what Professor Coates said reasonably possible as defined in FASB, ASC 450-20 because auditors are familiar with applying that. They apply it not only to loss contingencies all the time, but also in evaluating material weaknesses in ICFR.

Material effect is fine, but I think it would be a lot better to use the conventional material misstatement of the financial statements, recognizing that material misstatement includes material omissions. So I think bringing that language closer on those two points to what auditors are already familiar with would solve some of the issues.

MS. VANICH: Thank you so much. Let me call on the hands that are raised before we move on to another question. I so appreciate everyone's input. Mr. Croteau, I believe you had your hand up first.

MR. CROTEAU: Thanks, Barb. I think this is a great discussion relative to the threshold. I did want to comment just because Lynn had suggested a difference of view on the threshold. Just to be clear, I didn't make any comparison to likely and possible. There's clarity in my mind, it's the difference between those. And in light of Doug's comment, I think either could be models to think about here.

I was focused on the word is versus could, which is an important distinction, and it's in both the IAG letter and in the CFA letter as a recommendation, which I was just trying to anchor to as an example of something that I think we could be supportive of provided there's additional criteria that go with it.

And I don't think anyone's really talked about another point that Christian and I, for example, raised relative to the detection of violations of some of these laws. I don't think -- Sandy, actually Sandy did in fairness, I think. And I don't think investors are expecting us to monitor that the company is complying with these laws.

Certainly we may become aware, and there's a lot that we do to become aware. But when you use thresholds like reasonably likely or reasonably possible, if you're talking out the detection, that's a compliance audit. And I think that's an important distinction.

For example, when the SEC wanted for broker dealers a compliance audit over laws and regs, they didn't say over all laws and regs that broker dealers are responsible for. They picked a few. Customer statement, reserve, and the capital, the ones that matter the most.

That's a lot of work to do the audit to detect compliance issues which is different than the things we might do as auditors in terms of risk assessment and procedures to become aware. And when you think about that, it's not just factors. I think you probably want to outline some of the procedures you would expect auditors to perform.

One example of those procedures that's not in PCAOB standards today, we have it in our policies and it's in other standards is one around reviewing legal expenses that companies pay to make sure that we think about legal letters we're sending, inquiries we're making because that helps inform us as to whether there could be violations of the laws or regulations that we're not aware of that the company is working with legal counsel on.

So thinking about those kinds of things I think is important, but it's got to be procedural based for detection of noncompliance. And I think even identification of certain laws and regs beyond those that are central to the operations. And so that's why once you get beyond those that are, you know, directly related to the financial statements and financial reporting, I think robust risk assessment and other procedures is the right way to be thinking about that.

But the threshold that we're describing, you know, I think, you know, we could certainly live with and work with. Not the one that's in the proposal, but the one that's in the IAG letter, or even one that's based on reasonably possible. But I wasn't -- to Lynn's question, I was not -- I know the difference between those two and was not debating that threshold difference.

MS. VANICH: Thank you, Mr. Croteau. Mr. Peo, and then Mr. Coates. I think you're on mute. Mr. Peo, you're on mute.

MR. PEO: For crying out loud. Sorry. Can't land on the mute button. I think this might be a little bit repetitive to what Brian just said, but I think I'll have a few additional points here.

So I do like what a lot of folks are saying. I love the concept that Sandy talked about which is, you know, we really need to make sure we understand and can, you know, reduce the expectation gap that investors have here. Maybe one of the points that I would make again is we actually do a lot of work over indirect.

So the direct versus indirect threshold, Lynn suggested that it was time for that to go by the wayside. That could be. I don't think so. But that could be, and that's certainly what the proposal says. But the reason that that direct versus indirect threshold is there is because that is a way for the auditors to understand, sort of provide a boundary for when does it relate to financial reporting, and when does it tip over into compliance, the detection that Brian's talking about in those compliance audits.

And, you know, the folks that I talk to, they don't want us to do compliance audits. But the wording in the standard as it sits, as you get rid of direct versus indirect, and as you use language like this, we need to understand management's process and that includes -- earlier in the text, it says it includes testing the controls around it, not just sort of understanding the process, but actually going and testing the process, the design implementation and the operating effectiveness of those controls.

And Paragraph 6 says and you have to test that in terms of how the company prevents noncompliance, now you are into an area where -- I'll use a different example than some of the ones that have been used. Say that OSHA, which OSHA violations can be material, there is a reasonable possibility of having material fines come out of OSHA.

Do investors really want external auditors focused on the financial statements to go and understand management's process for making sure that the work place is free of OSHA violations? That they put the signs out, that they mop, that they, you know, do all of the important things that OSHA has? There's a lot of them though. And that is how we read the standard as it currently written.

And, you know, like Doug said, words matter, and we've been inspected for a long time now. And rightly so, the inspections process has really improved quality. But what the inspections process does is it says here's the words in the standard, how did you comply with this?

And the only way to comply with the words as written, as you move over into the compliance auditing and understanding and testing controls over how management prevents, among other things, prevents illegal acts is to go and understand those laws in great detail, and then go test the controls that management has around the compliance aspect. That's a very significant difference, and I do wonder whether that's exactly where investors want us to spend our time.

MS. VANICH: Thank you, Mr. Peo. I mean it's hard to believe we're already an hour almost 15 minutes into a two-hour discussion. I do want to hear from Mr. Coates. And then what we'll do is maybe combine questions two and three because I think we've gotten to some of that, so I'll go back to those. But let's hear from Mr. Coates and then we'll turn to the next section if that's okay with everyone.

MR. COATES: Thank you. Just two brief comments on some of the follow-ups. One thing, I do appreciate Mr. Bell's references to the existing materiality standard, but I just want to make what I hope is sort of a non-controversial point that the threshold here cannot be materiality because then there's no evaluation of the risk that could lead to materiality.

That really was the point I thought Rob Jackson was making earlier, that if you impose materiality at the threshold, then that means there's no room for any interaction, or discussion, or testing of management's assumptions about what might then produce. So I have to say it has to be broader than the ultimate materiality test.

I also want to make the point, the second point, the last one, is -- and I think it's a good question that was asked earlier, like why the need for updating? What do we do? Why are we doing this --

MS. VANICH: I think, Mr. Coates, you're frozen. Are you there? Okay. Well, when John rejoins, and maybe if one of our -- oh, here he is. Here he is.

MR. COATES: Sorry, guys. It's on my end. I don't know. Why are we doing this now? That's the question. And I've heard a couple things, and I want to add one.

One is, there is confusion between users of financial statements and the auditors, and the auditing standard setters over what's expected. And part of the reason for that confusion it seems to me, as outlined earlier, there have been a lot of changes in what is standard for companies to be doing to detect non-compliance, and none of the existing standards reflect any guidance with clarity about how the auditors interact with internal audit as it respects noncompliance, with a compliance function, or a compliance officer, or a whistleblower program, or go down the list. These are things that emerged in the last 15 years. I think that's the single biggest reason.

But then the last thing I would say is let's keep in mind that some companies, and this is going to touch on the manager versus auditor role here, I know in principle I completely agree, auditors should not be doing management's work, but part of the function of audit is to ask questions of management or provide information to the audit committee that allows the audit committee to ask questions that will move management beyond what their first inclination would be.

So, for example, a new company going into a bigger workforce might not realize that OSHA might come down with a hammer on them with a massive penalty if they have no signs anywhere in the entire organization. Not one sign. Not detection. You don't have a sign in one location. That's silly. But not even recognizing that OSHA has a significant penalty program is clearly going to be knowledge the auditors already have from other audits. I mean it's just commonplace knowledge. But some managers for some new companies will not have.

And so I particularly think we ought to, as we continue the discussion, keep in mind modal S&P 500 company, that's one thing. But newly created public company coming into more robust audits, that's a very different proposition for anything compliance, even with respect to clearly material risks that at the end of the day will have to satisfy Kieth's test about materiality on the bottom line judgment or -- I'll stop.

MS. VANICH: Thank you. So in the interest of time, I'm going to try to combine questions two and three for topic one. And I think we've heard a few ideas on each of this.

Maybe with respect to question two, very interested in perspectives on whether auditors should be able to consider the work of the company in identifying laws and regs, and if so people's views on how that should be done. Mr. Bell, I think, touched on that and that was very helpful.

And question three, and we might have heard a little bit of this as well, are what potential approaches could a standard take to facilitate auditors in identifying laws and regulations, or how do we think about factors that drive the risk of material misstatement due to noncompliance with laws and regulations. Just in the event we might lose him, if we could start maybe with Mr. Jackson on this topic.

MR. JACKSON: Well, thanks so much, Barb. And I did say a little bit about this earlier, so again, I'll be brief. We've got a lot of panelists here. And, Lynn, I want to say you're right. I am not an accountant. I won't even try to play one on TV, but I do want to try and give a helpful response to this question.

You know, to answer the question directly, Barb, I think management's work is absolutely the starting point, and should be the starting point for any of these conversations. And my experience, having worked on advising public company disclosure committees when I was in legal practice, is that that is how those committees already work.

Under 10 Cap A, as the question itself

suggests, and other existing legal provisions, auditors and others will be in the room asking hard questions, as John Coates suggests, about management's existing assessment. But they're going to start with management's existing assessment because I think everybody who's spoken today agrees that management has the best grasp of the relevant facts and the things that are most likely to be important to investors when it comes to any question about the company including compliance with law.

The only question we're asking today is what happens next. And my own view is that we have long standing existing procedures under 10 Cap A and other laws that require auditors to ask hard questions about those policies and procedures, to push management on its assessments, and make sure that those assessments reflect the facts on the grounds in a way that investors can understand.

So my own view is that drawing on those existing practices in the profession is what the Board should be considering doing, and that those are well-established practices. We're not asking or reinventing the wheel here. What we're trying to do instead is draw on those practices so that auditors can use management and the company's existing work on these questions as the starting point for getting the analysis that investors will need.

MS. VANICH: Thank you so much. Let me take this same section to Mr. Turner, and then Ms. Peters and Mr. Carmichael.

MR. TURNER: You know, Barb, as I thought about this, I thought back over the years, I was actually in a trouble shooting role for a while as a partner at the firm. And when we would get into issues like this, I'd get a call from New York and asked to go address it. And so I was thinking about what is it that I would do.

I went back and read your proposal, and the proposal had -- I didn't have any problem with what was in the proposal. I thought it was sound and good. I thought it did tell the auditor that they were -- or could clearly rely on processes and procedures at the company. So the points that have been made in that regard I would agree with

But it's not just inquiry, it's also just like with internal controls over any processes, you're going to need to test those, and that includes going into, you know, the general counsel's office and having a discussion, and look at how they identify these things because they'll obviously identify some as big ticket items and others as not for us, a semiconductor company.

We certainly had a focus on patents at a Fortune 150 board I was on. The company had been sanctioned for illegal shipments to China, so that was a focus. I audited a meatpacking company, and OSHA could shut them down at any minute. And you look back to J&J, a very reputable company, FDA was able to shut down some of their plants which had a very material effect on the company, and the financial operations because they weren't able to produce products.

So it's not that -- Brian and I had a discussion about this the other day, it's not that it's just OSHA, and so it's off the list. You have to look at the company and you have to start all this always with gaining an understanding of the company and the environment it operates in. And then there'll be big ticket items in the audit guides that the AICPA puts out or has put out. They often identify the big-ticket legal issues for various types of companies.

So that's all a starting point, then you're going to test the process. That would include the whistle blower program. You got to get in and test the whistle blower. I've seen too many instances where the auditor talked to management about the accusations, but never went and interviewed the whistleblower. And, you know, that's probably problematic -- it has been problematic in cases.

So I think there are some good processes. The other one was training. Look at the training that a company does. One thing that I've looked at all the time is the D&O annual questionnaire.

Having served on a board, for those of us that have served on the board, we know there is some great information in the D&O questionnaire. And it doesn't take, you know, this is something that takes you not that long to go through, and it's been prepared by management and the board. Great stuff. And to the extent that's there, you can probably rely on that type of stuff because of who that goes to.

So there's all these things, but they're not things that take a lot of time. And so you can go through that process, get an understanding, see if management's process is working, and if it is working, then that should impact the scope of further work that you got to do.

On the other hand, if you go in and

you find that's not working, there is no documentation at that, then you to some bigger issues that you'll have to respond to the risk and what that means to you as an auditor.

MS. VANICH: Thank you, Mr. Turner. Ms. Peters?

MS. PETERS: I mean I agree with what -- I agree with what Lynn said. I mean the real challenge for investors here is that management's responsible for these material omissions, but seemingly the auditor is challenged to audit this without making this distinction of direct and indirect.

And the challenge, I mean this is basically -- the procedures that Lynn are describing are really completeness assertion tests, right? So the challenge with noncompliance with laws and regulations that investors have is that all of a sudden, they go from indirect to a liability and a big one, right?

And so that distinction is really --

it's sort of seems to be a false distinction. In reading some of the comment letters, it seems as though we're trying to draw the boundary of internal controls over financial reporting very narrowly, but that's hard to do when you're testing the completeness assertion of a liability which is in effect what Lynn is -- what Lynn is talking about. But management is seemingly somehow doing it, and they're not making a distinction between direct and indirect per say, right? This is only a distinction that exists in an auditing standard.

So I, you know, in our comment letter, we said we don't really care about the distinction between direct and indirect. We just care that the audit procedures are the same. But I think that the language is actually, as I've seen in the comment letters and I've heard it played out, I think the language is actually a barrier to the thinking about assessing the risk and identifying a material misstatement.

And so I guess I'm leaning more to

saying we should move that distinction and think about risk assessment related to a material misstatement of the financial statements because investors do not know all of this, you know, direct and indirect, and, you know, what's the boundary of internal controls over financial reporting versus the assessment of disclosures, and omissions, and material statements.

I mean they just don't understand all -- the nuance of that is something they don't understand, and they aren't even aware of because, you know, I mean it's not disclosed. There's nothing on the contingencies footnote that says, well, we got everything that was direct, but not the indirect. Or in the audit opinion, it says we didn't get everything that was indirect. We didn't look at everything that could be indirect, right?

So in the end, if we need to create a scope exclusion in the opinion, then maybe that's what we need to do to clarify and have investors ask more questions about this, which might actually clarify some of the thinking. But to me, I agree that management is first responsible, always responsible.

I mean the auditors cannot change a thing. They can only detect and report it, and they are incentivized at times not to do that. We always want management, as investors, to be principally responsible. What we're asking is for the auditors to do a check on that and the audit committee as well.

MS. VANICH: Thank you, Ms. Peters. Let's hear from Mr. Coates, and then Mr. Carmichael, and then I'll turn back to the auditors.

MR. COATES: I'll be very brief on this. It is absolutely clear the auditors should be able to rely on work that management is overseeing for this overall purpose. I don't see the value in duplication for duplication's sake. Some companies have very mature and robust compliance programs so that the idea of auditors trying to create a shadow when, you know, running alongside of it clearly is just wrong.

I think the devil's in the details as to exactly how much and where the reliance needs to be tested in the interaction, how much of that can just be taken at face value, how much of it requires the auditors to do more than that. But on the basic question of reliance, absolutely, yes, and that clearly will reduce the costs of whatever this change may entail.

MS. VANICH: Thank you. Mr. Carmichael.

MR. CARMICHAEL: Yes. I certainly agree with the comments made that the auditor has to consider what management is doing, has to understand and test what management is doing that's in this area, and management's responsibility is to do it first, and the auditor needs to look at it skeptically.

I think it's difficult to separate issues and get started on what procedures should be done and so on without specifically addressing that direct versus indirect separation that is part of the questions in this session.

I think I was involved in both writing and developing the original SAS 17, which happened in January 1977, and the update in 1988 SAS 54, which is the current PCAOB standard. And I think at the time the direct versus indirect concept was put into the literature, it was a bright line that was understood at the time to really understate the auditors' actual responsibility.

Questions did arise, particularly after the update in 1988. I should say by the way that in both times there was also a standard on fraud detection and that received the bulk of the attention. So I'm glad the FASB, the PCAOB is focusing on this because it does deserve the separate attention. I think in the past, it was overshadowed by the fraud detection SAS.

But the questions that arose that really undermine that split between direct and indirect disclosure. The auditor had a responsibility. The auditing standards at the time said essentially that the user of the financial statements can assume the disclosures are adequate unless three audit reports says otherwise.

Very closely related to that, the accounting standards. There are standards on unasserted claims and asserted claims, and violations of laws and regulations fall directly into that. So if the auditor is testing in conformity with GAAP, the auditor has to address the FASB accounting standards that deal with violations of laws and regulations, particularly those that relate to unasserted claims. Unasserted claims must be disclosed in the financial statements if they are probable of ascertain, and there is a lost reasonably possible. So that has to be addressed.

And particularly then special industry knowledge, and the AICPA developed the audit guides, got questions from the committees working on the audit guides about the shortcomings of SAS 54 for specialized industries. And there are just a host of specialized industries, a short list, mining, extractive industries, healthcare, defense contractors, foods and drugs, banks and other financial institutions, regulated operations like utilities, casinos, waste disposal, pension plans, and a host of others. And in all those industries, and it's part of understanding the regulatory framework and the legal environment, the auditor has to understand those laws.

The split of direct indicating what's financial reporting just doesn't work because it ignores totally the responsibilities related to financial statement disclosure, which are extremely important.

And I think as far as procedures, I was trying to come up with ones, and I certainly endorse Lynn's point that the auditor needs to understand and see the whistleblower procedures that the company has, and test them as to whether they are effective. That's one of the few controls that is actually mandated under the

Sarbanes-Oxley Act. And I think auditors need to pay a lot more attention to it than they probably are right now.

If you look at those things, disclosure, conformity with GAAP, special industry knowledge, that kind of automatically leads you into what procedures you're going to use to do those because you look at what does the auditor not do now that would address those things. It just maybe a small extension of those things.

MS. VANICH: Thank you, Mr. Carmichael. Karthik, did you want to add anything?

MR. RAMANNA: Yeah. Just before we hear from the auditors, and it would be very helpful to hear what specific approaches they would like to see in the standard that they think would facilitate identification. But Brian very helpfully said that he would prefer is or would to could, and I just wondered if we could hear from Christian and Kyle about reasonably likely and reasonably possible, whether they had any specific objections to either of those would be helpful to know. Thanks.

MR. OWENS: Yeah. I can go ahead and start here. With respect to the specific threshold, I probably decided a little bit back to more to maybe a comment that Sandy Peters made about merging the 4A and 4B.

And thinking more about it from the auditor's responsibility to obtain an understanding of the regulatory and legal environment, and then really focusing on the identification of the risk and material misstatement related to noncompliance on the financial statement.

So I think from my lens, really focusing on the auditor's responsibility to identify risk and material misstatements probably where we want to focus our attention at. But, again, linking up those concepts of reasonably possible would seem to make sense to me.

MR. PEO: Yeah. I tend to agree. I

guess I'd have to give it some thought about exact words. I mean Doug is right, words matter. So I'd have to really think about those words and what they mean, those potential changes. But I also tend to agree with Lynn. I'm not sure that this is really the biggest issue that we're trying to face or trying to wrestle to the ground here. To me it's really, you know, how far do we go into compliance auditing?

MS. VANICH: Brian, anything you wanted to add to that?

MR. CROTEAU: Maybe. And I have a broader response to the other questions. Should I do both?

MS. VANICH: Oh, okay. No, no, please go ahead.

MR. CROTEAU: Yes. And maybe a few things. One, certainly agree with all the comments around management first. You might look to some of the words within COSO relative to existing obligations, particularly as it relates to contingencies. And, you know, I think a lot has evolved since I was -- well, I won't say how old I was, but I was alive when all of those standards were written by Doug and others.

But anyway, I think you'll find some helpful words in COSO that have evolved that could be a hook relative to thinking about how to draft some of management's existing obligations, or at least what they look to when reporting on ICFR.

I also think there's an important distinction like again, whether it's -- it seems like a lightning rod, that's why I think many of us are saying if you want to give up indirect/direct, I supposed you can do that. It isn't that in 10 Cap A, and I don't suspect Congress is going to take it out right now of 10 Cap A.

But I think you could even -- you could still do away with it in terms of what one does after thinking about compliance. And you certainly have to follow 10 Cap A. I don't think there's anything wrong with 10 Cap A today. It serves its purpose and is important.

But I think the more important points are not what you call a direct or indirect. Christian just said it and others have said it. It's what one does relative to the laws and regs that don't directly relate to accounts and disclosures, but instead relate to ASC 450 and contingencies. And what one does around those matters because there's a very wide range.

And I just want to come back to points that a few have made, and, you know, Lynn rattled off some examples of companies that have had large fines or reputational implications, or otherwise.

Auditors aren't going to be able to prevent companies from those circumstances. There may be, you know, there may be consequential benefit that's derived from this, indirect benefit that's derived from this that is earlier prevention, and in some cases, maybe there's deterrent. But auditors can't be expected to stop noncompliance or an illegal act from occurring.

And so when you look at some of those examples, you have to think, well, from a reliable financial reporting perspective, were the disclosures sufficiently timely and appropriate, and what was management and the auditor's role in each.

And certainly, the inspections function has the ability to do that. I think it's really important to use information from your inspections function. We'll get into this probably in the economic analysis discussion. But understanding the, you know, the areas where you'd like to see improvement, I hate to say the problem you're solving because when I say that, people think I'm saying there's not something to solve for. I think there's improvement to make here.

But you very much have to know what you're trying to get at further identification of laws and regs that aren't already on radar screen. Is it detection of matters that are illegal acts? Is it the accounting and disclosure under 450 and what companies are doing there? Is it all of it to some degree?

And the words really matter relative to how much work one does for those laws and regs that aren't directly related to accounts and disclosures because the body of work there can range -- there can be an extraordinary range. And that's what people are reading differently in your current proposal.

And on the flip side of that from a benefits perspective, you can't -- and we'll get to this later, but you can't assume the benefit is getting to zero cost for companies in illegal acts because we're not -- that's not the role for the auditor.

I would also say, you know, when you kind of -- when you kind of look at the, you know, the procedures that we perform, I think there's a lot to gain there, too. I rattled off a few procedures earlier, but certainly the levels of inquiry with the organization, review of minutes review of contracts, review of legal expenses.

There's all kinds of things that we're doing today that aren't necessarily fully articulated in the standards, and I don't know that they need to be. But I think what's missing there, and Sandy referenced it, there are other applicable risk assessment standards that go to the work that we do in that space relative to ASC 450 and accounting for contingencies, lost contingencies, and the company's work around that.

So I think it's important to think about that separately, think about your existing standards, and probably have appropriate reference to those standards and the work that's done there as well.

MS. VANICH: Thank you, Mr. Croteau. Before we take questions or hands, I do want to turn to Mr. Martin and Mr. Bell in that order to see if you want to add anything to this latest discussion.

MR. MARTIN: Not from Martin.

MS. VANICH: Thank you. Mr. Bell? I think you're on mute.

MR. BELL: Sorry about that. I would agree with some of the earlier comments. There's been quite an evolution in risk management by companies, and I think there are a lot of processes that have been put in place since this standard was put in place.

And I think the biggest changes that really occurred is most large companies have compliance functions. And if there's an area where the standard could be updated, it's actually in the procedures that would be applied in that area.

Without getting into a full compliance audit, I think there is an obligation that the auditor understand how the company is trying not manage its risk.

MS. VANICH: Thank you. We're at just about 11:15, and I know there are hands up. But let me do this. Let me at least tee up topic two, and I think we've touched on it, so I don't feel as bad about being where we are timewise.

But our second topic, and then I'll call people in the order they had their hands raised, related to direct laws and indirect laws, and what people thought of the distinction. There's also a question that maybe I'd like to get to at some point with the prepare an audit committee member of how auditors and management are assessing violations of indirect laws and whether that differs.

So let me start, and I know then -- I just want to make sure I say it in case we run out of time. I know you're all very busy people, and so thank you so much for deciding to spend your morning with us. We so appreciate your time and preparation that went into this. So topic two, and maybe any kind of wrap up remarks, we'll start with Mr. Peo here.

MR. PEO: So maybe I'll start with finishing the last topic, and then go into the other. Although I think I've pretty much given my thoughts on direct versus indirect. But I just wanted to say from a management perspective and relying on management, yes, I agree with all of those comments.

I also just want to clarify, or at least make sure that it's clear in people's minds, the procedures that you were just asking about, I think generally the profession, although I suppose I can't speak for the profession, we're happy to think about the robustness of those procedures and whether we should be doing more. That's really not an issue for us.

So we already do a lot of things to identify noncompliance, whether it's direct or indirect. So, for example, we send attorney letters. We have great discussions with attorneys in house. We have discussions with lots of people in-house. We review minutes. We review hotline materials.

And, you know, through the PCAOB inspection program -- this is a -- this is a great thing about the PCAOB. Through the inspections program you can see where there are inconsistencies, and, you know, you have a target team program where you could get really good information about where are the programs inconsistent on those types of procedures, and where do some firms go above and beyond those normal type procedures that we do, and should we bake those in and codify those into the standards.

So I think there's a real opportunity there. We are supportive of more guidance or more requirements even around what we should be doing at that level to improve our performance as it relates to noncompliance.

Where we really struggle is when, you know, some of the words in the standard around, you know, I'll keep going back to preventing, that's just one of the words. But where our responsibilities then move well beyond what we are asked to do right now.

And again, I just think that do investors really want us checking to make sure the company's process will -- the OSHA warnings on the break room walls, is that what we should be doing because that's the path that the standard is heading us down versus, you know, strengthening those procedures that we were just talking about. We are fully supportive of trying to codify and strengthen those.

MS. VANICH: Thank you, Mr. Peo. I see two hands up, so let me go to -- I think Doug might have had his hand up first, and then Sandy.

MR. CARMICHAEL: Yes. I'd just like to comment on a few things. The direct versus indirect is in other places, but that's I think only because in those other places, they had no choice. That was the auditing standard at the time, so there was nothing else to use unless you know, Congress was going to set its own standards, and they wouldn't do that. So the fact that it's in 10 Cap A, and there are other references as well, I don't think is significant.

I think the standards should put more emphasis on the risk of material misstatement.

But you must get into reasonably possible then if you do it, and risk of material misstatement is typically defined as the likelihood is reasonably possible, and the magnitude, which is the same as materiality. So although there could be more references in the standard to the risk material in the statement, I don't think it's separable from that reasonably possible and material threshold.

A lot of work was done in ICFR already, and I did want to mention that. In the control -- understanding and testing the controlled environment and management's risk assessment process, and the aspects of the information system that capture events other than transactions for a presentation in the financial statements.

And finally, and a lot of the work that's done in the fraud detection area would certainly apply. Some illegal acts are intentional and some are unintentional. If they're intentional, that's fraud. If they're unintentional, that's an error.

And I did not want to leave without pointing to the confusion in the standard itself. It wasn't intended that way. But the standard effectively says if it has a direct effect on the determination of financial statement amounts, it omits disclosure, which is probably the biggest item. You can't omit disclosure from financial reporting, and the standard certainly does as it written now.

But it says in effect, if it has a direct effect on the determination of financial statement amount, then you look at other auditing standards. Not this standard. And if it's one of those other violations of laws and regulations, if it has an indirect effect, that's what this standard applies to. And most people, including auditors don't really understand that.

And that because the standard itself says, well, after explaining direct and indirect, it says effectively here and after we're going to call indirect just illegal acts. So when people talk about the responsibility for illegal acts, it's really only indirect. But I think you should jettison that distinction as I made clear before.

MS. VANICH: Thank you, Mr. Carmichael. Mr. Owens.

MR. OWENS: Yes. Thank you, Barb. I think the last thing here that I really wanted to touch upon is that what I'm hearing from the number of procedures that are being listed here, those procedures are really about informing the auditor's risk assessment, continuing to build awareness of noncompliance that has occurred in the organization, right?

So we're inquiring with management to understand kind of where they see the risks of material misstatement related to noncompliance with their financial statements, whether or not noncompliance has occurred, how they think about that, we're looking for board minutes to see if there's things there that are being reported that are indicators of noncompliance and things that could potentially impact the financial statements as well.

And so as I think about the procedures, and maybe, you know, where I'm hearing the dialogue going, it's really about continuing to strengthen those auditor procedures of run the risk assessment to inform where that risk of material misstatement lies within the financial statements, due to noncompliance.

And so when I think about it in that lens, and thinking about the direct and indirect, I do believe that how we think about the risk of material misstatement related to those items that directly impact the financial statements may still benefit from a concept of thinking about whether or not there is a direct impact to the financial statements from the law and reg, or whether or not you might be a step removed from the financial statements meaning that you're thinking about it from a loss contingency perspective.

So I do think that distinction still

might help in practice from the perspective of the risk assessment. But I don't know once the auditor the identifies a risk of material misstatement, there's any further distinguishing, call it procedures, because now you have that risk and now the auditors going to respond to that risk.

MS. VANICH: Thank you. Let's here from Ms. Peters, and then Mr. Bell, and then Mr. Turner. You're on mute.

MS. PETERS: Sorry. I think we're using the term direct and indirect, like we all have the same understanding of what that means, right, because the moment a law or violation is -- or a law or regulation is violated, there's a potential contingency, right, and it becomes direct, right?

And so it's sort of a, you know, to me, it's a false distinction, right? And there are degradations of that, but that, you know, there may be disclosures and there may be contingencies that need to be recognized.

But from an investor perspective, they care about the ones that are going to relate to a material misstatement of the financial statements. So not hanging the OSHA thing in the break room is sort of -- it's a, you know, it's sort of a red herring or a lost leader in this whole conversation in the sense of that's certainly not what investors want.

They're worried about the risk of the material misstatement of the financial statements, and they're caught off guard by the fact that these things happen, and they go from being indirect to a very large direct effect on the financial statements. And certainly, the auditors can't prevent that. But it's really understanding the business and the potential for those events that could have an impact on the financial statements.

And, you know, I think what investors are -- what investors question is is that when these things come out, they've been going on for quite some time, right? It's just that they've become a big deal -- a big deal all of a sudden.

So I think, you know, I think that as we continue to discuss this standard and the need to revise it, because I think there is absolutely no question that there needs to be something done here. The question is the language related to it that we sort of have to set aside the every law and regulation urban legend, and we have to set aside that investors want management to do something that -- or aside from what management's doing, or step in the shoes of management, right?

And really think about how we get to I think as Kyle said, making better risk assessments of noncompliance and laws and regulations that can have a material impact on the financial statements whether they be direct or indirect. And I almost think we have to take that language out of our lexicon because I think it's anchoring us to the past when there's a whole lot of laws and regulations, Sarbanes-Oxley, 10A that have happened since this was written.

MS. VANICH: Thank you, Ms. Peters. Mr. Turner, Mr. Croteau, and then I don't think we've called on Mr. Coates. And I think that will probably bring us up to time.

MR. BELL: Yeah. I think you skipped over me. This is Mr. Bell.

MS. VANICH: Thank you. Mr. Bell, did you have -- go ahead, please. You had your hand up.

MR. BELL: Sure. Yeah. Coming back to the topic of direct and indirect, I think the distinction between the two on the determination of the financial statement in the current standard is useful for auditors to prioritize and manage resources and the procedures that are applied in an audit. There may be better terms, but I think the concept is right, and that is to try to focus on the risk of misstatement.

And I would also say that while it's true that indirect laws and regulations can result in material misstatements, it's also true that direct laws and regulations generally have a higher likelihood of resulting in a material misstatement. So I think some type of distinction and prioritization is important, particularly for industries that are highly regulated.

MS. PETERS: Can I just -- can I agree with you on that. I don't mean to --

MR. BELL: Sure.

MS. PETERS: -- interrupt. But I completely agree with you. But I think the distinction is being used to indicate the relationship with the financial statements, not the relationship related to the risk of material misstatement.

So I agree with you and in our comment letter, we made that point. But as I hear the conversation, we're using it in its direct connection to the financial statements, not in its direct connection to the risk of material misstatement. So I just wanted --

MR. BELL: I --

MS. PETERS: -- to agree with you.

MR. BELL: Yeah. I absolutely agree. I think the focus should be on the risk of material misstatement.

MS. PETERS: Great.

MR. BELL: And just to give context within the insurance industry as far as what we have to track on this topic. During last year we tracked over 5,100changes in general insurance laws, regulations, bulletins, and circular letters in the 50 states alone.

And so that's just general insurance regulation and laws. It does not include the laws that cover for regulatory financial reporting, related cap requirements. And then there's also other types of laws and regulations that we track that impact human resources, employment tax, SEC-related matters. So I think it's helpful from the auditor's perspective to have some type of distinction to prioritize the risk.

MS. VANICH: Thank you, Mr. Bell. Mr. Turner, and then Mr. Croteau.

MR. TURNER: The indirect notion, Doug was right about this. When it was originally put in the standard back in '76, first part of '77, it came out of hearings on the profession at the time because of illegal acts and bribes, and payments from the Watergate scandal days. And the profession didn't have any standard. Congress held hearings, and so the profession adopted something. But the indirect was to limit their exposure and what they had to do.

And as the standard said, on indirect, you only have to do something if it comes to your attention. If it doesn't come to your attention, for all practical purposes, you didn't have to do anything. You might get a letter or whatever at that point in time.

And we've moved well beyond that since that point in time with systems, with processes, and quite frankly, society expects more. And the uproar got to almost a rabid level when Wells Fargo blew up, and we can't afford to have any more Wells Fargos. That was the situation of indirect being improperly applied.

The focus has to get pulled off of whether it's indirect or not. It has to be on are you making -- are you being exposed to a material misstatement in those financial statements disclosure number or otherwise. And your procedures have to be focused on that.

Auditors themselves don't understand the difference between indirect and direct. I could give you a list of 20 things, give them to auditors, have them take a test as to which was direct and indirect, and heck, at least half would flunk. And so it's confusing. Sandy talks about confusing to the investors.

I'm not sure the investors -- investors have a reasonable expectation that the auditor will perform the audit to detect material errors and fraud by whatever purpose. And that they have that understanding because that's what the auditor tells them in the audit report.

So the notion that there's an indirect or direct notion, auditors don't ever see -- or I mean investors don't ever see most of them, you know, 99 percent wouldn't have a clue as to what you're talking about. And again, I don't think a lot of auditors have a clear understanding as well with respect to that.

So I think moving the attention totally off that, back on to what the auditor's real obligation is will get them focused on the risk of the material misstatements. And the notion of an OSHA notice in the breakroom in the ridiculous. I mean that's not what the standard says. The standard doesn't say you can't rely on management's stuff.

The standard doesn't say you have to be attorney. In fact, it says use the specialists, a lawyer is a specialist, as we do in other situations. So some of these accusations about where the standard takes, I'd ask you to point me to the words because the words just aren't in that standard.

MS. VANICH: Thank you, Mr. Turner. I know Mr. Martin said he had to drop off.

Anything you want to add before you leave, Mr. Martin? Thank you. Mr. Croteau, and then I want to make sure I hear from Mr. Coates since we haven't talked to him in this round.

MR. CROTEAU: Okay. Thanks, Barb. It's an interesting discussion on 10 Cap A, direct, indirect. I mean, you know, my former life at the SEC for a number of years, I used to come in on Monday mornings and the fax machine would be beeping, and I'd put paper in, and we received 10 Cap A letters through the fax machine that would come through from the weekend. And there's a lot that has served us well.

Again, I think there's a bit of a lightning rod here. But I don't want people to go away confused because I don't think it's that hard relative to direct and indirect. So that others can get the test right in the future, that might not today, if it's direct, it relates to particular accounts and disclosures in the accounting in those accounts and disclosures. If it's indirect, we're talking about potential loss contingencies and accruals.

And I don't think that that's confusing. I think it's actually helpful to have a distinction. But as I've said at the outset, it seems like it's a lightning rod, and it seems like people would rather not talk about it. And I'm fine with that other than 10 cap A where we have to obviously apply it.

But I think what you could almost do, Barb, is, look, the direct stuff is stuff that, again, tax law and pension, that's covered by reasonable assurance. You could almost forget that that exists and we'll deal with 10 Cap A, and then focus the discussion only on everything else here because all the rest is indirect.

And then it's what do we do around all of the rest? And I think that's the discussion we're trying to have here today. I don't think anybody's debating about what we should do around the stuff that's direct today where we already have reasonable assurance.

So you could do away with that

distinction, certainly at least in this discussion, and it won't change a single thing. But we still have to resolve how much work do we do over identification, and it sounds like there's a lot of consensus that we can look to what companies are doing, and we think about what we know about the industry, the geography, lots of things about the company in thinking about completeness. But it's not going all the way to identifying every possible law and reg.

And then what do we do -- what a few people have talked about today is what do we do about detection. And I think what we're coalescing around is a lot of discussion around the procedures auditors perform including those that Christian rattled off, and I rattled off some on the inquiries we make, the correspondence we review, the legal fees that we look to, and others.

And when you start to look at that relative to potential detection, I think that's what is reasonable. It's what we do in practice in many cases today, although like Christian, I'm happy to do more as long as we go through the right cost benefit analysis, and think through the extent of it and it passes that test, which I think there's room for some more.

But I think it just needs to be very clear what's not expected as well because -- and to Sandy's point, some transparency around that because we will create an expectation gap that in hindsight, we were able -- or should have either detected an illegal act that, you know, we wouldn't have had the ability to know. Or that we prevent it in some way, which goes to what Lynn's describing.

I mean to say that we can't have another, and, you know, another example of some large company that's had reputational failure or reputational harm, significant reputational harm, auditors cannot stop that. If a company or management -- if management wants to commit an illegal act or unknowingly does so, we're not going to be able to necessarily stop that.

Again, there may be an indirect and I see Sandy shaking her head, right? Like there may be an indirect consequence of this that's of benefit, but that can't be the obligation of the auditor. So, anyway, hopefully that helps.

MS. VANICH: Thank you very much. Mr. Coates, and then we'll wrap up with Mr. Carmichael.

MR. COATES: Sure. I generally echo the view that the direct/indirect is more of a confusion than it is a real distinction that needs to either be preserved or changed. I think it would be helpful if, in whatever final version of the document that will be standing there for the world to read, that is unpacked a little bit because I think non -- people who are not inside the audit world who are both in favor of eliminating the direct reference or against eliminating the direct reference, both ends of the spectrum currently in the comment letters are exhibiting confusion relative to this discussion.

So I think unpacking it and making it

clear that an auditor has a defense, it was only indirect so we did nothing. And it's also true that if it's direct in a conventional sense, a tax accrual or what have you, that they kind of have no ability to avoid being directly engaged in assessing the calculation involved and the basis for it.

I want to put one little note of hesitancy on prioritization here because you could imagine, I think not implausibly, a tax accrual that's pretty small where the amount of work you want the auditor to do is pretty small, and you could have a loss contingency assessment that could swallow the company if they don't have any FCPA compliance work at all, and the auditor knows that. So like prioritization doesn't completely track direct or indirect I don't think.

And let me end with just one note on prevention because it has come up a few times. I'm sure it'll come again later. It's absolutely right that I don't think it makes sense to write anything that implies auditors or guarantors are ultimately contingently liable for the non-compliance of their audit clients. If that's what I hear Brian worrying about, I'm with you.

But, in fact, auditors do prevent law breaking. And the way they do it, for example, and this is a real example based on a real matter I was involved in, is where a financial institution had law breaking occur. It was a minor amount, and it didn't get noticed, for perfectly understandable reasons, and probably no one would have wanted the company to invest, you know, in a system that would have detected it initially.

But what then happened was it accumulated over 20 years across multiple counterparties and aggregated to hundreds of millions of dollars, right? And along the way, that company did not recognize clear internal reports, complaints, indications that employees were aware of the problem. So what became a minor, inadvertent mistake turned into fraud.

And the auditors had an opportunity repeatedly in principle during that multiyear process to ask management questions about whether they -- how and when they were taking account of the internal reports and/or not accelerating and addressing it.

And again, I wouldn't want to be heard to say the auditor ought to bear culpability necessarily. But it's just the kind of example where prevention actually can happen. It can be very useful for the company and for its investors. And it's something I don't want to get lost in the sort of simple idea that you're out there stopping the, you know, the pollution from going in the river, like of course, not. But this other more system-based way of actually preventing things is a more realistic thing for the bigger companies with very good compliance functions. I'll stop.

MS. VANICH: Thank you. Brian, did you want to respond to that quickly before we move to Doug. I know we're now starting to get way behind.

MR. CROTEAU: Yeah. Just really quick, and I appreciate the acknowledgement that, you know, we're not stopping things from being dumped in the river, and there are limitations. And I completely agree. There can be an indirect preventive benefit here.

And I also just wanted to comment that we today under 10A have obligations. We make the inquiries we make, and we have obligations if we become aware of an illegal act to report that appropriately, and all the way up to the SEC if the right things are not done from a management and audit committee perspective.

I have no problem with further articulating that or reinforcing that. And from time to time, that's been reinforced, including when I was in my old role at the SEC. I think that's fine. And I think that's consistent with what John said. But I think the distinction between all of that and otherwise being in a role of preventing are two different things, and in a role of detecting, there's limitations to how far we can go reasonably without conducting a compliance audit.

MS. VANICH: Thank you, Mr. Croteau. Final words, Mr. Carmichael.

MR. CARMICHAEL: Yeah. I just wanted to point out that the standard as it is refers to a direct effect on material financial statement. Determination of material financial statement amounts does not include disclosures. I don't know what direct effect on disclosures might actually be, but it's not in the standard.

I apologize if we're going to talk about this more later, but I think there are frameworks in the standards for things that are difficult and complex like related parties and going concern. And related parties take, say, what I call a risk of material misstatement approach which, of course, they're always, but it seems to emphasize those things because of the difficulty in knowing all related parties.

And I put the going concern in the

must evaluate category. That is you have a whole bunch of procedures that are ordinarily part of the audit that we've mentioned like reading minutes, getting lawyer's letters, and that kind of thing. And it's that the auditor is directed to have -- a requirement to having to evaluate all those things to consider them. So those are other possible frameworks. I would lean towards risk of material misstatement approach used in related parties. But I think those are some things to consider as well.

MS. VANICH: Thank you, Mr. Carmichael. And thank you, everyone, for all your input. It's just really invaluable to us. Please feel free to submit any additional comments on these topics or others to the comment file.

For the general public, this concludes our first panel of the day. We will reconvene at 12:30 p.m. Again, I can't thank our panelists enough for participating and sharing your views. And thank you to those of you who have joined us online today, and we'll see you at 12:30 on the same link. Thanks so much, everyone.

(Whereupon, the above-entitled matter went off the record at 11:45 a.m. and resumed at 12:30 p.m.)

MS. VANICH: Welcome back, everyone.

I'm Barbara Vanich, Chief Auditor and Director of Professional Standards at the PCAOB. I'm joined today by Martin Schmalz, Chief Economist and Director of our Office of Economic and Risk Analysis. And it's our pleasure to be with you today.

Martin and I are joined by Karthik Ramanna. Karthik is a Professor of Business and Public Policy at the University of Oxford's Blavatnik School of Government. Karthik, when we're very lucky to have him, has taken a partial public service leave to advise the PCAOB.

We would like to welcome you back to the second session of the staff-hosted Roundtable on the Auditor's Responsibility for a Company's Noncompliance with Laws and Regulations.

We want to welcome our panelists, Board members, and the public watching this meeting.

Before we get started, I'll give the disclaimer for myself, Martin, and Karthik, that our views are our own and don't necessarily reflect the views of the Board, its members, or staff.

We would also like to remind those listening that the comment period is open until March 18th, 2024. We welcome all comments. We are particularly interested in substantive comments from the public concerning the roundtable topics and any points raised during the roundtable.

Back on June 6th, 2023, the PCAOB proposed amendments to PCAOB auditing standards related to a company's noncompliance with laws and regulations. The PCAOB received over 140 comment letters on the proposal. From those comment letters, the staff have identified several topics for which we believe additional information would be helpful in developing our recommendation for the Board.

This morning we heard our first panel on identification of laws and regulations. This afternoon we're going to hear from two more panels. The second panel goes from 12:30 to 2:30, and we'll talk about the assessment of noncompliance in laws and regulations, and from 3:00 to 5:00, we'll have our panel on the economic impact of the proposed standard.

The purpose of our roundtable is for the staff to obtain the perspectives of our panelists on specific aspects of the proposal that was issued in June. Additional background information on the topics and questions to be covered is available in the staff briefing document, which is available on the PCAOB's website.

Martin, Karthik, and I are here to listen. We will direct specific questions to our panelists in order to inform our efforts, but we do want to hear from all panelists who wish to speak on each topic and encourage open dialog within the time allotted.

As a reminder, if you would like to say something, please raise your hand using the Raise Your Hand function. Certainly, if that's not working, just type something in the chat. In the event you have any technical difficulties, please contact Brian Goodnough.

Thank you. Thank you for that.

A note to those watching online: panelists were asked to submit any new data or analysis that they planned to talk about today into the comment file ahead of today's meeting.

To ensure that everyone has time to speak, we won't be accommodating slide presentations from individual panelists, but we encourage panelists to refer to any submissions.

Those watching online can find those submissions easily by going to our website, clicking on the Event page that appears on the Home page, and then, selecting the Comment File option on the right-hand side of the screen. The most recent submissions are at the bottom of the page.

With that, let's get started on our second panel on considerations for an auditor's assessment of noncompliance and other legal considerations.

And we're going to organize this discussion into two topics. The first one is the competence to assessment relevant noncompliance with laws and regulations, and topic two is concerns raised by commenters regarding potential waiver of attorney-client privilege.

Our distinguished panelists include today:

Doug Carmichael, who is a Clare and Eli Mason Professor, Baruch College, Columbia University of New York.

John Coates, John F. Cogan, Jr., Professor of Law and Economics at Harvard Law School.

Emily Fitts, Partner at Deloitte & Touche.

I believe that Robert J. Jackson -- we hope that he's able to join us. He had to step away.

Josh Jones, the Americas Director of Audit and Chief Auditor at Ernst & Young.

Carole McNees, Director of Quality Management, Ethics and Assurance Policy at Plante Moran.

Lynn Turner, Senior Advisor, Hemming Morse.

And Alan J. Wilson, Partner at WilmerHale and the Chair of the Law and Accounting Committee of the American Bar Association Business Law Section.

You can find bios for each panelist on the PCAOB website.

So, let's dive into topic one, which is the competence to assess relevant noncompliance with laws and regulations.

So, the proposed requirement for the auditor to obtain an understanding of nature and circumstances of any noncompliance with laws and regulations that the auditor identifies or otherwise becomes aware of that has or may have occurred is similar to the requirement under existing PCAOB Auditing Standard 2405, paragraph 10.

The current standard requires the auditor to obtain an understanding of the nature of an illegal act and the circumstances in which it occurs when the auditor becomes aware of information concerning a possible illegal act.

The proposed requirement for the auditor to determine whether under any such circumstances noncompliance likely occurred is consistent with the requirement under Section 10A. Specifically, Section 10A(b)(1) of the Exchange Act requires that, if in the course of conducting an audit a registered public audit firm detects or otherwise becomes aware of information indicating that an illegal act, whether or not perceived to have a material effect on the financial statements of the issuer, has or may have occurred, the firm shall, in accordance with Generally Accepted Auditing Standards, determine whether it is likely an illegal act occurred.

As part of evaluating information indicating noncompliance has or may have occurred, the proposal requires the auditor to consider whether specialized skill or knowledge is needed to assist the auditor with such evaluation.

Let me turn to our first question which is: how are auditors currently complying with the existing requirements of 10A(b)(1)(A)(i), which requires auditors to determine whether it is likely that an illegal act has occurred when the first detects or otherwise becomes aware of information indicating that an illegal act has occurred?

Let's start with our audit firm representatives in the order of Mr. Jones, Ms. Fitts, and Ms. McNees.

MR. JONES: Thanks. Thanks, Barb.

I appreciate that, and I'm, obviously,

happy to talk through that first question and just to say overall thanks again to the PCAOB for hosting this roundtable.

I think venues like this are, and I found the discussion this morning, extremely productive and useful. And we appreciate the opportunity to be a part of the session today.

I mean, as it relates to the question you asked, when auditors become aware of possible instances of noncompliance, either through things like the performance of procedures designed specifically to identify them or, as we discussed, as was discussed at length this morning, through the performance of other procedures, such as inquiries; review of regulatory reports; you know, interactions with companies' legal counsel, and things like that, when matters come to our attention, I think, obviously, as you mentioned, Section 10A requires us to evaluate whether it's likely an illegal act has occurred and evaluate the impact on the financial statements.

And as part of executing that on that requirement, I think the first set of procedures we do really gets around understanding the nature of the allegation or the act, which includes understanding the circumstances in which it occurred; the nature of the allegation; the nature of the underlying law or regulation that was in play there; evaluating things like, you know, does it represent a single event? Or has it happened multiple times, or some pattern in the way the company might operate?

Does it relate to a current event? Or has it related to past events? Where in the company's geography has it happened and where might it be susceptible to happening, despite not having necessarily initial evidence to indicate otherwise?

All of those are intended to help evaluate the potential for whether an illegal act or noncompliance occurred, as well as evaluating the potential magnitude for the purposes of evaluating the impact on the financial statements.

And auditors will engage in terms of executing on those procedures. Auditors will inquire of management, have discussions with management; often, will engage with or consult with companies' legal counsel, internal and external, as well as any specialists that the company may have engaged.

And frequently, in most cases auditors will involve specialists to help evaluate all of those matters I mentioned for the purposes of evaluating the potential ramifications on the financial statements.

And so, I think that, and then, obviously, depending on the results of all of that, obviously, it's important for the auditor to make sure the audit committee is appropriately aware of those matters.

But I think one other thing -- and I think all of those procedures, as outlined as you mentioned, both in today, as outlined in the extant standard, quite frankly, as put forth in the PCAOB's proposal, I think are common things and expected things for audit firms to do today, when executing on that requirement.

And I think reflecting on our comment letter on the proposal, I don't think we raised a lot of issues with those expectations. I think, really, kind of one of the things that really impacted our appreciation for what's expected there, it gets back a little bit to the discussion that was had this morning, which really speaks to the extent of procedures expected of auditors to address the risk of material misstatement of noncompliance on the financial statements.

And I certainly don't want to rehash the very helpful discussion this morning, but the one thing I wanted to at least add to that is, you know, when you think about that risk of material misstatement, I do think it's helpful to break it down maybe to its components. And the first is the risk that noncompliance happened and was not detected, and as a result, wasn't appropriately considered for evaluation in the financial statements.

And when you think about that risk in the context of laws and regs that have an indirect effect on the financial statements, it creates unique challenges relative to other assertions in the financial statements where you're evaluating whether you're appointing reasonable assurance to performance of audit procedures, that they are presented fairly in accordance with GAAP.

And ultimately, the expectations of the auditor on performing risk assessments to evaluate the likelihood that the company's compliance programs would not identify noncompliance, potentially, and how they would evaluate that. Ultimately, that is I think where a lot of the concerns were in the context of, obviously, the proposal around the nature and extent of procedures that would be requested of the auditors, which could highlight additional areas that need to be evaluated for potential at maybe a level that was in advance of where the company would have otherwise been in their process.

And so, that's, I think, ultimately, how you peel that risk back to its components. It really is one of the primary areas, I think, as was discussed this morning, we've been concerned about in terms of how you address that risk and what is an acceptable amount of risk assessment evidence around the company's programs, as well as how you might address, ultimately, the risk to the financial statements of matters that may not have been detected; and therefore, not considered appropriately in the financial statements.

MS. VANICH: Thank you, Mr. Jones.

Ms. Fitts, would you go ahead and comment next?

MS. FITTS: And first, I'd like to thank the PCAOB staff for hosting today's roundtable on this really important standard-setting project. And I appreciate the opportunity to participate in this panel.

As Josh said, as auditors, when we become aware of information indicating an illegal act has or may have occurred, we generally approach our work around the illegal act in a multifaceted way.

We gather the facts. We understand and assess management and the audit committee's processes and approach, and we develop a planned approach to respond.

Now, an important distinction between the current 10A requirements and the PCAOB proposal is that the auditor would now be required to find all illegal acts, which was discussed on the earlier panel, which moves us more towards a compliance audit.

The proposal also removes critical parameters and acknowledgments from AS 2405 that provide context regarding the auditor's roles and responsibilities and extent of legal expertise.

Now, based on my reading of the proposed requirements, the auditor would now be required to perform an independent evaluation of NOCLAR and make a definitive conclusion regarding noncompliance. And in order to be able to make the definitive conclusion, the auditor will likely need to engage legal counsel and other specialists to assist the auditor. And involving legal counsel in every audit would be time-consuming, expensive, and inoperable.

And this would be very different from what we do today. In practice today, and consistent with today's standards, our actions and conclusions as to whether or not it is likely that an illegal act has occurred would very much be premised upon, and grounded in, the actions of management and those charged with governance. It would not include a definitive, independent judgment.

I'm concerned that the proposed requirements are calling for auditors' performance of a management function which would be inconsistent with prevailing rules addressing prohibited non-audit services. And I'm also concerned that it could be seen as the unauthorized practice of law.

MS. VANICH: Thank you, Ms. Fitts. I do want to get to Ms. McNees before we call on Doug. I will say that the proposal, I appreciate that's the way you're saying you're reading it, but that certainly wasn't the intention, to have an auditor to do an independent evaluation of each possible event.

Ms. McNees, who joins us from a smaller firm, would you like to add any perspective to that?

MS. McNEES: Yes, thank you. I also would like to start by thanking the PCAOB for their efforts in doing this outreach and appreciate the opportunity to be included in this roundtable.

I'll just try to incrementally add. I think the general description Josh and Emily provided on the auditor's response I would agree with. So, I'll try to not repeat those items.

But I want to maybe just speak

specifically, because we're in this -- topic one is really addressing competence. And so, I just want to speak kind of specific to what's required in that evaluation and share that I think it, obviously, depends on the nature of the noncompliance item identified. To the extent the matter identified is more closely related to financial reporting, those are going to tend to be items that the auditor is more equipped to evaluate whether or not compliance actually has occurred.

The further that deviates from that proximity to financial reporting, and particularly, as it might get into more operational or technical types of laws and regulations, that would be where it would be more likely that the auditor would require additional assistance from a competence standpoint; i.e., engaging specialists to assist with that evaluation of even determining whether noncompliance has, in fact, occurred.

So, that, understandably, is the

current requirement under 10A. That is the paragraph referenced there. I think if I think about how that relates to the proposed standard, and any differences there, I think it does come back to some of that scope discussion that was largely the topic of Panel I, and the extent to which the scope of what items we are required to seek out and try to find versus matters that come to our attention will play a significant role in the degree to which we have to engage specialists to evaluate those matters.

MS. VANICH: Thank you so much.

I was, next, going to turn to Mr. Carmichael and Mr. Turner. I see Mr. Carmichael has his hand up. So, Mr. Carmichael?

You're on mute. I still can't hear you. Maybe it's a technical issue.

There it goes.

MR. CARMICHAEL: Very good. Sorry.

The comments remind me of what was said in the beginning when the fraud law and standards were being changed; that if the auditor has a responsibility to detect fraud, they would have to detect all fraud. They'll have to look at every transaction. They'll have to make a legal judgment about whether it's under the legal standards, in fact, of fraud.

And all that has been dealt with in the auditing standard on fraud detection. And I think it would be equally easy to deal with adherence. It's just an immediate reaction.

It's a bit like, it reminds me of the reaction when the requirements for auditing ICFR first went into effect. It was as if the auditors were saying, well, we have to audit every control and test every control, because we're not giving an opinion on it.

It seems like auditors lost the notion that they are always applying in their audit an evaluation of the risk of material misstatement, and it can be applied in the same way here. I think it would be useful to look at some of the areas in which auditors always deal with something like environmental liabilities, where audit programs typically do include more procedures to try to detect environmental violations and pursuing the correct accounting for environmental remediation liabilities.

So, it's really not that different from problems that have been dealt with before, but because it's something new, it's being reacted to again as if this was not similar to fraud detection, which it is, or similar to dealing with litigation.

And this shades a bit into the next topic on attorney-client privilege, and so on, and the treaty that was reached back between the AICPA and the lawyers' associations on dealing with litigation.

It's not that different. It's not that difficult.

MS. VANICH: Mr. Turner?

MR. TURNER: Thank you, Barb.

I would agree with what Doug said. And I'm curious. Emily made two statements: that it would require all, quote, "all illegal acts to be identified by the auditors," and two, "require an independent evaluation in every audit, resulting in a compliance audit."

Emily, can you point me to the paragraphs in the proposed standard where it says that language?

I'll be honest with you. I've looked through it many, many times. I can't find that language in there. And if you think it does exist, it would be most helpful if you would send in a follow-on comment letter that we could all read that identifies where that specific language is there. Because I don't see it there.

As far as my experience, Barb, I think the auditor's practice is varied. I've seen some excellent situations where, when the auditors became aware of a problem, they did start asking, discussing it with the board, with the audit committee; started delving down into the issues.

In one situation involving Josh's firm, they actually resigned from the audit; did everything picture perfect. Information got filed to the public through a case, and did a wonderful, marvelous job.

I've also seen other situations where management actually advised the auditors of allegations of noncompliance/illegal acts. The controller had advised management of that. Management made the auditors aware of it, but, then, the auditors never followed up, never requested an interview of that auditor. And it blew up, and management ended up the subject of convictions by the Department of Justice, and notification to the share owners was delayed.

So, I've seen a range, but sitting on some of these investigations, sitting on arbitration boards that heard some of these, my experience is it's all the way across the spectrum from one end to another.

Probably in the better ones that have better outcomes the auditors did request the company to have an investigation. In some cases, they let the company do it. In other cases, they requested that an independent counsel be brought in and look at it.

My experience has been, in general, that the auditors do not make findings of law, if you will. And, in fact, our standards say we cannot make a determination as to whether fraud has or doesn't exist. That's not acceptable as a professional auditor.

But we do reach out, firms do reach out and use lawyers as the specialists in litigation, NOCLAR-type matters, just as they do for the normal letters that each auditor gets in each audit, discussing the litigation-type stuff.

So, just kind of my experience.

MS. VANICH: Thank you, Mr. Turner.

Before we go to Mr. Coates, Mr. Jones, you had your hand up first.

MR. JONES: Lynn, I appreciate the comment. I think you made it earlier, too, around how we're getting to some of the concerns raised around the standard. So, I thought I'd maybe expand a little bit around what I said a few minutes ago.

And I guess, right now, the standard says the auditor performs risk assessment procedures and has to perform procedures to address the risk of misstatement of noncompliance.

And again, as you peel that risk of misstatement back, I think you have to think about what is the nature, timing, and extent of what's expected of the auditor to address that risk. And that risk necessarily, I guess based on our read of the standard, would include evaluating the risk that noncompliance occurred and was not detected, and therefore, not evaluated by the company to make sure its financial statements are fairly stated.

To understand that requires an evaluation, I think, of the company's compliance program and an evaluation of the scope of it; its policies and procedures; how it identifies noncompliance, and how it evaluates that; and consideration as to whether there's any, I'll call it, residual risk associated with that, that needs to be addressed directly through the performance of other audit procedures.

And I think that's where that interpretation is coming from, is: what are the expectations of the auditor in evaluating that risk of, I'll call it, undetected noncompliance? I think, look, once matters are detected -- and we do perform procedures; it's not about performing any procedures around indirect matters, and try to make the auditor aware of potential matters of noncompliance.

But once you set that risk of material misstatement and a lack of defining the expectations, which current standards do, I think that's where the concerns are raised around the extent to which you would have to evaluate the efficacy of the compliance programs and evaluate whether they have detected all instances of noncompliance that could reasonably have occurred.

And so, that's, for better, for worse, the direct/indirect dynamic today. It does allow for, I'll call it, an easier way to distinguish around the nature, timing, and extent of procedures that auditors might do to identify those things.

I think there are probably other ways to think about doing that, but that fundamentally is, I think, part of the concerns with the interpretation of the proposal, as written.

MR. TURNER: Barb, can I respond to Josh?

MS. VANICH: Sure. Sure.

MR. TURNER: Yes, I understand that, Josh, but the standard itself makes it very clear that the standard is based on an assessment of material risk, consistent, you know, with the current auditing standards that's been there for a while.

So, it's not assessing all illegal acts; it's assessing illegal acts that have a material effect on the financial statements. And I think we can say you need to assess all material misstatements as a result of NOCLAR, because, otherwise, you're leaving out some material misstatements of the financial statements, and you wouldn't have a basis for your opinion.

And it doesn't matter if there's material errors because of indirect/direct fraud errors, whatever. If the financial statements are materially misstated, numbers or disclosures, as the result of noncompliance, you all turn around and have an obligation to detect that. The federal courts have ruled that.

The standard turns around and says that, and there's no footnote to the opinion that says, in the line where you say you designed the audit to detect this stuff, that you detected everything but anything dealing with an indirect law.

So, to say that you're other than going to look at all material misstatements in the financial statements -- direct, indirect, or other matters -- would be, then, issuing a report that would be factually incorrect to the public.

And, you know, the courts have already ruled here recently that the public has questions about whether or not these audit reports provide material information in the first place. And we don't need to have that continuing out there. We need to make sure we have reports that the auditors can trust and rely upon.

MR. JONES: Yes, and I guess I'm not exactly saying what you articulated, other than you have to be in a position to understand where noncompliance may have occurred to evaluate whether the financial statements are fairly stated. And at least from my perspective, I think a lot of the concern is, what are the extent of procedures to identify where those potential instances may have occurred, so that you can make sure they are evaluated appropriately?

MR. TURNER: And I appreciate that, Rich. I would have the same concern and want to make sure that you get it right, just as you talked about, and as you guys did marvelously in the case I cited to.

MR. JONES: Yes.

MS. VANICH: Thank you.

Ms. Fitts?

MS. FITTS: And maybe, Lynn, just to respond to the point about where it is in the standard, as Josh articulated, it's really the starting point as it relates to that "could reasonably" threshold, and having to identify all the laws and regulations.

But, Lynn, as you pointed out, the current standards today do include parameters and acknowledgments regarding the scope of the auditor's obligations and our ability to make definitive judgments. In the proposal, all of that has been removed.

And so, the absence of that information in the proposal, coupled with several footnotes to paragraph 10 regarding the auditor's evaluation of noncompliance, leads us to interpret the standard, at least myself, that I need to now do an independent assessment.

So, you start with that much larger body of laws and regulations that I have, according to the standard, a detection requirement, as John highlighted, and then, it moves into what I am assessing. And again today, I assess all laws and regulations that have an instance of noncompliance, whether it's direct or indirect. I assess them very similarly as Carole and Josh indicated. That doesn't change.

But what the proposal did change is now I'm not starting with management; I'm performing an independent evaluation. And again, that's the removal of some of the parameters that exist, as well as some footnotes and information in the released text that ensures that --

MR. TURNER: Yes, but you may interpret it that way, Emily, but that language is not in there whatsoever. And I think that's a gross misstatement of what the Board has put out there. And quite frankly, it reminds me of Chicken Little running around, and quite frankly, that sky just doesn't fall.

MS. VANICH: Okay. Let's see. We have hands up from Mr. Carmichael, and then, Mr. Wilson, but I want to make sure we hear from Mr. Coates and Mr. Jackson on this point as well.

MR. CARMICHAEL: Okay. So, who did you want to go first?

MS. VANICH: Go ahead, Mr. Carmichael.

MR. CARMICHAEL: Okay. I wanted to point out that a definitive conclusion is certainly not necessary. We have accounting standards that deal with how loss contingencies are to be treated under GAAP, and it doesn't require a definitive conclusion.

Lawyers likely, when they are consulted, they are not going to have a definitive conclusion. It would have to relate to adjudication.

It's looking for whether a question has been raised. I think auditors in a specialized industry have plenty of knowledge about the legal environment laws or regulations, the ones that you could use a variety of words that actually mean the same thing, that are foundational, that are fundamental, that are basic to the operation of the business and its financial reporting -- things that would put the company out of business; things that are critical to its financial reporting.

Identifying risks in particular circumstances. Now, obviously, a company that is heavily engaged in merger and acquisition activity is going to have an increased risk of violating securities trading laws. So, it's applying knowing that the auditor has.

And maybe you can say a bit more, but I would caution again to not let all the protective litigation language that used to be in SASs, and that is in some of the current PCAOB standards that haven't been changed yet, don't let that creep back in. Focus on what the auditor is responsible for doing.

MS. VANICH: Thank you, Mr. Carmichael.

Mr. Wilson?

MR. WILSON: Thanks, everybody.

I think I just wanted to underscore the point that Josh and Emily made. As you think about the structure, I think, really, the question we're asking is just for additional clarity, as you think about the expectations of the auditor. And it's paired with the discussion we'll have later. So, I don't want to jump ahead too far.

But it's worth bearing in mind thinking about the attorney-client privilege and the basis of the treaty that's grounded in the accounting standards framework, and how we orient that with the auditing standard that's being proposed here, to better assimilate the two and ensure that we're not eclipsing the attorney-client privilege protections that have been in place for nearly 50 years with respect to the structure in which the auditors are to go about their audit.

So, I think we can talk about this further, but I just want to make sure we're not losing sight of that, as we think about the bigger picture focus that I think we're all trying to address here.

MS. VANICH: Yes, thank you. The privilege point is very important, and we will get to that topic, too.

Mr. Coates and Mr. Jackson, with your experience in corporate governance and reporting and communications between auditors and various legal groups, both inside and outside of a company, what is your assessment of how auditors are currently complying with requirements we pointed out?

MR. COATES: You'll start?

MR. JACKSON: No, John, go ahead. I'll follow you.

MR. COATES: Okay. So, let me just observe, in the language of the proposed statement, there's an objective section. And I'm going to exhibit a little empathy for Emily's take on this; that when you first read those objectives, they fairly could be seen as saying you have to find all the lawbreaking.

Now, I recognize they're objectives, and then, there's an immediate next section that talks about what you're actually supposed to do that, importantly, clarifies and limits the objectives.

But just with the objective of trying to be clear, you might think about how to make that more clear, that there's specific expectations without it necessarily leading you to think: and you have to fill out the rest of the space.

And I get your point, Lynn, that litigation protectiveness ought not to drive the crafting of the language, but I know enough plaintiff lawyers that I know, you know, they'll be reading this stuff. So, I do think it's a fair worry, that we need to be clear.

On the substantive question, I like the particular. I always like the particular better because I think, then, actually, it helps illuminate the general. And so, when you get to the independent items, making inquiries of management, the audit committee, internal audit personnel, and others, I would recommend there building out what I think I heard our auditor friends saying is beyond that, that they already do, and that in my experience, responsible auditors do already do.

So, compliance functions, where they exist, ought to be something that the auditors affirmatively should have a responsibility for understanding and making inquiries of with respect to a particular instance. Or, if there is no compliance function -- and there are some companies, public companies, still that do not have a compliance function. That I think should -- "should" -- alter the course of the audit work in light of that. And I think guidance on that point would be constructive.

So, where there is a compliance function, I don't think it makes any sense to ask the auditor to duplicate it in its entirety. I think we have consensus on that. It's just a question of being clear about it.

I do think there is a role for the auditor because compliance functions can be underresourced. They can be badly designed. They can themselves have scoped out things that are of evident importance, things that are (audio interference) of the compliance function in that company themselves may not have.

So, there are ways in which the audit assessment of compliance can add value in a constructive way that does not involve wasted cost.

When the compliance function is either inadequate or absent altogether, then, I think it's fair to ask whether -- to Lynn's original point -- the auditor needs to think harder about how they sign off at all. At the end of the day, if there is, as the best source of information, just casual interaction among employees that happens to bubble up, that, to me, puts pressure on -- in a heavily regulated industry at least -- where there are material penalties that could flow from noncompliance, whether, in fact, the audit can be one that you can sign off on.

And that's where the pain point is going to be greatest, I think, in practice. But I think it's a fair question for the Board to think about: how far do you effectively push auditors into pushing their clients to build out a compliance function?

I will say, 30 years ago, the world was different. The courts had not said boards have personal liability of they have no compliance system. They now have said that repeatedly over and over again.

And so, I don't actually think at the end of the day the direction I'm suggesting, this push, is going to be really fought by informed independent boards and audit committees. It's actually going to be embraced and intellectually reinforce complementary things that ought to be going on anyway within public company governance.

But I think that is the place where the (audio interference) --

MS. VANICH: Mr. Turner, if we could hear from Mr. Jackson first, and then I'll turn to you.

MR. TURNER: I'm trying to turn that off, actually.

MS. VANICH: Oh, okay. That's usually the problem I have.

Mr. Jackson?

It's off. Thank you.

MR. JACKSON: So, I just want to point out that one reason to have a roundtable like this one -- certainly, this was my experience at the SEC -- is so that, when a practitioner like Emily sits down and reads a document, and worries about a possible read, she can raise it and we can rule it out. And that's a very construction thing for a regulator to do in my experience.

I would not have taken that read of it, Emily, but, like John Coates, I have empathy for a cautious professional taking a look at something like that and saying, "Wow, what are my obligations?" -- and wanting to know more. That, I think, is why we're here.

And so, I would encourage the folks from the Board listening into the conversation to take away that possible reading and make clear that that's not what you have in mind.

And I want to be clear, once again, maybe the kind of optimism that comes from a naivete involving being appointed to the SEC, but, for me, I hear a lot of agreement on the call today about assessment. In particular, what I hear is that an auditor is entitled to begin with management's assessment and rely on the policies and procedures that exist for communications as between the various units in the business responsible for compliance, oversight, and other areas that touch compliance with law.

That is my understanding of how 10A is implemented in well-governed public companies. And I don't read anything in the current proposal that would require more auditors, except as John says, to update quite considerably the degree to which they scrutinize the policies and procedures that ensure that management is aware of issues around compliance with law.

I think John is right to point out the importance of that. Because anyone who has been watching Delaware law for the last couple of years will tell you that a board of directors needs to be aware of those kinds of questions, and the confidence about the policies and procedures that get that information to the board and to management is crucial to addressing that kind of litigation risk.

So, my own sense is that the existing procedures and practices that exist could easily be adapted to this context, and would be. I think the kind of reading that Emily's worried about, where an auditor is responsible for ensuring or separately determining compliance with law, again, it wouldn't be my read, but I don't think it's what the Board has in mind, and I think it can and should be ruled out, based on productive conversations like this one.

MS. VANICH: Thank you so much for that.

I want to make sure that we give adequate time to topic two. So, I'm already keenly aware that we're almost an hour into this conversation.

With that, can we talk about both questions two and three at the same time?

And I'm going to apologize to Brian Goodnough, who put together slides with questions individually.

So, I won't read the question, but if people could maybe respond to both questions two and three, and I'll go around similar to the first question.

Brian, if you want to put up question three for a moment for those watching?

So, these questions really focus on what happens once an auditor detects or otherwise becomes aware that an illegal act has or may have occurred, and then, really what the process is after that.

Mr. Jones, do you mind if we start with you again?

MR. JONES: Sure. Yes, sure, Barb.

I mean, I think, as it relates to question two, I think, to the point you raised, I guess when the auditor becomes aware of potential noncompliance, right, whether it's related to a direct law or indirect law, the objective of the evaluation, as we talked about before, is the same.

The nature of the auditor's procedures to evaluate whether or not compliance has occurred, and the expertise needed to make that evaluation, as well as the potential impact on the financial statements, those are often different in terms of their nature, largely due to the fact that, you know, auditors likely will need the expertise of specialists to help evaluate the nature of the matter; the relevant laws to help the auditor evaluate companies; the company's assessment of both the nature of the act, as well as the potential significance for the purposes of disclosure. So, I think, fundamentally, that, you know, while the nature of the procedures is somewhat different, the overall objective is, obviously, the same.

Question three spoke to or asked about the interaction between the auditor and those hire or employed by the company to perform an investigation. And so, I think, in all cases of potential noncompliance that's identified, I think, certainly, auditors will interact directly with management; frequently, with legal counsel, both internal and external. They will often interact with any specialists that management has engaged to help them evaluate both the nature of the act itself and the potential ramifications for that.

Oftentimes, what auditors will do, they will leverage, as I mentioned before, specialists to really help them understand and evaluate the nature of the companies; of the investigation; the information used; the considerations that they are making, as well as, essentially, help the auditor really assess kind of whether the results of the investigation are reasonable and are sufficient to help the auditor evaluate the ultimate conclusion of the matter on the financial statements.

And so, oftentimes, we will have interactions with that specialist and the attorneys. We will, to the extent there are interviews of parties, we will ask for verbal discussions with any attorneys that are engaged and the interview of witnesses. I know that was another question as well.

We, frequently, request to get summary memorandums prepared by the attorneys who participated in those discussions, really, for the purposes of helping inform whether we've obtained sufficient evidence to assess whether the management conclusion is reasonable, and whether the financial statements are fairly stated.

As I'm sure Alan will mention later, in some cases, the nature and extent of those interactions, there may be some tension around the nature of those, and whether that's going to put privilege at risk. But that is, ultimately, the auditors will, ultimately, need to satisfy themselves that they've got enough information around the facts, the investigation, and ultimately, the conclusion, to be able to satisfy themselves that they've obtained enough to evaluate the impact on the financial statements and judgments around the timing and nature of any disclosures.

And so, we work through those as necessary, and that can impact the level of depth of information we might get with respect to any witnesses or any other evidence that's identified as part of the investigation.

MS. VANICH: Thank you, Mr. Jones.

Ms. Fitts?

MS. FITTS: Thanks, Barb.

And maybe just to add onto what Josh said, you know, depending on the law or regulation, we do have a tailored response, and it's always based on the facts and circumstances of the situation.

But the one point I do want to quickly highlight -- because Josh did a really great job of explaining all the different things that we do for all laws and regulations when there's been an indication of noncompliance -- is that I do want to highlight that not all noncompliance with laws and regulations will result in a fine and penalty, or result in disclosure in the financial statements.

And this is the case for both direct laws and indirect laws. Because, today, loss contingencies are recognized in the financial statements when the loss is probable and the amount is reasonably estimated, has a reasonable estimation.

And then, there's also disclosures related to when it's reasonably possible that there's a loss contingency, but it's not probable. But if those are probable and that they're subject to reasonable -- they're not subject to reasonable estimation -- then those are disclosed. But it's important to remember that remote loss contingencies will neither be disclosed or recorded.

And while I heard on the first panel that there is a desire to have early detection and disclosure around reputational harm, potential stock price implications related to NOCLAR, I want to just say, I want reiterate again that not all NOCLARs have a financial statement impact, and that the audit is designed to provide reasonable assurance that the financial statements are free from material misstatement and based on those applicable financial reporting frameworks.

And the other discussion on the earlier panel as well about indirect laws being known by both auditors and management, and at some point, those becoming disclosed in the financial statements, again, that's where I think it's important to go back to ASC 450 and getting to that probable and reasonably estimable threshold, in order to have that loss contingency recorded.

So, I do think, if there is desire from investors to receive earlier information, that we need to look to the accounting standards, and potentially, there might be changes warranted there to have the disclosure recording of loss contingencies earlier for investors.

MS. VANICH: Thank you.

Ms. McNees?

MS. McNEES: Thank you.

So, I'll start by addressing question two, which is really kind of asking, is there a difference between our procedures with respect to direct versus indirect, once a potential noncompliance has been identified? And so, I think just a couple of points I'll add there on that are:

In evaluating whether, when faced with a knowledge of a potential noncompliance, and evaluating whether actual noncompliance has occurred, I think the more important factor is the nature of the subject matter versus whether it's direct or indirect. I think direct or indirect may have some influence on kind of where it impacts the financial statements, but the subject matter I think would more drive what the response is in terms of, particularly, the need to engage specialists or what our particular procedures would be.

But I do think the evaluation of the potential impact is different between direct and indirect, more likely because, when something is falling into an indirect category, the potential consequences of noncompliance are likely less known. They may be known. Maybe there are stated fines or things like that, but the fact that they may be subject to some ramifications from a regulator or other kind of legal ramifications, it may be more difficult to identify what is the financial impact of that when it's at that stage in the process.

On question three, then, kind of the extent to which the auditors would engage with those employed by management, I think Josh and Emily hit on this. But I would just maybe reiterate: we would, certainly, auditors would attempt to have as much access as possible to whatever management or those they employ. Whatever analysis or evaluation that they have done would absolutely be important, valuable information for us to obtain, subject to what we may have access to. And that gets into the privileged topic, which I know we're talking about in a little bit. So, we certainly would want to have as much access as possible and may or may not get it.

And then, there's a question in there that I just want to touch on about whether the auditors would be -- you know, the extent to which we would be involved in, say, planning management's response or management's investigation. And, of course, I'm sure that depends on a number of different things, but again, I think the less related to financial-statement-related noncompliance matters, I think the less likely that management would seek out the auditors' input on their response to their investigation.

So, if there's an OSHA violation or a food safety violation, or something like that, that management is investigating, it seems unlikely to me that they're engaging with their auditor to say, "Hey, how should we conduct this investigation?" So, I would expect that that would be unlikely.

MS. VANICH: Yes, sure. Thank you.

And before we turn to the attorneys, maybe they could weigh in on that. I mean, I don't think that we were trying to suggest with the question that the auditors would tell the company what to do, but more assessing what the company plans to do and whether that's sufficient for the auditor's needs to eventually opine on the financial statements.

If I could start with -- well, let me start with, before we turn to the attorneys, Mr. Turner or Mr. Carmichael, to see if you have anything on these two questions.

MR. CARMICHAEL: I can start.

One thing I would add is that the scope of how the investigation is going to be conducted and who is going to do it is, naturally and typically, the determination of the audit committee. And they will respond depending on the seriousness of the matter, and typically, do engage legal counsel. And legal counsel may decide to engage its own audit firm to assist in that.

So, I think the role of the audit committee there is extremely important, but, of course, the auditor needs to be satisfied with the result. But when the auditor has access to that information depends a lot on what the audit committee is going to do.

MS. VANICH: Thank you, Mr. Carmichael.

Mr. Turner?

I think you're muted.

MR. TURNER: This is a question I was

going to ask John and Rob earlier. Because auditors are kind of put in a real uncomfortable position at times because general counsel's job is to be an advocate for the corporation. He or she is going to be the person that has to defend the corporation if it's found that there is a breakage of the law. And so, as a result, you don't have an independent perspective coming from GC.

Another question also runs into external counsel, if external counsel is the typical counsel on retainage with the firm and providing services throughout the year. So, the auditor does face, I think, a very difficult question as to, do you want to request that an independent investigation be done?

And where that is done, certainly, my experience has been the auditors take a very important role in dictating what it will take to satisfy the auditor. What does it take to provide the auditor sufficient competent evidence that they can, then, feel good with whatever opinion they decide is appropriate to issue, given whatever the attorneys are telling them?

But I do think that the auditor is facing this question of, how far do I go in reliance on the policies and procedures, when it's not a situation that gives you pause to think about whether or not you're getting the correct information? Or what if it's a situation where you really think you need to go have the company retain independent counsel?

And in those situations, when that happens, I will tell you, typically, the auditors are tied at the hip to the attorneys, telling the attorneys what evidence they want to see; who they want to have interviewed, and are in that process from beginning to end, such that they don't get to the end of a process, and then, find out the attorneys -- or the auditors don't trust the process.

So, I've actually been involved in one investigation where a major law firm did an investigation, and at the end, one of the Big

Four Firms said, "We just don't trust your investigation," and asked the client to go get a second one, which turned out, by the way, to be substantially different in outcome from the first one, and the auditors had made the right call.

So again, there's kind of a spectrum. It depends upon the facts and circumstances, as do many of these legal questions. And it's specific to that case. And it's tough to generalize.

Probably good to provide some of the specifics that John suggested. It was good to hear John is not a principles-based guy; he likes his specifics.

(Laughter.)

So, at any rate, that would be my response to that. I would be interested if John or Rob have any thoughts on just how far the auditor can go in trusting counsel.

Actually, in the case I cited Josh's firm for, the counsels actually misled in-house, and outside misled the auditors.

And in the last couple of years, I was involved in another one where the attorneys misled, one might say, the auditors, as well as the regulators.

MS. VANICH: Thank you, Lynn. Go ahead if Rob or --

MR. JACKSON: I have a few thoughts, John. Do you want to go first?

MR. COATES: You start this time.

MR. JACKSON: Okay.

So, Lynn, it's a very good question and let's face it, it's very difficult to legislate in advance of the specifics of something that's so facts and circumstances heavy.

But like John, I like specifics because it tends to exclude general, and because it gives folks a sense for the regulators' expectations.

Let's start with the basic and obvious fact that the auditors responsibility is to ensure at least two things in this area.

And, the first is as you say, the policies and procedures that get information about non-compliance up to the senior management level.

But then there's a separate step, Lynn, and in my experience, this is a moment where an auditor has a lot of influence, and should and does right now. Which is the moment where management has to have a conversation with the board.

And for me, what's very important about ensuring policies and procedures, is ensuring that there is a way for the board to get access to the view, an independent view, about the company's compliance.

And one thing that's worried me from time to time is an auditor has said to me well, you know, they reported it to the board.

And I say, are you sure? And they say well, you know, we think so. They're supposed to. And my answer, Lynn, and I bet yours too, would be, that's not good enough.

No, no, at a minimum, the auditor has to ensure not only that there's a theoretical policy about board level reporting, but that there was a report and that the board is satisfied about the independence of the report that they got.

Now, we can talk further and in more detail John, maybe I'll let you say a little more about exactly how many levers the auditor should pull after that.

But I'll tell you one thing, Lynn, there are facts and circumstances where the kind of detailed influence you're talking about is appropriate.

One of them is when the auditor was given the impression that there was board level reporting, and it didn't happen.

Because here now, the auditor has some basis to worry about whether there's some lack of independence in the communication channel between management and the board.

And there I think, the board's

responsibilities would include things like advising about the nature of any investigation, and such.

But for me, there's a separate responsibility here not only for a general policies and procedures to get information up to senior management, but that crucial moment where information gets to the board, who are the fiduciaries, who are going to be held responsible as John says in some cases personally, if it turns out that they got incorrect or biased advice about compliance with law.

So, I would give the auditors a fair bit of responsibility over ensuring that that message has been received at the board level, too.

MR. COATES: Should I jump in now, Barb?

MS. VANICH: Please, please.

MR. COATES: Thanks, so --

(Simultaneous speaking.)

MR. TURNER: I wouldn't mind hearing

from Alan, too.

MS. VANICH: That's, fine, thank you. Alan, would you go next?

MR. COATES: I do believe principles. I've never understood any tag that either excludes principles or bright lines rules. No rules system I've ever been aware of works well with only one.

And so here, let me say at the risk of saying something slightly rude, in my experience, the audit profession is remarkably honest. Not always, but remarkably so.

But also sometimes it comes to rule following, or if there's a procedure and there's three things I check them off, and I do them, and then I'm not going to think about it. And that's the rudeness.

I think on this question, the board might think about a principle, which would get at some of the points that Lynn and Rob's sketch, which actually were embedded in what we heard from the audit firms, too, which is that the degree to which you rely on lawyers, or on in-house counsel, or the nature of the reliance, or the nature of the inquiry, is intensely fact specific.

And it requires inevitably, an assessment of the credibility of the people involved.

So, I would think that could be written down. It is appropriate for the auditors to rely on information derived from lawyers.

But in doing so, it is a professional obligation to make an independent assessment of the credibility of the sources of information.

And you could even go further and sketch some things that to go into that, like some obvious things.

Inconsistent statements, refusal to provide information on a timely basis, refusal to cooperate with reasonable inquiries.

Go down the list of things that kind of go into a standard working, a good working relationship. What would be a good professional working relationship, lay that out a little bit.

I don't think this is a rule book. Like just to be clear, I don't want it to be written or read as a checklist.

It should be the auditor I think job in this context, should appropriate, I think it is for the best auditors because they actually at the end of the day themselves understand audit firm liability, and their own careers depend upon this.

This kind of qualitative assessment of who it is that's speaking to them about the particular potential non-compliance in question.

It is remarkable then, that there are times when law firms lie. They do. Auditors know that.

Lawyers even more than clients are trained in the art of deception. And so, that has to be a significant constraint on simple reliance.

So anyway, those are some things I would have to say about this topic, Barb.

MS. VANICH: Mr. Wilson, do you want to have the last remarks on that and then we'll try to move to question 4.

MR. WILSON: I mean, a couple of reactions to all of this, which is I agree that if we're thinking about changes in regards to either questions 2 or 3, that a principles-based approach makes sense.

And, I'd also note that there are existing auditing standards that talk about reliance on other experts, and the things that auditors consider.

And so, I think there may, this may actually largely be addressed. And in my experience in working with auditors in the course of several investigations, I do find the process similar to what was just described.

Which is that there's a good working relationship between auditor and counsel on my end, throughout the entirety of the investigation to ensure that you get to the end of the investigation, and reach an outcome that the auditors are comfortable with.

And it's largely driven by the fact that throughout the course, the auditors are doing their own procedures.

At the end of the day, the auditors are rendering an opinion on the financial statements. And, they're doing so on the basis of a number of procedures.

So one element of the support they gather would be input from the investigation being conducted.

But there's actually additional work related. And it all circles back to a point we talked about earlier, which is the grounding in the financial statements, and the facts and circumstances of the particular issue.

The procedures that are required to get comfort for that particular financial statement assertion.

And so, I think it's helpful to think of about the views of the lawyers and what they're communicating to the auditors, but it's also equally important to understand the additional financial statement analysis, and review work that's happening in parallel.

And if you think about the legal profession, and it's really a bigger point for the next topic, but it's really understanding the limitations on what auditors can say due to professional responsibility obligations that we've talked about before as it relates to the treaty.

And managing the confidentiality obligations of lawyers, as well as protection of the attorney/client work product protection.

I think at the end of the day, it's ensuring that we're balancing all of that in a way that gets you to the right answer, which is I think what all of the auditors are trying to achieve in this instance.

And it's really being driven by a group effort between audit committee, auditor, and law firm.

And, I think that there's a process

that's in place that we can leverage from the existing treaty, for that purpose without going beyond what we have to do to mitigate the impact and importance of the attorney/client privilege.

MS. VANICH: Thank you.

Karthik, did you want to ask a follow up question?

MR. RAMANNA: Yes, thank you.

So I just want to, I mean, Josh was very clear in answering question 2 effectively that there are no differences in the evaluation process in detecting direct versus indirect illegal acts.

So, this last 20 minutes has been very sort of informative but nothing in the last 20 minutes isn't already required by 10A(b)(1).

So just want to clarify that that is in fact, the case. And nothing here we're saying isn't already required by, if you were sort of following 10A(b)(1).

Unless someone disagrees with that point.

MS. VANICH: Thank you.

If we could do this, if the auditors want to respond to Karthik, and I know Ms. McNees, you've had your hand up. But I don't want to short-change our discussion on privilege.

If you could also give, and I'll just ask the auditors to do this, to answer question 4, which is what specific audit procedures can auditors perform to identify and assess laws, or the related assessment of risk.

Because I think it's incredibly important that we hear that. We heard that a little bit in panel 1 today, and let's use that before we move on to privilege.

So Ms. McNees, would you like to go ahead and start because I know you had another comment?

MS. McNEES: Yes, thank you.

I have just a couple follow up points from the discussion. This will be quick, but I wanted to clarify as it relates to question 3 and the auditor's input into management's investigation, that it may not be up to the auditor.

It's really up to management once they identify and they proceed to begin an investigation, to seek out the input of the auditor.

So, as auditors, we may not have control over whether we have input into the investigation once management has begun that.

So, I just wanted to clarify that point.

Two, I wanted to agree in substance with Mr. Turner, you had referenced kind of the fact that we may not be able to rely on information coming from management in terms of their analysis, investigation, et cetera, whether it's internally prepared or external but at the direction of management.

And I think that's again where some of the comments related to auditors need to independently perform investigation, or engage specialists to investigate comes in.

So, and then I think I can fairly quickly address question 4 with just a couple comments here.

I think some of the suggested procedures in the proposal are items that I believe are within the auditor's skillset, and I think are valuable items to help with whether it's on the risk assessment side of things or directly with identifying any known, non-compliance.

Or understanding the extent to which management has adequate monitoring procedures in place for non-compliance.

I think my concern would be really related more to the scope of the requirements, what auditors are obligated to perform.

And similar to I think some of the other discussions, based on how I read the scope of what auditors are, the intention of what we are expected to perform risk assessment over and then determine procedures to find, would include things like detection of non-compliance.

And, I think the procedures that are within the auditor's skillset that are listed in the proposal would not be sufficient to meet that kind of obligation.

MS. VANICH: Thank you.

Ms. Fitts?

MS. FITTS: Thanks, Barb.

Maybe I'll just respond to Karthik, your question about the last discussion over what we've been doing from an assessment perspective. Maybe just one point of clarification.

You said detection, and I think that gets to what was talked about on Panel I. I think what we just all spoke about was once an illegal act, or a potential non-compliance had been detected, so we're past the detection point, what we do as auditors for assessing, gaining that understanding of the matter and then thinking about its impact to the financial statement, we do that for both indirect and direct laws.

Again as we've discussed, there might

be some additional expertise needed. There could be different outcomes from a financial statement perspective, going back to what I mentioned earlier about 450.

But the detection really, this is past that point. It's been detected and now we're in that assessment line.

So I just wanted to make that one point of clarification, because it gets to my earlier remark about the detection piece.

Bringing back Barb, to your question as it relates to question number 4, what more could we do.

As we said in our delayed comment letter, we think additional risk assessment work is definitely an area where we can do more.

We already do a lot today as it relates to risk assessment. And we highlighted specifically having discussions with the chief compliance officer, and having more of those discussions.

But I do think it's important to

ground ourselves in our overall audit approach, which is grounded in risk assessment today.

So as we think about moving forward with the proposal, really being grounded in doing the risk assessment and then how does that ultimately inform our additional work.

We have to think about the nature, timing, and extent of all the things that we do from a risk assessment.

And there are lots of requirements in AS 2110 already today, to think about the regulatory environment.

To then think about how that impacts the company's risk assessment and the work that we're doing.

So Barb, I would say we stand ready to do more risk assessment work, and maybe to codify some of what we're already doing today.

MS. VANICH: Thank you, and let's close this question off with Mr. Jones.

MR. JONES: I know we're running on time. I don't have a lot more, lot to add to what Emily and Carole said.

I mean, I think the root of kind of some of the concerns raised I think in the comment process, really focused on I think the topic earlier, which is kind of how you tune the could reasonably have versus reasonably likely.

I think that was really where some of the concerns around the nature and extent of the procedures the auditor might perform.

But as Emily and Carole said, I think additional risk assessment procedures as contemplated in the proposal, and many of which we're doing today around understanding the whistleblower program, helps us identify the types of things that are, the company might be subject to.

And like potential allegations, I think understanding information in the market place that's available about the company.

I think as we commented in our comment letter, we had some concerns around the notion that you evaluate kind of all communications that may be in the public, that a company may put out, or may be said about the company when you consider the number of jurisdictions many companies operate today.

So probably more about degree than about the procedures themselves.

I think some other procedures we do is we look at things like short-seller reports. And adverse mainstream kind of media accounts to help, help us appreciate maybe other things that are out there that may indicate areas of non-compliance, as to the types of procedures that I think we highlighted in our comment letter as well.

And, the things that could help us identify a potential non-compliance incremental to just the baseline risk assessment stuff.

So, I think from that perspective, it's really more where we set the bar up front.

MS. VANICH: Thank you so much for that.

So, let's transition to topic 2 of

this Panel, which is on attorney-client privilege. And I'm going to skip my little intro because we want to hear from you, and not from me.

But our first question is, in light of attorney-client privilege issues raised by some commenters, how do audit firms currently comply with requirements of PCAOB Standards, and Section 10A of the Exchange Act?

And we'll actually start, let's start with the attorneys. Mr. Wilson, in light of your comment letter, we wanted to offer you the floor first.

MR. WILSON: Thanks, Barb. And delighted to be here and to talk about this.

I think to set the stage a little bit, it's important when we say attorney-client privilege that we also are taking into account that that's shorthand really for three core protections that we're thinking through.

Which is confidentiality of client obligations, our client information and confidences; the attorney-client privilege; and, then work-product protection.

So it's really all three that we're thinking about from a professional responsibility perspective.

Attorney-client privilege of course, is the one that everybody thinks of first. And I think it's probably implicit in the question because the way in which attorneys and auditors have worked together for purposes of discharging obligations under the Auditing Standards, has been governed for nearly 50 years pursuant to ABA Statement of Policy, regarding auditors' inquiries.

And I think under the ABA Statement of Policy, there's a construct that was developed between both of the professions to balance these competing interests.

And so, for certain folks here are aware of the process and the way in which it works from both the audit firm and then the attorney side.

But it provides initial sets of coverage for the auditors to reach out with client consent to the attorneys advising those clients, to obtain information about asserted claims.

And then there's a specific provision which I think is really critical to highlight for this audience, which is paragraph 6 of the ABA Statement of Policy, is a provision for the auditors.

Which says that the auditor may properly assume that whenever in the course of performing legal services for the client, with respect to a matter recognized to involve an unasserted possible claim or assessment, for instance, getting at part of what we're thinking about here in the NOCLAR context.

Where that may call for financial statement disclosure, i.e., something that's grounded in the financial statement disclosure obligations.

And in the lawyer has formed a

professional conclusion that the client must disclose, or consider disclosure, concerning such possible claim or assessment, the lawyer will as a matter of professional responsibility to the client, so advise the client and consult with the client concerning that question, and the disclosures related thereto.

I think that's really critical to think about because that's a rep that's made to the auditors in most of these attorney response letters.

And that rep provides comfort for the auditors as it relates to the matters that have been discussed with the client, but without jeopardizing the privilege that attaches.

And so, it covers a lot of the ground without having to actually go further from the auditor's perspective, in terms getting information from the attorney at would potentially impair attorney-client privilege, work product protection, or the confidentiality of the client information that's been disclosed in those engagements with the client, and the attorney.

It's this construct that primarily governs for contingent liability matters, but it's also the core basis through which auditors and attorneys communicate.

Section 10A is separate. We've talked about that a little bit earlier so I don't think we need to go through all of the way in which that process works, other than to say that in the course of an investigation when counsel whether it's independent external counsel, or company counsel, or just external counsel that's not otherwise viewed as independent, is doing the work there is always a consideration given to confidentiality and attorney-client privilege, and the way in which those discussions are held.

And it's a facts and circumstances analysis that's undertaken by the attorney to walk through the process with the auditor, and ensure that the auditors are getting information they need.

But in a manner in which the client's interest and protections are balanced, and that in fact, the client is informed about that.

Which is maybe the other piece and I'll raise it here and we can talk about it throughout the rest of the panel, which is as we think about the proposal, I think it's important that clients are informed about the privileges that attach, and their power over those privileges.

Nowhere in the proposal did we see the word attorney-client privilege mentioned. And because it's so critical and underlies the relationship between auditors and attorneys, I think this is an area really where it's worth considering whether there's a re-proposal that should be issued so that others in the public interest can actually be aware of the impact, and think through and comment on that aspect.

Because one of the core elements of the attorney-client privilege, and really the audit letter process under the ABA Statement of

Policy, is informing the client about the privilege protections that apply, and any potential waivers that might result from the disclosure of information to their auditors.

And, that's a professional responsibility on the attorney to ensure that they're having those communications.

So as we think about this standard and what might be required of the auditor, I think it's also equally critical that we work in parallel with the legal profession, and think through the way in which the standard changes might affect those types of disclosures.

And ensuring that the public has had adequate opportunity to weigh in on that, thinking about it from a holistic perspective.

MS. VANICH: Yes, thank you for that. We would certainly hope that commenters would also use this opportunity while the comment period is open, to address these important issues we're discussing.

Alan, if I could just ask you one more

question and again, thank you for the comment letter.

In the course of the audits, what if the auditor becomes aware of an illegal act? How does that implicate conversations with in-house counsel, and outside counsel?

For instance, if the auditor would learn of something as part of risk assessment?

MR. WILSON: Yes, so I think it really again, it's facts and circumstances. But in the ordinary course, if the auditor is the one that actually learns of the illegal act, it's raised to management in the first instance.

And then, it's management that has the obligation under 10A to work that through the process of escalating it up to the board.

And there are processes in place in the Audit Standards for that purpose.

The information necessarily goes to the general counsel in most instances that I've seen, unless the general counsel is implicated and of course, in which case it's a different analysis that would apply.

And there, the general counsel of course, would advise the management on their obligations both as it relates to 10A, but as it also relates to the substantive matter at hand that's been raised by the auditors.

And, advising the company and navigating the process with the auditors.

From what I've seen, typically that advice to the company is specific as it relates to management's obligation to interact with candor to the auditor, and ensuring that they're acting truthfully and in accordance with the Section 10A requirements.

And, ensuring that the auditors are getting the information they need on a timely basis to conduct the audit.

External counsel is doing the same and advising the company on its obligations in the same score.

Then when you think about the auditor's interaction, it really is a question next of how the matter gets handled within the company.

And whether it's handled at the management level for purposes of investigation, or if it gets escalated to the audit committee, or another special committee where an investigation is undertaken.

And the need for an independent investigation is recommended either by counsel, or the auditors.

Then the communications go from there depending upon the counsel handling that investigation, and what the auditors will need for purposes of designing audit procedures, to take a better understanding of the impact on the financial statements.

To the extent that the auditors don't already have a pre-formed view.

My sense is that the auditor is doing procedures in parallel to also get a better understanding, but will also look to the company and management in the first instance given that there's also the importance in maintaining independence.

So as you think about auditor independence, we've got to make sure we keep in the back of our minds that auditors can't be inserting themselves in a way where they'd be acting in, in the position of management in either the investigation context, or otherwise.

So I think that it's maintaining that distinction that we should keep in the front of the mind, as well.

MS. VANICH: Thank you so much. Let's hear from Mr. Carmichael, and then we'll turn to some of the other attorneys on the panel.

MR. CARMICHAEL: Okay, I was involved in the negotiations that resulted in the treaty. A few things stand out in my mind.

I would advise avoiding reopening the process. Certainly it was extremely difficult. That's when I first learned the difference between a securities lawyer and a litigation attorney.

And that there was a big difference, the litigation attorneys were a lot harder to deal with in reaching the treaty. But I think you want to keep that in place.

The Auditing Standard already to a great extent, covers that. So it might be something, I wouldn't put anything about it, much about it in the, in NOCLAR.

But the release might explain the connection to the existing Auditing Standards that relate to litigation claims, and assessments.

And particularly how the subject of unasserted claims is treated under that.

So I think in informing investors, coverage of that and the release would be worthwhile.

But I am also reminded that when we presented the treaty, lawyers and the AICPA met with the Securities and Exchange Commission

The, Rod Hills, Chairman at the time, said that he wanted to remind both professions of their professional obligations.

The securities lawyers' obligations to the client; and the auditors' obligations to the public. I think that's very important to keep in mind.

One thing I think is worth considering is changing to some extent, the notion that in making the response to lawyers' inquiry, auditors' inquiries of lawyers, that the specialist Auditing Standard does not apply.

I think that's in the current Standards. And, I would apply the typical requirements that apply to any specialist used to consider the competence and objectivity before accepting the results.

MS. VANICH: Thank you so much, Mr. Carmichael.

If I could turn to Mr. Coates and Mr. Jackson. And if you wouldn't mind maybe in the interest of time, think about both question 1 and question 2, which is how would the proposed amendments affect privilege differently than the current audit requirements.

MR. COATES: So, I think I can be extremely brief. Mr. Wilson's letter acknowledges I think is clear, the Standard as proposed does not in any way mention or effect privilege.

There is a brief reference to privilege in the surrounding language, which is a little bit oblique, but it does imply no change.

And, I don't think anything in the proposal should, should change for the reason Professor Carmichael alluded to. God help us if it has to be renegotiated.

So, I think dropping language to that effect into the final release would help clarify and alleviate any concerns that lawyers might have.

I do think at the end of the day, the privilege sometimes, this is not really directly responsive but it's just worth noting.

It is sometimes misused. It is meant to only cover information meant to be kept confidential.

And it's not meant to just cover up every conversation that two employees want to have by looping in a lawyer.

And, I don't think maybe in this it's worth highlighting that fact, but I do think along the way the board over time ought to consider whether some of the attempts to shield information from auditors can be tested against, using traditional attorney-client privilege ways of testing things.

It's not like you turn it all over. There are ways to handle that.

I do think particularly in the most acute settings where frankly, the entire company's franchise is at risk, that issue is worth thinking about some more, I'll just say in passing.

And that's all.

MS. VANICH: Thank you. Mr. Jackson?

MR. JACKSON: I'll be brief, too. So in preparation for the conversation I had a look at the comment letter that Mr. Wilson provided.

And, I think it provides a very thoughtful overall assessment of important considerations.

And I agree with Professors Coates and Carmichael, that the board should be clear about wanting to preserve and protect the privilege.

But I candidly think that the comment letter proceeds on a premise about the proposal that this morning we have ruled out.

On the first page or two of the comment letter, it suggests that the proposed Standards require auditors to conduct a legal audit of a company's compliance with all law and regulation.

That's not what, at all what I've heard this morning. I think there is agreement about the scope, or I hope there is agreement. I heard this morning some considerable agreement about the scope of the auditor's obligations here.

And I think given that scope, this is

very, very similar to the 10A and other procedures that have been used.

That is Mr. Wilson's comment letter thoughtfully acknowledges better, balance very well the need for auditors to have information and the need for attorney-client privilege.

So, it's my sense that just to tie together the conversations we've had throughout the day, that to the degree that the board hears what was said in the first panel about the scope of the auditor's obligation, add some language along the lines of what Mr. Carmichael has suggested, and as Mr. Coates has also suggested.

I think that should get at the bulk of the issues to the degree the comment letter and concerns about privilege were worried about a broader set of auditor requirements and its effect on privilege, it just doesn't sound like that's the reading of the proposal that the, that is most likely to prevail.

And I think it would be good for the board to be clear about that, and hopefully that will address these issues.

MS. VANICH: Thank you so much. Let me say, oh, Mr. Turner has his hand up, so, thank you, Mr. Turner.

MR. TURNER: Just a couple of points to add on to Rob's. First of all, in most states there is ethics standards that say that if something is required by law, and this is also in the international standards, you know that, Barb.

That if something's required by law or by subpoena, then the auditor is obligated to turn that over underneath our own, underneath our ethics standards. Section 10A to that effect, is required by law.

SOX, we also insert in SOX that people inside the company cannot mislead the auditor subject to some pretty severe penalties.

The auditor work papers are their own work papers. Sometimes auditors are faced with people trying to get their work papers but the ownership of those work papers, that's their work product. It's not the company's work product.

And, I've been in a number of cases where attorneys from one side or the other to John's comment, they all seemed to be good at coming up with privilege logs.

And, I found that there are privilege logs and then there are the logs that are left over after a court goes through them.

So just because something is cited as privileged doesn't necessarily mean it is.

And on this issue of client-attorney privilege with respect to the auditors, there are some court decisions out there.

And, there are some cases where the judges have said that there is not that confidential privilege with relationship to the auditors.

So, with all due respect to our present attorneys, there's what attorneys say and then there's what the court will say.

And ultimately, it's the court.

MS. VANICH: Thank you.

Mr. Jones?

MR. JONES: Yes, Barb, just real quick. I just maybe just wanted to emphasize maybe a point Rob, that you made.

I mean, and I think I know we raised a brief, we spent some time in our comment letter speaking about the risks related to the impact of the proposal on attorney-client privilege.

And it wasn't in the context of changing the expectations when matters were identified, as was discussed earlier.

I think it really was the notion of depending on the expectations of the auditor to detect levels of non-compliance kind of at that threshold level we discussed this morning.

And it would be more matters potentially identified that would be discussed perhaps earlier on, of lesser degrees of significance where that, where that because auditors need to get the information, they need to be able to make their assessment, that privilege would effectively be waived as part of that evaluation.

And I think as Alan or in particular, so it's just more, I mean, in the end it's more recognizing there could be a cost associated to that to companies and others that would need to be considered in the process.

And certainly obviously I know we don't have a, necessarily a preparer on the panel today, but they could probably have spoken to that more articulately than I did.

But I guess largely, I agree with your premise assuming I think, the extent and the nature of the types of laws, and the procedures around that detection, it, there's some evolution of that.

I think that was largely the genesis of at least the comments we raised in the letter.

MS. VANICH: Karthik, did you want to ask a question?

MR. RAMANNA: To clarify something Josh just asked, or Josh just said.

That privilege at the sort of let's call it stage 1, is that in any way different from privilege or envisioning that is not a problem in the stage 2, which is once you've sort of, you're in the world where you have sort of some suspicion and now you're making an assessment?

MR. JONES: Well, keep in mind I'm not an attorney, so I don't know the degrees of attorney-client privilege that may be impacted here.

But I guess if we're doing more procedures to evaluate potential non-compliance, right, then you have indications of matters that you have to evaluate as to whether non-compliance occurred and the financial statement impact.

So I wasn't thinking there was a difference in the nature of that dynamic, just that it might come up more and earlier in the process.

And that could result in ramifications to companies at some point down the line, that certainly we probably don't appreciate as fully as they might, and others might. If that's helpful.

MS. VANICH: Mr. Wilson?

MR. WILSON: Yes, happy to weigh in. I think Josh put it nicely, but it actually really is a bigger picture point on question 4, just to elaborate further.

I think to get to the question you're asking, which is the difference, right. And so the first question is nailing down an understanding of the interaction between the lawyers and auditors, and the first instance for the scooping, other activity.

Page 28 of the release actually indeed says that the proposal was far broader than in Section 10A.

So, it's making sure that we're clear on that in terms of what's expected at that scooping stage. So, attorney-client privilege would operate the same regardless of the stage.

But it's notable that the attorney-client privilege protects the disclosure to third parties, of confidential attorney-client communications that relate to legal advice.

That's the point we've all talked about, right? That's the point Lynn was making earlier about just because you've copied an attorney doesn't necessarily mean it's privileged.

That's indeed, true. But if what we're saying is in fact, we are, that the auditors need to go out and get a broader set of information available to do the job, I think that that just increases the magnitude of potential instances where lawyers may be asked to reveal client confidences.

And that's the pressure we're trying to address. It's been addressed at the treaty before but I think the question becomes, how much pressure is there for the auditors to get that initial scope where they then need to do the evaluation.

And it sounds like we may actually be addressing that already, so perhaps that it's just a misunderstanding of the actual drafting of the proposal. And that solves the problem.

But it's helpful to understand and really if we think about it from the work product protection perspective, the other privilege that I talked about, I think that's actually more important.

Because when we think about work product, that prevents, or protects from disclosure to third parties, documents and tangible things that a party or its representative prepares in anticipation of litigation.

And so, if we're talking about things that are far earlier in process and not prepared in anticipation of litigation, there may not be the availability of the work product protection for those types of issues, as compared to others if they're further in the process for purposes of sharing.

And as you think about the court decisions across the country, every jurisdiction handles it a little bit differently.

But the majority view is an attorney's disclosure to auditors waives the attorney-client privilege, but it doesn't waive the work product protection in a majority of states.

And so, if we think about things that are later in the process that are closer to litigation, they might be subsumed within the work product protection and have adequate coverage from that angle.

But it still doesn't answer the question of attorney-client privilege, but it might actually enable you to have a greater degree of comfort from the work product perspective.

So I think it's those dynamics that we laid out in our letter that are worth bearing in mind as part of this scooping exercise, which I think we've talked about before.

MS. VANICH: Mr. Turner?

MR. TURNER: Yes, Barb, having read these comment letters and gone back over these issues, I don't think you really need to re-propose on this.

I've gone through those same issues and discussions as John and Rob have at the SEC. And, I don't think this raises to the issue of where you would need to re-propose but along the comments of all three attorneys, there's probably some clarification here that you consider whether or not it's appropriate to do.

But I think on re-proposal, I don't see that as a big, big enough, significant enough issue that you'd need to re-propose on this particular item.

MS. VANICH: Thank you.

Before we move on, I do want to respond to Mr. Jones' remark. We did have a preparer teed up for this panel who unfortunately, had to drop out at the last moment.

But before we move on, Ms. Fitts or Ms. McNees, is there anything that you'd like to add to the discussion so far?

MS. FITTS: The only point, Barb, maybe

just to counter Lynn, your point on re-proposal. I do think re-proposal is really important.

We've had a lot of discussion, maybe Lynn, maybe not specific to the attorney-client privilege.

But what we had, the discussion earlier in the panel on clarifications regarding the scope, the auditor's detection requirements, and those things, I do wholeheartedly believe that re-proposal is necessary in this instance to be able to have a full and transparent vetting.

Particularly because one change in the standard will cascade throughout the entire piece, and that's Barb, just wanted to highlight the importance of re-proposal.

MS. VANICH: Ms. McNees, anything from you, if?

MS. McNEES: Yes, just a couple points real quick.

One, there were a couple of mentions of the privilege perhaps being overused, or over relied upon to not share information.

And, I wanted to share I think that potentially puts auditors in a pretty difficult position.

We've had situations before where we believe that privilege doesn't apply. We believe we should be able to get access to certain information.

The client's asserting no, you can't, we can't provide that access because privilege applies and we don't want to waive that.

And we're not really in a position to argue that point with them. We can try, but it's ultimately it's up to them to make that call.

So whether we think that it's appropriately being applied or not, we're not really in a position to sort of legally challenge that.

The second thing very briefly, I think Josh mentioned this, and Mr. Wilson I think, also addressed, too.

But I think the discussion about privilege, I think really it's not that it doesn't apply to what we do today. Obviously we have to manage through that in what we're doing.

I think it's with the scope of the NOCLAR proposal, it's how does that impact the frequency and number of matters that we have where we as auditors, are trying to investigate something and have to manage around restrictions to, access to information due to privilege.

MS. VANICH: Thank you.

Mr. Jackson?

MR. JACKSON: My thoughts to Lynn and to respond to something Emily's just said. I have to say, I've been through a number of these comments and as an SEC commissioner, we often receive requests for re-proposal of rules.

I don't think re-proposal would be necessary based on the conversation we had today, and I don't even think it's a close call.

I can understand why those who are skeptical of the rule would love for it to be re-proposed because pushing back the time in which it is adopted, is always desirable.

But I, and with all respect, whether or not a re-proposal would be necessary is a question of like administrative law.

Thank God nobody with that expertise is here today, but I'll just say the idea that it would have to be re-proposed thinking kind of comments is both wrong, and also a worrying implication.

Because to the degree that having conversations with the market about the details of a rule like this, clarifying it so that it provides some of the helpful modifications we've discussed.

And then to say well, you've updated it and accommodated our concerns but now it's all different so re-propose it again, or else violate our rights to due process, with all respect, I don't think it's an especially serious argument.

MS. VANICH: Okay, thank you for that.

I think Mr. Carmichael had his hand up next.

MR. CARMICHAEL: I just wanted to join

in saying that I would urge you not to re-propose. That I think the kinds of comments and the comment letters that we've discussed today, are things that are readily dealt with in the typical release that accompanies a standard to explain how you treated the comments and the comment letters.

I don't think it merits re-proposal at all.

MS. VANICH: Okay, thanks for that.

Many hands and we have about 12 minutes left. Happy to have people say what they're going to say as part of the last two questions but I would just like to tee those two up.

So we have question 3, which is commenters and staff have observed that non-compliance with laws and regulations are typically identified by issuers through means which are generally non-privileged, such as systems designed to address violations of laws and regulations of company policy.

And so the crux of the question is, are there other common areas of identification of non-compliance such as through privileged communications?

And then, I also know that we've touched briefly on question 4 but in the interest of time, how do the considerations relate to the potential waiver of work product protection, and do the proposed amendments effect that differently?

Sorry for crunching everything into the last few minutes.

If I could start with Mr. Coates, because I think he had his hand up for a while.

MR. COATES: Sure.

So, I think Alan earlier covered work product as well as I could in a brief form. One, is privileged communication a source of identified law breaking.

Just to be clear, that would have to then be client-lawyer in that set of communications. They then identify something for the first time as potential non-compliance.

Absolutely that happens all the time. I will say as a general matter as it touches this topic, it's less frequent than you think that the auditor would be in some sense, harmed by not being allowed to know about that.

What do I mean by that? Well, when it's a privileged communication that actually identifies for the first time, that usually means there's some uncertainty in law.

And that uncertainty in law means that the actual bottom line of the analysis is almost always of the kind that would allow for substantial discretion in thinking about the impact on financial statements.

Which then means it's actually in a subset of the issues that we've been talking about, right?

I mean, it's probably worth maybe just sketching. We've got clear law breaking where the law is clear and the facts are clear.

We've got clear law breaking where

maybe the facts are a little unclear, but we know what the law is.

And then we move into the zone where we don't really know for sure until either more investigation is done, or some lawyer finally decides what they think the law is.

And obviously as you move along that spectrum, you're introducing uncertainty, which then puts pressure on anyone ever being able to say well, it's definitely going to have an impact on the financial segment.

So, while the answer is yes, it's maybe not as general as you might think. That would be my answer to that question.

One last circling back on the re-proposal point. I don't know how I was talked into being general counsel of the SEC, but I was.

And in that role, I did have to learn about this issue and it's logical outgrowth is the likely result of the final rule, a logical outgrowth of what was proposed.

What I heard this morning is

absolutely yes because what was being discussed is in effect, a scaling back of some of the more worried readings of the proposal, which then means it's nested within. It can't possibly be greater than.

It's not a dramatic (audio interference) --

MS. VANICH: Okay, I think we've lost him maybe for a second.

Mr. Wilson?

MR. WILSON: I actually, I understand where I think he was going and I would more or less add that I think that it's just worth bearing in mind with respect to the others that are against re-proposal, just to take a fresh look along the lines John was thinking of, as to what a revised proposed Standard 4 adoption would look like.

And understanding and taking a view through --

(Simultaneous speaking.)

MR. COATES: -- if it would actually

be a surprise in some sense from, a departure from the proposal.

Now if you do, if the board concludes as a result of this round table, and if they do want a dramatic departure that would actually be a surprise in some sense from -- sorry.

MS. VANICH: Yes, sorry about that. Thank you.

I'm sorry, Mr. Wilson, do you want to go ahead?

MR. WILSON: I think just to wrap up, I think where John was going with this is just taking a look at whatever revised version of the Standard the board is looking to adopt, and taking a view of that proposal before adopting and considering whether re-proposal makes sense from the logical outgrowth perspective.

And would emphasize that I think the point Emily made, which is to say that if there are a number of significant changes that flow through, it's taking a hard look at whether or not it in fact, revised the proposal to be substantially different from what was actually proposed.

Whether in fact, there are reductions in the scope that's envisioned particularly as it relates to the attorney-client privilege, just the point I made earlier to make sure that people are thoughtful about that to the extent that it actually has ramification throughout the way in which the revised draft looks.

MS. VANICH: Thank you.

Mr. Jones?

MR. JONES: Yes, I don't have much more to add to question 4 than what Alan said. I'm not sure I couldn't even play an attorney on TV.

But I guess going back to the re-proposal kind of comment, I guess look, I just want to make sure everyone appreciates.

I mean, speaking for myself, I think speaking for the profession, we very much understand and hold true our obligation to support investors in providing information, quality information to the capital markets.

And, we want to do what's necessary and what's expected for us. And part of that is understanding what is expected with the clarity that is necessary to do it; to do it well; and, to do it consistently.

I think that's, those are similar objectives everybody on this round table kind of hold.

And I think what you've heard, at least what I've heard today is while lots of commentary around a ways to evolve the proposal, you also heard what that was based on is some divergent views on what was intended.

And in some in a very meaningful kind of way, and I guess would challenge at the risk of having unintended consequences and lack of clarity in what's expected, whether another go-round from a proposal perspective wouldn't be helpful.

Not because we aren't interested in complying with whatever the expectations are as soon as reasonably possible, but to make sure we do it right for the benefit of investors.

And so that's really where we're all coming from, I think, from that perspective, and why I think you heard Emily say what she said, which I wholeheartedly agree with, as well.

MS. VANICH: Thank you.

Mr. Turner?

MR. TURNER: Barb, just a couple quick points. On question 4, I have seen those come up through privileged communications.

Things where people are self-reporting like on FCPA, and more importantly, the growing number of cybersecurity attacks and hacking, I think there's going to be more and more of that occur.

And people find out about it, and in places where I was that we had to worry about cybersecurity, we did have the attorneys attached to us at the hip.

And so, I think you're going to see continued self-reporting companies doing the right thing, and those do come up not unusually through those type of communications.

With respect to Carole made a comment about the auditors being challenged in some cases with respect to what they can request, or not request.

There's a flip side to that. When people reject the auditor's request, then the auditor typically has a scope limitation.

And those conversations, I've been in many of them and those conversations have been two-sided in that one, you can decide what you will or will not give us; and two, then we'll decide what opinion we'll give depending upon what you tell us.

So, that's actually a two-sided conversation and the auditors do have some leverage in that regard.

And then finally, time and time again we've seen investors' survey where the number one issue with respect to someone making an investment, certainly I've had this on a personal level as well as on two asset manager boards I've sat on, is the integrity of management and NOCLAR, there's nothing like NOCLAR that runs to the integrity of management and tells you a lot about those.

That's the number one issue. And so, this is a material item, and material information for investors.

And, investors need to know that the auditors are doing the right thing and providing to the auditors, or to investors important material information that they have with respect to NOCLAR, and integrity of management.

MS. VANICH: Thank you.

I don't see any other, Mr. Jackson, you had your hand up. Did you take it down intentionally, or?

Okay. Well, I will take this chance then to thank you all so much for our time and input. We really do appreciate it.

It's time to conclude our second panel. Again, we look forward to seeing some additional comment letters come in to the file.

We will now take a short break and reconvene at 3:00 p.m. Again, thank you panelists for participating today and sharing your views, and to those who have joined us online.

And I'll look forward to seeing you all back here, or the people that need to be back here, at 3:00 p.m. Thank you.

(Whereupon, the above-entitled matter went off the record at 2:29 p.m. and resumed at 3:01 p.m.)

MR. SCHMALZ: Welcome back to our last session today. I'm Martin Schmalz, Chief Economist and Director of the Office of Economics and Risk Analysis. I'm joined by Barbara Vanich, Chief Auditor and Director of Professional Standards. Barb and I are joined by Karthik Ramanna. Karthik is a professor of business and public policy at the University of Oxford's Blavatnik's School of Government, who has taken a partial public service leave to advise the PCAOB.

We would like to welcome our

panelists, board members, and the public back to this staff-hosted roundtable on the auditors' responsibility for a company's noncompliance with laws and regulations.

Before we get started I want to issue the standard disclaimer for myself, Barb, and Karthik one last time for the day. Our views are our own and do not necessarily reflect the views of the Board, individual board members, or staff.

We would also like to remind those listening that the comment period will be open until March 18th, 2024. We welcome all comments. The staff are particularly interested in substantive comments from the public concerning the roundtable topics and any points raised during the roundtable.

On June 6th, 2023, the Public Company Accounting Oversight Board proposed amendments to PCAOB auditing standards related to a company's noncompliance with laws and regulations and other related amendments. The PCAOB received 140 comment letters on the proposal. From those comment letters the staff have identified topics for which we believe additional information will be helpful in developing our recommendation for the Board.

The purpose of today's roundtable is for staff to obtain the perspectives of our panelists on specifics of the NOCLAR proposal that the Board issued in June of last year. Additional background information on the topics and questions we are covering during today's roundtable is available in the staff briefing document available on the event page that you will find linked to the home page of the PCAOB website.

Barb, Karthik, and I are here to listen. We will direct specific questions to Board panelists in order to inform our efforts as we work toward a final recommendation to the Board. Our objective is to hear from all panelists who wish to speak on each topic and to encourage open dialogue among the panelists within the time allotted. We have two hours.

As a reminder, if you would like to say something, please just use the raise your hand function. If that's not working, just type something in the chat function. No need to write down your question. Just say call on me, or a few characters, whatever works, and we'll do our best to get to everyone. In the event that we run out of time, we welcome all panelists to submit additional comments to the comment file.

If you have any technical difficulties during the meeting please contact Brian Goodnough. Thank you in advance for your patience.

A note to those watching online. Panelists were asked to submit any new data or analysis they plan to present here today to the comment file ahead of today's meeting.

To ensure all panelists have time to speak, we will not be able to accommodate slide presentations from individual panelists, but we encourage the panelists to reference any such submissions to the comment file.

Those watching online can find those submissions easily by going to the PCAOB website, clicking on the event page that appears on the home page and then selecting the comment file option on the right-hand side of the screen. The comments are ordered by date, helpfully. The most recent submissions therefore are at the bottom of the page.

With that, let's get started for our last panel of the day on economic impacts of the proposed standard. We have 10 distinguished panelists with us. There is Brian Croteau, who is a U.S. Chief Auditor and Auditing Services Leader of PwC; Colleen Honigsberg, Professor of Law, Stanford Law School; Jonathan Karpoff, who is the Washington Mutual Endowed Chair in Innovation and Professor of Finance at the University of Washington; Dennis McGowan, who is Vice President, Professional Practice at the Center for Audit Quality.

We have Carole McNees, who is a CPA and Director of Quality Management, Ethics and

Assurance Policy at Plante Moran. There's Laura Posner, who is a partner at Cohen Milstein; Tom Quaadman, who is Executive Vice President at the U.S Chamber of Commerce Center for Capital Markets Competitiveness, the Chamber Technology Engagement Center, and the Global Innovation Policy Center.

We are glad to have Brandon Rees, who is Deputy Director of Corporations and Capital Markets at AFL-CIO, as well as Bob Temple, who is General Counsel and Secretary at NuScale Power Corporation. And finally, Luigi Zingales, Distinguished Service Professor of Finance at the University of Chicago.

You can find bios for each panelist on the PCAOB website.

We have one topic for this panel which is the benefits and costs of the proposal. By way of introduction to the topic the expected benefits of the proposal include improving financial reporting quality by requiring auditors to better identify, evaluate, and communicate a company's noncompliance with laws and regulations which can lead to more timely intervention by companies to seize and remedy noncompliance thereby reducing the harm to investors and the public at large caused by noncompliance.

To the extent that investors currently expect that auditors play a larger role in identifying noncompliance than they actually do, as some commenters have indicated, the proposal would help reduce the expectations gap between investors and auditors which can raise -- which can increase investor confidence in financial statements and the capital markets generally.

The proposal identified costs of the proposed standard to firms that would include certain fixed costs related to updating audit methodologies and tools and training staff. Variable costs for firms would include efforts to identify the relevant laws and regulations, assess risks of material misstatement due to noncompliance, and develop audit responses. The magnitude of the costs will likely depend on the nature of the company and its operations and the related regulatory environment. The proposal also highlighted that the likely cost of the proposed standard to companies would include engaging with the auditor to respond to information requests and increased audit fees.

I want to briefly tee up all the questions that we want to ask. We have six questions. We will try to go in order, but just in case we will have panelists respond to costs and benefits jointly, I want to just tee up all of them at the beginning.

Our first question is what do panelists or commenters perceive as the economic benefits and costs of the proposals and how do they differ from the status quo, both quantitatively and qualitatively? We discussed earlier today what the status quo is and what additional work is required and we're interested in finding out what that quantitatively means. I'll add to that I'm particularly interested also in the methodology, if you can explain that, that you would have used to assess these costs and any justification of that methodology.

So whenever possible we would also be interested in hearing responses separately by firm size. So perhaps they differ by large or medium or small firms as well as perhaps different responses to different stakeholders; for example, preparers versus firms. That is the first question.

The second question regards any additional data or studies that would clarify the economic impacts of the standard. So if you're aware of additional data or studies on the current cost of unidentified noncompliance with laws and regulations to investors or the public at large we would be interested in hearing about that.

The third question is whether -- what the panelists or commenters perceive as the impact of the proposal on small and medium-sized audit firms and whether such an impact can be quantified differently.

The fourth question is what broader impact you may have identified of auditors' identification of noncompliance with laws and regulations that could reasonably have a material effect on the financial statements. So that's question 4, Brian. So that could have a material effect on the financial statements on capital formation or more broadly the macro socioeconomic environment. Add to that the environment, the proverbial chemical in the river.

Are there any data and studies that would help us estimate those impacts? For instance, is there evidence to suggest that capital costs would be lower if investors had greater confidence that auditors would identify noncompliance with laws and regulations that could reasonably have a material effect on the financial statements?

The first question is to the extent panelists and commenters provide additional alternatives to the proposed standard if there's any data or studies that can help us estimate the benefits and costs of any of these alternatives.

And finally, the last question we want to address will be in light of the discussion of costs and benefits we will witness how investors, issuers, and auditors view the justification of the proposal overall.

So in discussing these costs and benefits we strongly encourage the panelists to be prepared to discuss the quantitative impact of the proposal on audit fees; on issuers' internal costs as a result of identification, evaluation, and communication of information indicating that noncompliance with laws and regulations has or may have occurred; auditors' existing reliance on compliance work and legal analyses already carried out by issuers; and potential costs associated with the auditor's use of specialists.

Now, let's go back to question 1 now that we've teed up the entire spectrum of what we intend to discuss in the next hour-and-forty-five or so. The first question again is what the economic benefits and costs of the proposal are relative to the status quo, both quantitatively and qualitatively ideally split up by different sizes?

So I saw that on Monday Professor Honigsberg submitted an additional comment letter that speaks of both costs and benefits, so let's start with that.

MS. HONIGSBERG: So, thank you guys for having me here today. And yes, when I was thinking about the broader sort of costs and benefits I actually went through the comment letters. And so I went through the comment letters to just get a sense of what are potential direct and indirect costs? Also what are the broader potential unintended consequences, which I think would be more severe here than perhaps the direct and indirect costs. And then separately on the benefit side, hat are some of those benefits that we would want to consider that are potential, direct, indirect, unintended, however they may come out?

So I can kind of go through and just

describe what are we thinking for the direct costs and indirect costs? Well, obviously we have direct fees in terms of auditors, lawyers, IT, software. Higher potential litigation exposure a number of people noted and I assume we'll discuss that in more detail from some of my colleagues on the panel.

In terms of the unintended consequences though I think these are just -- in my view cannot be quantified. And so I'm happy to discuss them, but it's like there are sort of broader comments about maybe we have fewer public companies or maybe we have more consolidation in the audit industry that may or may not occur and that I think just I personally would not be comfortable quantifying because it would require too many assumptions.

So I'm happy to actually go through and read out the unintended consequences, Martin, if you think that would be helpful, but I -- yes? Is that -- okay.

So the first one, greater demand for

those with specialized expertise, making it difficult and expensive to recruit and retain qualified personnel. That one seems fairly direct.

We also have potential reduction in audit quality because you have auditors who are being squeezed of fees. That one though of course that's a potential benefit too so I don't think we know exactly which way that's going to go.

So risk of violating PCAOB and SEC auditor independence rules. This one I believe came up this morning, and there was certainly pushback on whether that would occur.

So increase time to perform an audit because there would be more work and perhaps more demand for particular specialists.

Reduction in number of public companies.

Potentially weakened attorney/client privilege, again something that was discussed this morning and that I think there was a fair amount of pushback on.

Increased risk of market concentration for the audit firms.

Increased information overload for the audit committees because there would just be more information communicated to them.

Perhaps real effects on business operations like inability to justify continued operations in certain areas.

Greater tension between auditor and management.

And then increased stickiness between the audit firm and the issuer because we would have an audit firm that would have -- to bring in somebody new would be greater fixed costs, greater up-front costs right away.

Now on the potential benefits of NOCLAR though, I think you've already hit on a number of them, but I think our main one would be reduce frequency of detected and undetected fraud, which I am guessing my colleagues here on the panel are going to discuss, but it is when we're thinking about the effect of fraud on market cap, it's huge. And so I assume we'll get into that a little bit more.

Certainly we can try to cost out what the effect of fraud on market cap would be, and I'm guessing some of my colleagues might have some insight there. But obviously that one is really, really difficult to quantify. So certainly a huge cost, but very difficult to quantify.

Also potential reduction in information asymmetries between investors and the audit committee or the managers. And then also the audit, auditor, and audit committee.

Improve compliance environment within the firm, so allowing for better decision making.

Improve data quality and better alignment of investor expectations and auditor behavior.

So again we have a lot of potential costs and benefits that I think -- in my view, in the comment that I submitted, I think we can try to anchor some of those numbers, but can I come to a number that I feel like I can really quantify the cost of the proposal? No. Do I feel like I can really quantify the benefits of the proposal? No.

MR. SCHMALZ: Thank you very much, Professor Honigsberg.

May I call on Mr. Quaadman next whose comment letters have quantified the cost of the proposal?

MR. QUAADMAN: Sure, Martin. Thank you very much and appreciate the Board having this roundtable today.

Let me just give a few thoughts, answer the question, just a couple other general thoughts as well.

So first off, in writing for a unanimous court in TSC v. Northway, Justice Thurgood Marshall rejected the theory of materiality that would require disclosure of a fact that might be important to an investor. Instead Justice Marshall held that a fact is material if there is a substantial likelihood that a reasonable investor would consider the importance of a fact viewed within the total mix of information to an investor in deciding how to vote. In a later case, Basic v. Levinson, the Supreme Court reiterated that TSC materiality standard and extended it in fact to investment decisions.

Those Supreme Court decisions are important as financial statements provide material information for investors. Auditors provide the assurance that those statements could be relied upon. The almost-50-year standard on illegal acts with its direct/indirect test regarding financial statement impacts work seamlessly within that TSC's rubric.

The Chamber's long-called for updating the auditing and accounting standards. Indeed we have written to past SEC, FASB, and PCAOB chairs with proposals on financial reporting forms. However, any updates or reforms must be evidence-based and follow appropriate legal procedures for due process and transparency. the NOCLAR process here falls short on all those points and we again call for its withdrawal.

Furthermore, under the Sarbanes-Oxley Act PCAOB standards must be submitted for approval and directs the SEC to follow the process under Section 19 of the Securities Exchange Act. If the SEC were to attempt to approve the NOCLAR standard, it would violate the various holdings of the courts -- the holdings of various courts from our challenge of the mutual fund rules in 2005 all the way towards a successful challenge of the Stock Buyback Rule last year.

In coming days we're going to file a comment letter as well as a study outlining in detail the process flaws and cost/benefit deficiencies that the NOCLAR proposal suffers from. Let me just name a few.

First, the Board has failed to share a rationale for changing well-settled policy that has worked in the past or provided any evidence for the need of a change. The Board also has failed to consider reasonable alternatives.

Second, the Board has failed to provide any cost-benefit analysis to NOCLAR for commenters to comment on. To be clear, benefits cannot be understood unless relevant consequences are considered and costs are qualified. Simply stating that a proposal will benefit investors doesn't make it so.

Using data from audit analytics, the Chamber, in its comment letter, estimated that NOCLAR will drive up audit costs by at least $36.4 billion. Public companies and their investors will have to bear those costs diminished return.

This will accelerate the decline of public companies, and in fact I'll submit it, this is a University of Chicago chart showing the number of public companies in the United States since 1996. That is a downward trend. That will increase. It will also endanger the global leadership of the United States in public capital markets. On its face NOCLAR fails to meet the SEC's legal mandate of competition in capital formation.

The Board also failed to take into account increased litigation risks for public companies and audit firms. The Board failed to consider the legal expertise and subject matter experts that would have to be hired by audit firms.

The Board does not consider how auditors would have to deal with conflicts of law issues. This is interesting since the first congressionally-mandated resource extraction rule was thrown out by the courts on exactly that point. The NOCLAR proposal seeks to replace the objective direct/indirect test with a subjective standard. So for example, NOCLAR uses the term reasonableness in the matter that the Supreme Court rejected in the use of might in TSC.

Furthermore, as stated in our 2015 letter to the SEC and PCAOB on internal firm -- on internal control reforms, I just want to cite what SEC management guidance states. The concept of reasonableness of necessity contemplates --

MR. SCHMALZ: Mr. Quaadman? Mr. Quaadman --

MR. QUAADMAN: Yes?

MR. SCHMALZ: -- I wonder if I can direct you to the question on the costs and benefits?

MR. QUAADMAN: Martin, please, let me finish because there's a number of different issues. I want to make sure I cover and I'll be finished in a second.

The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors including the costs of compliance, which you have not provided anything on. So that is troubling.

So, and you know, I can get into some other things later on, but I would have to say based on the data, I would also have to say based on the change in capital formation markets with interest rate increases as well as deficits, it is much harder to raise capital. And that has not been taken into consideration by the Board as well.

Lastly, I would just say the Board also fails to take into account how FASB moved away from its loss contingency proposal years ago because of the same issues that were raised regarding attorney/client privilege and litigation risk. So just want to put that out there.

MR. SCHMALZ: Okay. Thank you. So I didn't hear anything on substantiation of the cost estimate or on benefits here.

MR. QUAADMAN: Well, Martin, with all --

MR. SCHMALZ: I wonder if Mr. Temple might speak to that. Can I call on Mr. Temple on that?

MR. QUAADMAN: Martin, will all due respect, you have to provide that and we have to react to that. There are court cases holding that. And if we're not going to do it here, we're going to do it in the SEC rulemaking process.

MR. SCHMALZ: So may I please call on Mr. Temple, if he would like to speak to the cost estimate?

MR. TEMPLE: Well, and I guess to Tom's point, the PCAOB bears the responsibility to project the likely cost of compliance with its proposal, not only to inform the public but our comments as well.

My company is an issuer, which is a small emerging growth company for which full SOX 404(b) compliance is still in our future, but near future. Simply stated, expanded auditor scope and requirements impose a cost to my business that I can ill-afford.

As a public company we already receive appropriate auditor inquiries about compliance with laws to management and to directors under the current auditing standards compelling auditors to become specialists in business lines and having them perform compliance reviews would impose additional costs, but I cannot be certain as to what those are, Martin. I just have not studied it enough to tell you.

We spent all of our million dollars on our audits last year, and I expect certainly with SOX 404(b) testing starting in 2024 for us our audit expense will increase based on that alone. Having additional requirements, having a broader inquiry, having new specialists required that understand our business and have legal competence, they have to impose additional costs. I just don't know what those are.

Whoops, Martin, you're still muted.

MR. RAMANNA: You might need to un-mute, Martin.

MR. SCHMALZ: Ah, excellent. Thank you very much for the bailout.

Thank you very much, Mr. Temple.

I wonder if Professor Zingales could speak to costs and benefits?

MR. ZINGALES: Yes. First of all, thank you very much for inviting me. Can you hear me?

MR. SCHMALZ: Yes.

MR. ZINGALES: I think that noncompliance with law regulation can be extremely expensive for investors, and I think that the costs can be mostly of three nature. One is firms get caught and pay large fines and sometimes have been punished in damages. So I think that those are important costs.

Second, and even if they're not caught, the extent that the market perceives that there is a noncompliance, and so there's something going wrong. There might be an important lemon discount, at least this is a term we use in economics, some form of reluctance to deal with a firm, and from the point of view of all the stakeholders, whether these are investors, these are customers, or these are employees.

And of course there are important externalities. So if I am an oil company that bribes an African government, I create an enormous amount of instability in the African country as a result of the corruption. And that's something very, very hard to measure, but can be really first order.

Now with two co-authors I tried to measure the first two of these costs and we had some novelty methods to try to calculate how many of these noncompliance go unnoticed because they often the research focuses only on the one that we do notice that tend to be the visible part of the iceberg and not the other.

And why we limit our analysis to large firms, more than 750 millions in sales? I think that in -- we find that roughly 10 percent of these firms are noncompliant in a way that is sufficiently material to generate a non-trivial lawsuit. So these are not a small noncompliance, but a large noncompliance, and they are quite pervasive among large firms. And on average these noncompliance tend to destroy 16 percent of the value of equity.

And so on average basically the

noncompliance of publicly-traded firms destroy 1.6 percent of market capitalization per year that the current value is $800 billion per year. So these numbers are very, very large.

Now you're saying why do we care about this number? It's because the aim of this regulation is reduce this number. Now how much this regulation will be reduce this number? I think is very hard to estimate on an exact basis. I think I encourage the PCAOB to structure the system so that we could measure.

And one ideal situation is for example to introduce it separately for large firms first and small firms later so that we have a beautiful discontinuity that allows us researchers to identify the impact of this for the results. So that is something that kills two birds with one stone because, number one, allows you to get a good estimate exposed, and number two, make it less costly for small firms to have this procedure.

But I think it's fairly easy because

the question, the way I take it, is not that we need to measure precisely what are the benefits and what are the costs? We need to determine whether the cost are bigger than the benefits. And this can be done in a much more approximate way.

So my simple calculation is if we look at the cost of the introduction of SOX -- I look at the SEC numbers for cost of audit before and after SOX and if I got the number right, there is an increase of 62 percent. Now that's very, very large. I don't expect this regulation to have this cost, but imagine that this is the cost of regulation. So again, if I did that right, audit fees of publicly traded for companies are roughly 6 billion, so a 65-percent increase in this would represent 3.72 billion. Let's be generous. Let's say $4 billion. Okay?

So now what I say is as long as this regulation can increase the probability of detecting fraud or reduce the cost of fraud by an amount equal to the ratio between the 4 billion, which is the cost, and the amount of fraud which is 800 billion, so by 0.5 percent, then this proposal is viable. So if you tell me that audit firms are able to spend 4 billion and not reduce this probability by 0.5 percent, I think we should rethink audit overall because we're wasting our money.

So I think that by any reasonable number, even a number that Tom floated, the American Chamber of Commerce, 36 billion, I can tell you with my calculation that as long as you can reduce the fraud by 4 percent -- and I am pretty sure that the good enforcement of noncompliance with the law or regulation rule will be able to reduce by more than 4 percent, but as long as it is reduced, this proposal is valuable.

And by the way, and I will postpone to a second intervention, I have not factor in the fact that, as was pointed out this morning, the baseline is already very high. So here we are taking enormous costs without factoring in that most of what this regulation requires is already requested. And so the cost must be very minimal.

And by the way, if you're interested, I can provide a perfect solution with no expected cost of regulation or the benefits, but I leave the substance for the end on how I can do that.

MR. SCHMALZ: Thank you very much, Professor Zingales.

I wonder whether Mr. Rees could speak from the perspective of investors on the same question of costs and benefits?

MR. REES: Thank you, Martin. It's a great opportunity to be here to share our views. I'm Brandon Rees, Deputy Director of Corporations and Capital Markets for the AFL-CIO. I also serve as a trustee of our pension plan. All together union members have over a trillion dollars in retirement savings through their pension plans and are significant investors in corporations. They're also -- workers are also stakeholders in companies and have an interest ensuring that illegal acts are deterred and detected to prevent accounting fraud.

As other speakers highlighted, I want to make three points: One, that the value of the NOCLAR proposal is first to prevent fraud. As we all are aware, the track record for auditors for detecting fraud, fraudulent accounting, has -- could be improved and I believe having a specific explicit duty to consider illegal acts by clients and to have the internal reporting mechanisms as proposed are entirely appropriate, and frankly, what investors already think their auditors are already doing.

I had the pleasure of attending the Wells Fargo stakeholder meeting in 2017 after the cross-selling sales fraud came to light. And the investors were demanding, retail investors in the audience said where was an auditor? Why were these illegal acts not detected? And the CEO correctly (audio interference) accounting rules, replied, well, it wasn't their job. It wasn't their job to detect it and it went undetected.

Secondly, it's my belief that by

having a specific obligation to consider and report legal and regulatory violations will have a therapeutic effect of deterring bad acts. Locksmiths have a saying that doors have locks to keep honest people honest. And it's the idea that if auditors have a duty to consider potential illegal acts that that can help deter and keep people -- keep executives from feeling the temptation to bend the rules, so to speak. And so that is beneficial.

And then thirdly is maintaining investor confidence in our capital markets. Since the Sarbanes-Oxley Act was passed in 2002 we've seen the S&P 500 increase fivefold. And a large part of that is trust and confidence in our accounting process in 404, for example, and because investors believe that auditors are providing that insurance. And it's frankly hard for me as an investor to understand how an auditor can provide assurance that the financial statements are accurate if they're not doing a risk assessment for the potential for illegal acts to have occurred.

And so, I just want to remind everyone what this proposal is doing. It's updating and replacing the AICPA standard that was adopted back in 1988. I was 14 at the time, so I had to go back and look up what happened in 1988 to refresh my memory, but that was -- George Bush was running against Dukakis for the president, Gorbachev had just introduced perestroika in the Soviet Union, and George Michael's song Faith was the top of the Billboard charts. So it's been a long time since these rules have been updated.

And they were only adopted by the PCAOB as an interim step for final rulemaking. It's my understanding that the AICPA has actually outdated their own standard and so there's actually a higher standard in place for private companies compared to public capital markets that we as investors, that working people have their retirement savings invested in.

So I just want to reiterate our strong support for this proposed rule. And in terms of the benefits if you're permitting just one corporate-earnings scandal, one WorldCom, that was $175 billion in value that was destroyed with that -- the collapse of WorldCom.

And then there are the second order effects on the economy that are not even concerned as narrowly looking at the cost to investors. What about the 30,000 WorldCom employees who lost their jobs? What about the communities that company operated? Those are economic impacts that this rule, the NOCLAR rule will help prevent that type of accounting fraud from hurting not just investors, but also employees and other stakeholders.

MR. SCHMALZ: Thank you, Mr. Rees. That already goes to what is at question 4 that I was going to ask, but that's why I asked all the questions ahead of time, assuming that some of these responses might get bundled. So thank you very much for that perspective.

I see Mr. McGowan has the hand up. The CAQ has also provided a cost estimate and he's also here to speak about the ACC estimate.

And again I would very appreciate if you could briefly outline what the methodology is by which these estimates were arrived at as well as any justification for these methodological choices. Please take it away.

MR. McGOWAN: Sure. Thank you, and I appreciate being here this afternoon to talk about this important issue and just kind of reacting to also -- to picking up a little bit on what Mr. Rees said about the standard not having been updated since 1988. I can assure you from my work with our task force members that we certainly are supportive of modernizing this standard, and that was our position in our comment letter.

I do think though that based on the conversations we've heard this morning as well as comment letters that were submitted to the PCAOB -- I think we all -- we're not all on the same page in interpreting that this standard is just a minor update to bringing it up to what the AICPA or FASB updated their standards to be. So I do think that what's proposed where we all are interpreting, some are interpreting, right, as more substantial. And I think that's where, right, the importance of data and understanding the economic costs and benefits of the proposal is absolutely important to whatever the path forward is for this particular project.

And I do think that from -- picking up a little bit on what Mr. Quaadman was saying earlier around the PCAOB's requirements around what they need to do from an economic analysis standpoint, we certainly in our comment letter were of the view that further study and evaluation were certainly needed. I think that in my view the PCAOB has not sufficiently studied the cost, benefits, and alternatives in the proposal that was put forth last summer.

I think that in our analysis of the comment letters submitted to the PCAOB we certainly saw many commenters question the robustness of the economic analysis that was included in the proposal. I do think that you're right we did try to quantify what we thought perhaps the costs of the proposal could be, but I think that in doing that, right, we the CAQ are a little bit more limited in what data is available to us.

I think that the PCAOB likely has access to a bit more data than us and I'd be curious to understand what outreach could have been done with the accounting firms or audit committees or issuers to understand what some of those costs could be. Agree with some of what Colleen was -- Professor Honigsberg was saying earlier about what some of those costs could be like the costs of implementing the rule.

So we did look to -- for purposes of our comment letter we looked at what the costs were of implementing facts looking about -- we thought that there was about 59-percent increase in audit fees from 2003 to 2004 as a result of SOX. If you applied that 59 percent to audit fees in 2021, we came up with a potential $9.1

billion increase.

But I think the difference we thought with this proposal compared to SOX is -- depending on how you interpret the proposed requirements and what those requirements would be if they did require more of a legal expertise that that would even make probably the costs even more expensive and perhaps different than the costs implement SOX.

And we did find a study from Wolters Kluwer that had on average what companies were spending -- paying, large companies were paying their legal counsels. And kind of we used that percentage to try and estimate what we thought the potential increased costs could be from a legal expertise needed. And I think that we -- assuming that it wouldn't be exactly the same as what companies incur, which was about $148 billion, if it was even some subset of that, say half, you'd get to 74 billion.

So again, I think we attempted to use publicly available data to come up with a number.

I think, right, holes I'm sure could be poked at that estimate, but certainly I think that we came to the consensus that the costs could be in the billions.

Looking at the benefit side of the equation, right, that's just the cost. I mean, I think that to me, when I think about the proposal, and while it does make reference to large dollar losses in connection with a couple of events that occurred, to me it doesn't provide evidence that company -- NOCLAR is widespread and prevalent. And I think to think that any one regulation could prevent one-off events -- like some of the large events were mentioned in the proposal. I just think that perhaps this is a solution that's overcorrecting perhaps.

Now, maybe there is some tweaking that can be done that modernize it but doesn't fundamentally change the responsibility of the auditors, but I do think that those are real things that we need to think about. And I even think probably in addition to economic analysis, which I know is the point of this discussion, but I also think it's -- whatever the alternatives are, whatever the final requirements wind up being, I think demonstrating how that those requirements will prevent some of the large events that were referenced in the proposal or perhaps help us understand what's being solved for here.

MR. SCHMALZ: So, thank you very much. I appreciate speaking to the methodology. You mentioned that there could be data the PCAOB that you imagine we could be using to inform the costs. If you have any specific data in mind, we would welcome a pointer to that.

Also I wanted to follow up. You mentioned that in terms of the legal costs companies presently incur, if one takes say half of those -- I wonder if there's any explanation of who you arrived at the halfway mark in order to address that. I'll ask the follow-on question I wanted to ask after that just to give you more time in case you need to.

And I did want to ask Professor Honigsberg and Professor Zingales on taking SOX as a baseline. So I heard Professor Honigsberg say that she does not feel comfortable quantifying and I heard much more optimism from Professor Zingales. So I wanted to hear what the disagreement there is.

And on the question of the one-off event you had just brought up I will want to call on Professor Karpoff, who has studied the prevalence of these items as well. And I see Mr. Croteau's hand up. And Ms. Posner has studied various of these events as well. So I want to go in that order, if I may, but first back to you, Mr. McGowan, in case you want to respond to these specific queries.

MR. McGOWAN: Sure. I mean, in terms of data the PCAOB has, I mean I think a bit of this came up this morning with the baseline understanding of what auditors are doing today with respect to the requirements and what is the incremental effort being proposed and what costs do the accountants think they're going to incur with respect to those. So that's what I was referring to is that the baseline of what's being done today and the costs of that.

In terms of our assumption around -- that was really more of an -- I mean, more just trying to get at -- we're recognizing that the auditors wouldn't incur the same level of legal expense that companies do recognizing, right, that they're employing lawyers for a whole lot of things beyond compliance with laws and regulations. And so that was simply meant to represent that it would be a subset of dollars spent related to certain laws and regulations. So there's no magic science behind that. Again, we were simply trying to quantify a dollar amount for purposes of our comment letter.

MR. SCHMALZ: Appreciate that. Thank you very much.

Let me contradict what I previously said and go backwards and start with Mr. Croteau, who might be able to inform the question as well.

MR. CROTEAU: Yes, thanks very much. I've been listening to the dialogue here, ad first of all, appreciate being invited back to this panel as well. And you have a very difficult task here.

But when you think about the discussion on the last two panels and then what I hear now, the starting point for this has to be agreement on what it is you are trying to accomplish. And I worry that that dialogue is incomplete at the moment. And even as I hear some of the discussion around fraud, and WorldCom for example, which was an accounting fraud, plenty has been done relative to the standards around fraud for accounting fraud. When you think about the risk assessments standards and the work of the PCAOB, SOX 404, and 302 certs, lots of things have been done. Certainly I think it's an area where incremental attention and focus is warranted.

We have as a firm our own initiatives which we're calling our actions to enhance confidence in the profession. We're focusing incremental efforts around things like the whistleblower program, not that we don't today, but incremental efforts there, fraud risk assessment and the like, voluntarily, beyond what's required in the standards. And you can read about that in our audit quality report. I mention that because I think those are good topics to spend time on, but I don't think that has anything to do with the proposal.

And then when you talk about what's in the proposal, it's back to being up front about what it is we think we're going to accomplish with the proposal because I don't believe that the proposal or any proposal for auditors can stop entirely illegal acts from occurring. And so --

MR. SCHMALZ: Mr. Croteau, I apologize for interrupting. I promise I'll let you finish whatever else you wanted to say, but I do want to jump in here. I don't think the argument is necessarily that they would stop the entirety of it, but Mr. Zingales previously calculated a small fraction thereof.

MR. CROTEAU: Yes.

MR. SCHMALZ: Can you speak to whether you think there is a chance it would be a small fraction --

MR. CROTEAU: Yes.

MR. SCHMALZ: -- that could be prevented? I just wanted to clarify that. I will let you finish. Go ahead. Sorry.

MR. CROTEAU: Yes, yes. Sure, sure, sure. And I'm not sure it's quantifiable per se, but I do think that there's an indirect benefit that could occur like there is from a lot of things that auditors do that could be somewhat preventative or help with earlier detection. But again, I think you've got to identify up front how much you're expecting auditors to do, back to the discussions this morning, relative to identifying matters beyond what management's already identified. And there are costs to that and risk assessment.

You think about risk assessment procedures and how far one goes. There are costs to that and decisions need to be made around that, and obviously informed by economic analysis. I think you've got a lot of data from a standard-setting perspective, or from an inspections perspective that should inform standard setting here relative to -- even in hindsight relative to the work that auditors are performing today and where it might be helpful to be additive.

Also the baseline discussions this morning were hugely important because the baseline is not what's in the current standards today. Auditors are doing more because they're -- there are a lot of reasons auditors are doing more, but certainly at least the large firms are doing more because of what's in the ASCs and in incremental things that we've done over time because of other PCAOB standards that affect the work that we do on ASC 450 around loss contingencies. And I don't think that's been factored in. So the increment may not be so large for some of what's being asked for here, but I think referring back to the earlier discussions, it's hugely important.

If done right, in my view and kind of what I was at least describing this morning, and I think it accomplishes what many investors want -- probably not some of what we're hearing right now that probably is not accomplishable -- but the unintended consequences around specialists or quality or independence or the amount of time, privilege, all those things -- I think all those things are manageable, but those are all really risks depending on where you land relative to decision making here.

So I think it's important to step back, get those things right, think about the potential benefits in a reasonable way relative to the incremental efforts that you're thinking about.

I also just wanted to mention the idea of writing this in a way that would be phased in.

If it's done right it should be scalable. And I think you do need to think about small and large firms, different size audits, but if done right, what we were describing this morning can be done in a scalable way. If you have to phase it in, I think you've done something wrong, in my view.

And then I just want to add the point on -- this dialogue does show to me at least that audit standard setting is different than certain rulemaking. And I don't want to get into all of the discussion about whether you re-expose or not; you guys will figure that out, but it requires a less insular approach where these kind of debates around the words in the standard can happen and inform the process. And I think this demonstrates that, what's happening here today when you think about the proposal, the range of the way people read the proposal.

So whatever you do next with this and your cost/benefit analysis, I would get some sunshine on it before it goes anywhere else because it may not be read as you intend it and this demonstrates that.

MR. SCHMALZ: Thank you very much for that and also responding to the large versus small firm perspective.

So I'll take that opportunity to once more contradict my plan and call on Ms. McNees, who is representing a relatively small firm, and in particular just ask as a starter whether she agrees with the idea that large firms already do more than the standards, and if that's also true for small firms or whether that might give rise to a difference in the costs, relatively speaking, to large versus small firms, and any other aspect that would shed light on the small firm question, of course.

MS. McNEES: I would not be able to speak to knowledge of what larger firms are doing necessarily, so I don't know if other firms or large firms are doing more or less per se.

And I don't know that I would characterize our current audit approach as doing more than what's in the standard, but I do agree with -- I think Brian made a couple of points of there are things outside of the NOCLAR standard, fraud standard for instance, where a lot of the concepts that are being discussed today are really taking place under that standard. What we're doing really just in terms of auditing assertions related to completeness of liabilities, including contingent liabilities, and incorporating things into there.

So I think some of the concepts that are being discussed as perceived as being missing from what auditors are currently doing are actually taking place perhaps in other -- with respect to other requirements from the audit standards.

And I do think we've talked at length throughout the day today in the different panels about there may be some perception that there's ignoring of indirect effect laws and regulations, and I think that's just not true based on the current standards as well. So I think there may be some misunderstanding of, as Brian said, kind of the baseline where we're starting from based on that.

And I'd like to maybe just also concur with one other thing that Brian said that I think is a really important point. I've edited my notes since the panels this morning because I think the cost element of this really -- we need to further define the scope. So when I think of what do I think the cost is, I think it depends a lot on everything that was discussed particularly in Panel I, Panel II to some extent as well, and really then what does the final standard incorporate into the scope? Because I heard a wide range of understanding and -- understanding of the words that as written and the intention of what the expectation was. And so I think really to be able to quantify in any way the cost I think we need better definition of what the scope is.

MR. SCHMALZ: Very good. Thank you very much.

So, Brian, I'll just refer to you as

Brian because of my inability to correctly pronounce the last name. I apologize for that.

You refer to inspections data that we might be able to use. I wonder if you had any specific data in mind there.

MR. CROTEAU: Yes, so I mean, I think that -- well first of all, I think this would be a great area that your target team could spend time on in even a more specific way than is already covered in inspections, and probably in fairly short order, to make sure that there's a thorough understanding across the profession of the procedures being performed today and how to the extent -- and in the extent to which those go beyond existing standards. That will at least give you help with your baseline relative to existing performance.

I also think there's work that could be done, and maybe some of this has -- I can't presume what's been done by inspections already or not other than what I know from my own firm, but I presume that there's a fair amount of data relative to inspection comment forms today, where there's obligations today relative to ASC 450 and our audit work relative to loss contingencies. Are firms doing enough there? Are we doing enough relative to assessing accruals and disclosures that are being made today? Are those not being made timely and the audit work around that not sufficient?

The PCAOB has the benefit of hindsight when they're looking at that work from an inspections perspective. And so I think there's presumably a fair amount of information and data that will help with all kinds of things. First of all, it will help with what are the various points in the process today that you want to make improvement and being clear about that so that -- for lots of reasons -- to inform the economics around this, to inform what we actually do going forward and the public policy decisions that are being made.

So, and again, without knowing all of the things that are done inspections, I know that this is an area that gets looked at as part of inspections today. So I presume there's all kinds of data that would be available that could be very informative. And sharing some of that in the rulemaking and the cost-benefit analysis relative to what's working well, what can be improved is I think hugely important.

MR. SCHMALZ: Thank you very much.

Now I'll catch up with my promise and want to call on Professor Zingales and Professor Honigsberg on their view on SOX as a baseline and the ability to quantify.

MR. ZINGALES: So, Colleen, go first.

MS. HONIGSBERG: Well, so I'm actually so happy that I went after Brian and after Carole because I feel like they really outlined exactly where I was going. When I was going through the comment letters there were -- most common comparison was SOX and that people were saying, well, let's take the cost of SOX as a sort of anchor point. And it wasn't clear to me why people were picking that because I think what you would want to do is, exactly as sort of Carole and Brian were describing, first let's figure out what auditors are currently doing, whether -- what sort of overlap do we have with loss contingencies or with the Exchange Act requirements?

And then let's better understand what is going to be incremental. And then let's understand the team that's going to staff those incremental tasks, what sort of specialists and -- are we going to need for that. How many hours are we going to need? And let's get a comparison of what this sort of additional work is going to look like and who's going to perform it relative to what we have now. And once we have that we can better understand -- all right, let's take an average cost per individual and do at least some baseline calculations there.

It wasn't clear to me from any of the comment letters that people were really taking that approach and that they were really comparing what we're going to have in the future under

NOCLAR versus what we have now. It was more like, hey, the last big thing we had in audit was SOX, so let's start with SOX and let's kind of sometimes use cost of SOX. Sometimes we'll say SOX doubled. Sometimes we'll say triple the cost of SOX. It just wasn't clear to me how they were getting those numbers.

So in terms of like methodology I think I would suggest really what Brian and Carole were doing and let's understand what incremental is going to happen and who needs to staff that. And then that will give us a better sense of like is SOX a comparison or how do we calculate the cost of this?

The other thing too -- but I would notice even if we're using SOX, it's unclear to me whether we should be using the cost of SOX when it was originally implemented or if we should be using the cost of SOX now? And I think this actually really gets to Brian's point about sort of scalability and how we're implementing it.

Because the cost of SOX, as I believe sort of -- I think Dennis mentioned earlier -- if we just compare what happened in 2003 to 2004 and the increment increase in audit fees, we're talking 59 percent. And thus, you end up with an estimate for additional audit fees of over 9 billion. But if you look at the cost of SOX over time, it's actually gone down.

So for example, Professor Coates, who was on the earlier panel, actually has a paper on this where he talks about once people got more comfortable with SOX, you had more people who were able to perform the tasks, you saw a decrease in costs.

So for example, there was a survey published in 2013, which surveyed almost 3,000 companies-- found that the total mean cost of compliance was 1.2 million and the median was 0.5 million. The SEC's ICFR rule, the requirement where they rolled back SOX -- ICFR for low-revenue companies -- admittedly there they were talking about low-revenue companies, so smaller companies here, but they suggested that it would save approximately 210,000 per year comprised of approximately 110 per year, would action audit fees. So quite a big difference from that initial 59 percent.

So I think we should think about do we do SOX at implementation? Do we do SOX now? And especially to Brian's point about scalability, well, if you are able to delay it, you give time for implementation and hopefully you can avoid that initial huge ramp up. So that was the -- even if we do us SOX, I think are we using the initial cost or are you we using once people get a little bit more established, because those numbers are going to be different.

MR. SCHMALZ: Thank you very much for pointing to these studies.

I want to just reiterate the request and invitation from the proposal and other places to please point us to specific data and studies that would help us with the quantification of these costs and benefits and submit them to the comment file. This is of course for the panelists, but also for all listeners and viewers online.

With that, let me get over to Professor Zingales, please, to speak to that.

MR. ZINGALES: So I completely agree with Colleen that it's much better to do a detail study than do a rough calculation. What I wanted to show is that do all the thesis that you want, but when the potential benefits are so large, they're second order.

So if you have time to spend, go ahead, and I think it's going to be a fantastic job. But to me, as an academic, I try to invest the resources where there is some value, other investing. And it seems to me that the value added is limited.

This is -- I disagree slightly with your characterization of measuring the increment. If you go down the path of measuring the increment, you should not measure the increment between what they spend now and what they spend in the future. You have to measure what they should have spent now.

Because we know by evidence that they under-performed the role of bringing up a red flag of fraud as for 10(a) of the Securities Exchange Act. And I can tell you actually two personal experiences when I board of large companies that were trading on the NYSE, where the auditors completely failed their responsibility of bringing up to the audit committee some clearly red flags.

So one case was a $300 million payment in -- for intermediation done to a company without a website. We said this smells like bribery so far away. And they didn't bring up to their audit committee. This seems to me like a blatant violation of Section 10(a).

The other one was a tax fraud done at the expense of the Italian Government, but using the company I was on the board of, which end up paying hundreds of millions of dollars in fines.

And was enough this was done by a subsidiary that in one year was doing one-third of the sale to one company located in Austria. For those of you who are not European, Austria is a shady place from a fiscal point of view and a business point of view.

And if you do any analysis of the phone call, they had one billion euro in revenues of phone calls. Every phone call lasted either 53 seconds or 1 minutes and 22 seconds. So any analysis -- any analysis would say wait a minute, the viability of the business of the subsidiary depends for a third on one company?

If you are an auditor you want to check what the one company is doing and how reliable. This was not brought to the attention of the board.

Even looking at the evidence from the United States in recent years, look at the Colonial Bank case. The Colonial Bank case, the auditors were not doing that. And were not pointing out that a lot of the mortgage were fraudulent.

And we're not talking, Brian, about accounting standard, we're talking about old-fashioned fraud. Corruption, sort of a fraud, tax fraud.

And Wells Fargo, KPMG revealed that in 2013, they knew they were overdoing with incentive contest. They didn't say anything to the board or the SEC.

So I think personally that we would not be here with NOCLAR if the audit firms had done their job under Section 10(a). The only reason why we're here is because they don't do it.

Now, using the benchmark that they don't do anything, you say, oh, it's very costly to do something. It seems like completely preposterous. Thank you.

MR. SCHMALZ: Thank you very much for that passionate perspective. I see two hands up, but we haven't heard at all from Ms. Posner and Professor Karpoff. So if I may combine questions two as a prompt to them --

MR. QUAADMAN: Excuse me, Martin?

MR. SCHMALZ: No, no, so that's --

MR. QUAADMAN: I've had my hand up for a while, and you've gone back to several people a few times. Do you mind if I?

MR. SCHMALZ: Yeah, I would like to hear from Ms. Posner and Professor Karpoff first, and then we'll get back to you.

So I would like to ask --

MR. QUAADMAN: I'd just assume that you're not as interested in the public company perspective.

MR. SCHMALZ: No, I'm interested in questions, in answers to the questions we're posing.

MR. QUAADMAN: Well, I was hoping to answer a few, which is why I've had my hand up for over a half hour.

MR. SCHMALZ: Thank you. So I want to reiterate the second question, which is on additional studies or data to clarify the economic impact, and the submission of Professor Karpoff points to that. And I'd also like to call on Ms. Posner on that.

The fourth question points to the broader macro socioeconomic environment, in addition to capital formation, firms' cost of capital, and so forth, if there was more trust in financial markets.

So Professor Karpoff, let's have you go first, given that in your submission, you're referencing several studies and data on the topic.

MR. KARPOFF: Just as things start to heat up. So I, so my comments are going to be, if I can use first names, overlapping and similar to Colleen's and Luigi's. Although my conclusions are very much closer to Colleen's and very different from Luigi's in that I think we don't have reliable numbers on which to assess the benefits of the proposal.

So Martin, I think, tasked me originally with trying to think through a framework with which to think about the cost and benefits from a social or society point of view. And that's what the comment that I submitted does and which I'll follow.

And I think in doing this, I want to point out that the terms "fraud," "misconduct," "noncompliance" get used somewhat interchangeably, both here and in the literature. And the empirical literature treats these various types of unsavory activities differently and draws from different types of them.

So, for example, this'll be important because if we're looking at empirical estimates of, say, financial misrepresentation-related cost, that could be very different from the potential benefits of reducing noncompliance associated with, say, workplace safety activities. So the data that are available have to be interpreted with that in mind.

So in thinking about this, I think there are four buckets or types of costs that we want to consider. And the first is the direct compliance and cost of the regulatory bureaucracy.

And this is the bucket I think a lot of the discussion so far has focused on, trying to estimate how much the extra audit fees are going to be and how that redounds to investors.

But the idea is to risk increasing that cost associated with fraud and fraud management in exchange for a benefit of reducing the social cost of fraud in three other buckets. And the first of these three other buckets is for detected fraud.

And here, my estimate of the cost of detected fraud is somewhat similar to the numbers that Luigi cites in the paper that he mentioned. And what are those costs? Well, they're the incremental cost of investigations and the legal process, including lawsuits. There's a loss to reputational capital.

And in a project I was involved with, we estimate these costs to be quite significant, up to a quarter of market cap of the fraudulent companies. And what does that mean? Decrease in reputational capital means a decrease in the value of the assets the firm has that help bond the firms' contractual performance of the counterparties.

And it shows up with things like higher cost of capital. So a paper by Graham and Lu in the JFE in 2008 show this. Papers by Chava, Murphy, and all, in JFQA, JFE show that you have these specific types of costs that we lump together and measure in total as being about 25% of market cap.

They're also firm-level disruptions for detected frauds. A paper by Fich and Shivdasani shows that there's director overturn -- or turnover, I should say.

A paper I've been involved in shows that 93% of named respondents at firms that are targeted for enforcement action by the SEC for 13(b) violations, that is, misrepresentation, 93% of these people do leave the firm. Which is a measure of the type of internal disruption.

Then you have cost of undetected fraud. And here's where my thoughts on this differ significantly from Luigi's. What are the costs of undetected fraud?

What would the cost be, say, if we had a firm that was misreporting its earnings for two years, it was never detected, and then goes back to truthful reporting? Well, some people might argue no harm, no foul.

On the other hand, I think we do know that there are substantial costs. There are the costs of resources burned up simply to maintain and cover up the fraud. More importantly, during the period in which the books are in error, you're going to have price distortions.

And the price distortions are going to lead to suboptimal investment to the extent that managers of the target firm and other firms use price signals to help guide investment decisions. And they'll have suboptimal portfolio formation as investors bear risk suboptimally because they're dealing with distorted prices.

Now, my estimate of the size of the price distortions come from an exercise in which we used various types of machine learning models to try to understand about how much undetected fraud is going on at any given time.

And here we're talking about financial misrepresentation. And without getting into the weeds, you know, the exact estimates depend on things, like how you tune the model. That means how you weight the cost of type one and type two errors in classifying firm or not firms.

And they depend on things like how long you assume violations are going on. But in a base case estimate, it looks at any given time on average, you have a large number of firms, up to 24%, that are engaged in accrual management that distorts prices.

And that price distortion averages about 10%. That is, these firms prices are inflated by 10% compared to a benchmark in which we -- this hypothetical benchmark where you have full information.

But the damage doesn't stop there. Investors, knowing that there's some fuzziness in the information that they're getting, are going to apply a discount to all firms. So even non-fudging firms are going to have a price effect.

And we estimate the average effect to be about a 3.3% decrease or distortion in the prices of the shares of firms that are not fudging or pushing the books.

MR. SCHMALZ: But that's like an asymmetric information discount, is that the right way of thinking about that?

MR. KARPOFF: That is, yes, that on average, you know, investors are not on average going to overpay for shares. So they're going to discount all shares accordingly.

MR. SCHMALZ: So can I ask you, in the interest of time, to also speak to any societal tradeoffs. So not just on investors, but perhaps the environment, social capital, and so forth. What does the literature say there?

MR. KARPOFF: If I can, here's -- I

should point out why I disagree with Luigi's estimate on the effects of the undetected fraud. And Luigi knows this, I wrote an extensive note once about this. That he -- on which he's relying.

It draws from another paper that shows that in the firms that the author of that paper think are misrepresenting firms, they experience a decrease in share price performance of 11% compared to other firms. And if you apply that 11% number as a measure of cost fraud, you get the numbers that Luigi was presenting.

And I just think that is not at all related to the cost of fraud at undetected firms. I think it gets cause and effect backwards. But so that's a hopefully good faith, honest disagreement with that particular measure and why my angle on this is different.

You mentioned societal spillovers. Here I think there's a lot of really important work that we're so far not giving much attention to, and that is to the extent that you can decrease the incidence of fraud, there's a lot work showing that the decrease -- a decrease in fraud or the perception of fraud increases trust in social capital.

And here, I just criticized Luigi. Let me praise the leading work that he and his authors have done in a number of papers that help show, along with others, that higher trust and social capital are associated with high use of credit, financial market development, industrialization, trade and economic growth.

Increase in fraud or the perception of fraud decreases stock market participation. Quentin Dupont has a paper that shows that the effect is to decrease households' investment in the stock market and ex post measures of the impact on their wealth is in low six figures measured over time.

So again, I think, we have some way to start to get some traction on these -- on these measures.

If I can point to one last thing. I

left out an important area that we -- we've been talking about the direct cost of the regulatory process in compliance. There's one more aspect of that that I think should be considered, and that is the cost of regulatory burden overall.

And here I want to refer to a couple papers by Joseph Kalmenovitz and co-authors, where they have this interesting data-intensive measure of regulatory burden that I think is persuasive and in which they're able to show that regulatory burden is associated with higher cost of goods sold, more overhead spending, less investment, more lobbying expenditures.

And even the -- being in the pipeline, having regulations in the pipeline such as this one is associated with higher political uncertainty and lower investment. So again, a big cost of doing this type of proposal, but also big cost of fraud that hopefully you might be able to make some traction on.

MR. SCHMALZ: Thank you very much for that perspective and all the references to studies and data. Now let's go in the planned order of Ms. Posner, then Mr. Quaadman. And then I do see the other hands up as well.

MS. POSNER: Thanks, Martin. So I'm not an economist, so I'm not an accountant. I occasionally kind of play one on TV in the course of litigation that I bring on behalf of institutional investors against companies that commit fraud.

So I'm pretty well-versed in the kind of fraud we see, both by corporations, but also occasionally by accounting firms. And I thought I'd start by addressing a couple of the comments I heard with regard to the cost of litigation and then turn to the benefits.

With regard to the cost, I thought what Brian said was -- and then Colleen reiterated this perhaps or expanded on it -- I think understanding the incremental difference between what the rules already require auditors to do and what this rule change would require them to do is a really important quantification.

Quite frankly, I have a hard time understanding how what this rule requires of accountants is all that different than what is already required via other aspects of the rules in terms of risk assessment and otherwise. So I do think understanding that delta is a really important one so they understand whether the costs kind of outweigh those benefits.

And when you have a handle on what that is, I think addressing some of these comments about what the cost flowing from that change would be are kind of easily dispensed with, or at least negated in some material respects.

So for example, one of the things I heard was oh, there'd have to be significant additional consultation with subject matter experts. That's something that the accounting rules already require, particularly with regard to the areas that are the material subject of the financial report.

So I would hope that in most instances

the accounting experts are consulting with those subject matter experts on a regular, ongoing basis in order to fulfill their obligations under PCAOB standards to begin with.

Same thing with regard to communicating with legal experts. I just read an article a week or two ago talking about the fact that the Big Four accounting firms receive billions of dollars in revenue every year from the legal services that they provide to their clients. They are the largest law firms in the world.

So the idea that somehow there is not this internal legal expertise is kind of baffling to me, and certainly exists for them to consult with to the extent it's necessary.

We heard a little bit about the fact that somehow these rules lead to less IPOs and less public companies, and that the costs of rising capital will be impacted by the change in these rules.

I don't see any connection to the

specific rule change being offered here. And more importantly, it's the same charts and the same arguments I see in response to every single rule change proposed by the SEC or the PCAOB, no matter the subject matter or topic.

I've heard the same testimony, I've seen the same charts at least I don't know, 100 times in the past five or six years. It's the same arguments that are raised in the Fifth Circuit when the Chamber challenges every single rule change the SEC and PCAOB make.

It'd be nice if we saw some kind of specific direct connection to the actual change that is being proffered here and how that might be affected by it.

Talking now just with regard to the benefits. So just to give kind of a slice of what we're talking about here, between 2018 and 2023, so just a six-year period, we saw 608 securities fraud class actions that were settled for approximately $27.5 billion. It's a little less than $5 billion a year.

Now, the amount of the settlement obviously does not necessarily reflect the total cost to investors as a result of that fraud.

On average -- and by the way, I'm getting all of these numbers from the Cornerstone Group. Cornerstone Group is -- uses professors who defend corporations in securities fraud. So this is not a liberal think tank by any stretch. These are the folks who defend corporations for a living.

They assess that this number is a very small fraction of actual simplified tiered damages in securities cases. They average -- they say that the number ranges from less than 20% of damages in the smallest of settlements, so under $25 million, to about 2.5% of the largest damages -- largest settlement, so $1 billion-plus settlements.

I can tell you last year, since it's come up a couple times, I settled the Wells Fargo case. We settled that case for a billion dollars. We actually received 25% of our estimated damages in that case on behalf of investors.

There is no comparison to that. That is like off the chart, not even in close to what is ever recovered in securities cases, particularly securities cases of that size. And that was just a quarter of the estimated damages in that case.

So while 27.5 billion is a lot of money already, just over a six-year period, the number of actual damages and loss suffered by investors as a result of securities fraud is infinitely higher than that number. That also assumes, of course, that every valid securities case survives a motion to dismiss.

For those who are litigators on this case -- on this call or listening in, know that surviving a motion to dismiss in a securities fraud case is extremely hard. Approximately 50% of cases survive a motion to dismiss.

That doesn't necessarily mean that the other 50% were not sufficient or did not mean that there was an actual fraud. It just means that they weren't able to meet the extremely high standard in securities fraud litigation. So it's under-counting the number of cases in that regard as well.

It also assumes that every instance of fraud is detected, and that a lawsuit is brought in the first instance.

But I don't think we even need to quantify that undetected fraud, as we kind of heard this debate going on, to know that just based on the detected fraud, the extreme impact on investors from fraud that is detected. Often by the way not detected by auditors. It's detected because it comes out through other mechanisms of action, unfortunately.

So I think that's a really important kind of numerical way to measure the benefits here of what a very small percentage of detecting fraud could mean for investors. Just a small percentage change would have a huge impact on investors.

The other thing I thought I would talk about is something a little bit more amorphous that I can't necessarily put numbers on, but perhaps Brandon could speak to this a little bit as well, which is that the reason institutional investors invest in the U.S. markets is because they believe the U.S. markets are generally as free from fraud as they can be.

That they are better than other markets around the world. That because we have the SEC, because we have private enforcement, that there are opportunities here to ensure that their investments are safe.

And if they do not have that comfort, if they do not believe that they are getting the benefit of paying the additional cost to invest in U.S. markets and that the folks who are supposed to be the gatekeepers for our markets are not doing their job, they will not invest in U.S. markets, or at least not to the same degree as they currently do.

And at a time at which the markets

across the world are considerably more available to institutional investors in particular, and that they are widely deciding to invest abroad and not just in the U.S., the idea that we wouldn't want to have those added protections here seems to me to be something that corporations and the Chamber would be concerned about.

That you would want to have the added protection that these types of provisions allow so that you have investors who want to invest in your companies, as opposed to going elsewhere.

MR. SCHMALZ: Thank you very much for that perspective.

Mr. Quaadman, please.

MR. QUAADMAN: Yes, and that's why we did not support any legislative changes to SOX 404(b), so that businesses had the certainty to grow from small to large.

So to go up to cost for a second, with our estimates, as I said before, we used audited analytics data. And the reason why SOX was used, and other commenters have used SOX as a baseline, is because between 2002 and 2003, audit fees doubled.

So if you take a look at what we did is, in using the data from 2023 -- sorry, 2021, updating that for inflation and just doubling that number, that's how you get to $36.4 billion. It does not include increased litigation risk, it does not include things like increased broker-dealer fees.

So actually in our view that, just based on history, that's even an underestimate. Additionally, when you take a look at the SEC's cost-benefit analysis in SOX 404, they were off before reforms by 4.67, a factor of 4.67. And even after reforms, they were off by 3.67.

So SOX in and of itself is instructive as to what that could mean here. Additionally, as we had in our comment letter, this, the NOCLAR proposal, has the potential to continue the concentration in audit firms that has been occurring, as I said, over the last six years.

I would also have to note, I know there's been a discussion about societal spillovers. I have to note, earlier morning, the SEC refused to include any sort of a double materiality consideration with its climate disclosure rule. It is not within the ambit of the SEC or any organization that falls under it to take societal issues into account.

And I would just raise as well, if anybody meets with companies that could go to the IPO process, look no further than the JOBS Act and the creation of the emerging growth company category, which Congress had to act in order to deal with some of the issues there, because companies felt that they could not be able to scale some of the requirements around that.

And the two issues that are often raised why companies will not go public is proxy advisory firms and some of the PCAOB standards that are just not relevant to that model. And as Brian notes from his previous experience, it took over 15 years to get those SOX 404(b) issues factored out.

And I would also have to see too, just with our cost estimate, again, yes, there are a lot of different resources within audit firms, there are a lot of different resources within companies. But this is going to require additional lawyers and additional subject matter experts in different areas that are non-legal in order to deal with some of the issues that are going to be raised here.

MR. SCHMALZ: Okay, thank you very much for the perspective. Now just to tally things up, we have a bit less than half an hour to go. We have two questions to go and lots of hands. I do think I kept track of the order of the hands.

I just wanted to remind us of the question. So one is the extent -- to the extent there are alternatives on the table, whether they are studies or data that could help us estimate the benefits and costs of those. I haven't heard any so far, we can skip the question if there are no responses to that.

But then also the overall question of in light of the discussion that we've heard so far, whether there are any updates to the views. Again, if that's already implicitly covered, I'm happy to essentially skip these questions.

But with that, I'll go in order. Professor Zingales, I think was first and might want to respond to the comments that Professor Karpoff made, or anything else of course. Please take it away.

MR. ZINGALES: Yeah, no, I appreciate John's comments. And I think I want to make it clear where the disagreement is, in a sense that half of the cost that I describe comes straight from the probability of that in fraud and the cost of fraud that both of us agree on.

So even if we were to put at zero the cost of undetected fraud, which I don't think is zero because honestly, if this was zero, we should abolish auditing. In this way, we are sure that nobody's caught.

I think the only one. Yes, you see the PCAOB altogether. So we know it is caught. And everybody lives happily ever after, so.

But even if we take that extreme view, which of course I'm not taking, you still are at 400 billion a year, which is a very, very large number. And so all our argument goes to even under this extreme, extreme assumption.

And I want to be very clear, because I think that there is often a confusion, and John I think played on that confusion, we're not just talking about financial means of presentation. We're talking about fraud. And the example I brought of Colonial, of Wells Fargo, and the two other companies that we're describing is exactly of that type of fraud.

So I think that that's pervasive. That's very costly. And I think that the benefits of reducing it is very large and can be obtained with very little. In the cases that I described, if the auditor had done their job normally, would have been avoided and saving all the legal cost.

I think that all the legal cost that Dennis estimates, I think that if -- that's a wrong estimate. Because those legal costs will not occur, because those are to patch the problem. If you fix the problem to begin with, you don't have those costs.

So in fact we have to say that introducing this save corporation all the cost that he estimated. So instead of being a cost of this regulation, this will be a benefit of that regulation.

MR. SCHMALZ: Thank you, Professor Zingales. And we'll hear from Mr. Temple and Ms. Shortly as well. I first wanted to make sure Mr. Quaadman, your hand is still up, whether you got to say everything you wanted, or whether there was --

MR. QUAADMAN: No, I just wanted -- it actually goes to one of the two questions you were thinking of skipping. Some of the academic studies that are in the file, in the comment file, in support of NOCLAR actually also look at not-for-profits as well as non-public companies.

And it's really inappropriate to use that as a data set to justify an audit standard for public companies.

MR. SCHMALZ: Thank you for that. And the next on my list was Mr. McGowan. I hope I the order right.

MR. McGOWAN: Thank you, yes. So just picking up a little bit on something that Ms. Posner mentioned about institutional investors. We did do a survey of institutional investors just to so -- to see a cue from time to time do you know, interviews and surveys with institutional investors.

And given that the primary thrust and underpinning for the PCAOB's proposal is investor protection, in January we asked institutional investors about the NOCLAR proposal.

And some of the things we found was that according to this survey, most investors responded, about 88% responded that the information available today on NOCLAR meets most or some of their needs.

So I think our reaction to that was that, you know, that might suggest that investors are not looking for the substantial changes to requirements that the PCAOB has proposed. And perhaps, you know, as Ms. Posner was mentioning earlier, that the attractiveness of the markets and the gatekeepers maybe are working here.

And so it doesn't, again, you know, maybe there needs to be some modernization, some updating, but not substantial changes.

When we asked them about, you know, who they believe, who these investors believe were most responsible for better detecting noncompliance and fraud, only 17% of investors responded that public company auditors could do a better job.

And nearly seven in ten of the investors believe that the costs associated with the PCAOB NOCLAR proposal reporting requirements are too high to justify the updated rules. While our survey showed that investors would support some increase in costs to bolster auditor responsibilities on company NOCLAR, the majority said a 30% increase in costs or less.

And so I think that -- and I think we heard even this morning from the gentleman from the Fedex board, you know, mentioning that he's not getting a lot of -- he meets with hundreds of investors a year and is not getting questions about NOCLAR.

So I mean, I do think that there's probably an opportunity here for the PCAOB to engage with investors more broadly. And then perhaps, you know, there were some investors that did submit letters into the comment file.

And I think hearing from them as to, you know, those that I know we heard this morning from some that were supportive. But I think it's equally important to hear from those investors that were not supportive of the proposal.

And I think that brings me to kind of my, one of my final points, which is just I think that multi-stakeholder dialog is really needed to drive to a consensus on a standard that's practicable.

I think, you know, given the differing views and interpretations we heard in the panels this morning, and even the discussion this afternoon I think just underscores kind of the need for really transparent and robust dialog.

You know, based on our analysis of the comment letter to submitted to the PCAOB, 19 commenters, or 14%, said that the proposal should be rescinded or withdrawn. Twenty-two suggested that the PCAOB hold further dialog. So, very pleased that this round table is happening today.

I do think that this, you know, I do think it's going to take more than one virtual round table I think to really, you know, debate these issues and really come up with a path forward that is practicable and is solving for the problem that we need to solve for. And that an auditing standard and the auditors' behavior is the right mechanism for solving that problem.

Because if the request is for more information about company NOCLAR, you know, an auditing standard may not be that solution.

MR. SCHMALZ: Thank you, Mr. McGowan. Mr. Croteau, I did my best.

MR. CROTEAU: Thank you. Back to the earlier comments that I made that, you know, the difficult problem here to solve relative to economic analysis.

I mean, the discussion we're having now again demonstrates I think that there's a range of things that people are focused on here. And I do think that we have to be clear.

If there are aspects of the auditors' responsibilities on fraud that we want to focus on, we certainly should. There's been a lot done in that space today. More could be done.

I think Luigi, one of the first of the conversations you and I ever had together where you were trying to convince me auditors weren't responsible for fraud today, and certainly we are at a reasonable assurance level relative to financial reporting and misappropriation of assets. I think that's important, a lot's been done in that space. More could be done.

In fact, the SEIAG subcommittee, which I sit on, on emerging issues, and I'm speaking only for myself in this regard, but we're working on some recommendations in that regard. And there's been dialog from a CI perspective. And I mentioned our actions to enhance confidence as a firm.

But you know, again, you know, a lot of this discussion is not well-linked or sufficiently linked, even to the range, the wide range of things we were discussing this morning. And so you think about the range in which people are reading the existing proposal, and some of this is outside of that. Although some of it's already addressed I think in existing standards.

But this I think just demonstrates the real need to have clarity on what it is that we're trying to accomplish. And it doesn't, I don't -- when I say that, I really don't mean that there's not things we shouldn't do. I really do think there are.

But I don't think there's clarity in some of these discussions that can sufficiently inform actions for the board. Or the staff, I should say.

And I did just want to comment on, just to be sure, in the U.S. accounting firms, it would be illegal for us to, speaking of really lax, illegal for us to practice law. So accounting firms in the U.S. are not practicing law or making revenues from doing that. That would be illegal.

The other thing I just wanted to mention was a few of the examples that have been given demonstrate that either 10-A have not been followed or there are circumstances where perhaps enforcement was warranted relative to some particular set of facts and circumstances. And I think those are informative examples perhaps relative to is there something to do.

In response to that, you look at the

nature of it, the frequency of it, what generally the performance is. There's a lot of factors one would consider. But just because we can find an example of something I don't think means necessarily that that's justification necessarily by itself.

It could be, but it may not necessarily be. So again, I think that's where the inspections process in addition to inspections enforcement and all the information that the board has relative to thinking again carefully about what problems do we think we're solving, what do we think the attendant benefits would be. Because this is a very, very broad discussion.

And then I'll just close by saying the proposed -- well, let me -- two data points. One is the IAG letter, which says we believe such costs to investors are significantly more than cost derived from ensuring companies are not engaged in illegal acts including fraud, ensuring that.

And then, you know, when you look at the PCAOB's proposal, there's a reference to harm over 20 times. Only four of those that I could find referenced risk of material mistatements. So now we're talking about prevention of, I think, the illegal act to begin with.

So and some of this I think goes broadly to all kinds of fraud, which is again, kind of handled separately. So again, don't take any of this, don't -- to mean I don't suggest that there's good things that can be done, and I'm supportive of advancing the current standards.

But I do think that this is a pretty wide-range discussion that we're having that, you know, you've got a lot to think about here.

MR. SCHMALZ: Thank you very much. The order that I have on my sheet here based on when the hands went up is on -- Professor Honigsberg, Mr. Temple, Ms. McNees, Professor Karpoff, and Mr. Rees. So Professor Honigsberg first, please.

MS. HONIGSBERG: I'll be quick, I know we have a lot to get through. So I just had two points to add.

First, in addition to when Professor Karpoff had an excellent summary of like the consequences of fraud, one other paper I wanted to mention is the effects of fraud on employees, to the degree that you are considering the sort of effects more broadly as opposed to just on investors.

But so after fraud, employees had on average about 9% lower wages and were 18% higher to have a separation from the firm. So if you then just kind of conceptually can think about it, you have about 17,000 people who lose their job in one month after WorldCom.

Many of them are located it the same region. They all have to find a new job at once. And the jobs they find are often, you know, something they have to find quickly that is going to pay lower than what they had previously.

And one thing to note about the study

is that they found the effects were really concentrated on lower income workers because they just had less savings and so were less able to wait to find a new position. Whereas higher income workers were able to hold out for several months until they could find something else.

The other point I would make is, so I'm not sure we're actually going to get to the question on sort of small and medium issuers. One thing to note, and I think this actually goes to just what Brian was talking about, is like what are we really trying to achieve.

Because the latest data that I see from Audit Analytics on restatements from 2021, so of the restatements, 73% were U.S. filers who were non-accelerated filers. And then an additional 10% were non-accelerated foreign filers. So I think we can sort of say that the non-accelerated filers are where we'd be most concerned.

And if we're thinking about the cost-benefit analysis, well, the way the conversation was going earlier, it seemed like there was some inclination that maybe we'd want to you know, have a loop -- have a carve-out for smaller firms. Maybe that makes sense, I don't mean to say it doesn't make sense.

But then I would note those are also the firms that are mostly likely to have restatements. So you know, it's a little concerning.

And this, actually to what Laura was saying too, is like if we really want institutional investors to be comfortable investing in all firms, well, those are the ones who perhaps need the protection the most. And the additional, you know, sort of comfort that NOCLAR might provide.

I would also finalize by Luigi, I am an Austrian citizen and I did not appreciate your comments. So thanks.

MR. SCHMALZ: Thank you very much. Mr. Temple.

MR. TEMPLE: Just with deference to

the security litigation plaintiff's bar, the settlement of claims and securities litigation is not a measure of fraud despite the threshold to bring such litigation, the Private Securities Litigation Reform Act of 1995. And it is a business decision to settle such claims in cases where no fraud has been substantiated.

So but speaking as a smaller issue, the compliance function within my company is robust. The proposal in many regards is duplicative of that function, which would not -- is not adequate -- acknowledged in NOCLAR.

Moreover, the 302 certification process I'm sure as the self-identified compliance issues are disclosed by management to our CEO and CFO before they certify financials and are reported to our auditors.

But PCAOB standards without NOCLAR are already sufficiently broad to cover what is needed. Thank you for the opportunity to participate on this panel. I look forward to PCAOB reevaluating the need, scope, and precise nature of NOCLAR and supporting that with a well-funded -- founded cost-benefit ration.

I need to jump off, I need to hop on a board call. But thank you very much, Martin.

MR. SCHMALZ: Thank you very much for coming on the panel and the perspective.

I saw Ms. Posner's hand go up. I did put you in the queue, so if you can hold on, we'll go in the order. Ms. McNees was next in line.

MS. McNEES: And I wanted to hit on some of the points from question three as it relates to small, medium-sized firms in particular.

So I think it's probably quite obvious as it relates to the cost component of the equation here that to the extent a firm that has a smaller public company audit practice incurs overhead cost related to this proposal, certainly basic math would tell you that cost is spreading over a fewer number of clients, and they would be disproportionately impacted there, as opposed to larger firms.

There would be overhead costs associated with implementing the standard. But I also want to point out in addition to that I agree with some of the points in Ms. Honigsberg's presentation that she shared on some of the unintended consequences.

Smaller -- small and medium-sized firms are less likely to have internal expertise, would be more subject to seeking out external experts, subject to availability of those experts. Perhaps a limited, you know, pool of experts that we could call upon.

So I would encourage in the cost-benefit analysis and thinking about the impact of small medium-sized firms, that we're not simply assuming all firms that are serving public company clients have Big Four accounting level of resources available to them.

I also want to highlight, too, that I think the other aspect of this, and this was commented on to some degree already by Mr.

Temple, but that our client base that we serve, having a, you know, a smaller practice, tends to be smaller public companies, the non-accelerated filers that internally have less resources, less robust systems and controls, etc.

I'm not necessarily advocating for, you know, scoping out or anything like that. But I think it's important to understand that as we talked about in some of the earlier panel discussions about, you know, really starting with, you know, looking at what management is doing and if you imagine, you know, a Fortune 500 company that has this really elaborate compliance department that you could go to as an auditor and you know, see all of the different programs that they have and use all of that information to identify risks of noncompliance with material effect.

To the extent you don't have that sophisticated system, I think that that puts more burden on the auditor. And again, that may be the right answer, but that will increase the cost necessarily for the audit fees. And I think that would be disproportionate -- disproportionately adding more cost to the audits of those smaller companies because of that.

MR. SCHMALZ: Thank you very much. Yeah -- I hope I didn't interrupt. Please continue.

MS. McNEES: Yeah, sorry. I think that covers for the most part. There's probably more but I know we're tight on time. I just wanted to maybe address a couple other comments that have been made in the discussion that I wanted to highlight.

I've heard some comments that, you know, either the proposed standard is really not that different for auditors, like we should be doing all these things anyway. We should be seeking out subject matter experts, we, you know, that there's not much incremental impact.

And I would question then if the, obviously that has all to do with the discussions from earlier on what truly is the scope of the requirements. And I think there's a lot of uncertainty with that.

But if the intention is really not to substantially change what auditors' responsibility is for, I would question then why we would expect a significantly different outcome and result, and that suddenly now we're preventing, you know, billions of dollars of losses due to noncompliance as a result if we're saying well, no, this is really all the same thing auditors should be doing anyway.

So that seems like a dichotomy to me and I can't quite reconcile sort of how those two things are -- would fall in line.

MR. SCHMALZ: Thank you very much. And I saw Professor Zingales' hand go up. I don't know if we have enough time to get to it because we still have to get through various hands and close the meeting.

But I just want to reiterate that if there's any evidence, data, or studies on such unintended effects that Ms. McNees just reemphasized, please do submit them and refer to them in the comment file. It's very important for us to really hear on them.

So I have Professor Karpoff, Mr. Rees, Ms. Posner, and if we get to it, Professor Zingales to close out on it.

MR. KARPOFF: Quick, I guess three quick comment prompted by the discussion just for things for the PCAOB to consider as you move forward on this.

One is if you look at the compilation of the types of cost and benefits that we want to think about that I submitted and I think also you'll find the same thing on the list that Colleen submitted, you don't see a line item for legal settlements or regulatory fines. And the reason for this is that such settlements are transfers.

And if you're trying to take the perspective of you know, cost and benefits to society, you'd want to consider the cost to the payer of this transfer. And also the benefit to the receiver of the transfer.

And so I encourage the board to only consider such settlement or regulatory fine amounts as measures of the cost of fraud only if you could somewhat persuasively tie it to some real deadweight loss.

Second, my comments sort of swing both ways in terms of whether they favor the proposal or not. But similar to the comment that Ms. McNees was just making, I have a genuine question about the effect of tasking auditors to a higher standard and to look into more areas of a firm's operations.

On the one hand, Luigi's examples point to, you know, are great examples which suggest that maybe if auditors were so tasked, they would have stopped some of those frauds. The counter argument is that they didn't stop them with existing rules and they are violations of existing rules.

So would the failures happen anyway? You know, really, what is the delta of the impact on fraud detection. That's a genuine question. I don't know of any work in that area.

And my third comment is sort of a large one. It's about whether this, considering social spillovers are part of the purview of the PCAOB. And I think there's an important distinction. And I think -- I think I probably agree with Mr. Quaadman about the SEC's rule that it's been considering.

But I don't think that undermines the mandate that the PCAOB has in considering rule changes to consider cost and benefits for the, you know, for the broader community.

It's different to mandate a firm's social outcomes than it is to simple consider the broad social impacts of the PCAOB's -- of acting within the PCAOB's mandate and jurisdiction.

MR. SCHMALZ: Thank you very much. And you all know from my accent that I'm German, and Germans get very nervous when it gets close to the final time and there's a risk we'd run out of time. So I just ask you to keep it as short as you can.

But Mr. Rees and Ms. Posner, then Professor Zingales. And then we have to close it.

MR. REES: This has been perhaps one of the most frustrating conversations I've had to participate in as an investor. To be lectured by the audit, representative of the auditor and prepared community about what investors think about NOCLAR is just really unfortunate.

From an investor's perspective, the cost of compliance with the NOCLAR rule is money well spent. And you don't need to take my word for it, you can look at it in the comment file. There's letters from the SEC investor advisory group, from CalSTRS, the Council of Institutional Investors, Consumer Federation of America and the AFL-CIO all strongly supporting this rule.

This rule will also benefit capital formation. If you're going to talk about the costs of SOX compliance, you also have to look at the benefits of SOX compliance. And as I said in the beginning, the stock market has increased five-fold since SOX was adopted in 2002.

The decline in public company listings, the number of public companies, is not -- is completely immaterial because the value of public companies today as a proportion of our capital markets is as high as ever.

This rule is vital to ensuring investor confidence in our capital markets because investors already think this is what auditors are doing. Our capital markets are the deepest and most liquid in the world precisely because of that trust, and we need to have strong rules in place to ensure that we honor that trust that investors, including working people such as my grandfather.

He grew up during the Great Depression, before we had federal securities laws. He hid his money, his life savings, buried in his trailer. Because of the PCAOB, because of the SEC, because of SOX, we now have investor confidence where working Americans trust their retirement savings in the U.S. stock market.

And my last point is whether it's appropriate for the PCAOB to consider impacts of financial wrongdoing and fraud on other stakeholders beyond investors, of course they do. Because the PCAOB has a duty to protect the interests of the end-users of financial statements. And that's not just the institutional investor community.

Creditors, business partners, employees use financial statements to assess the financial strength of the companies that they're doing business with. The spillover effects of this rule are tremendous. They're not limited to the investor community.

But that being said, based on everything I've heard today, even if we're able to prevent just one WorldCom, just one mega fraud from happening in the future, then this will be money well spent.

And so I strongly urge the PCAOB to move forward in adopting this long overdue rule.

A rule, which by the way, as I said in my introductory remarks, has not been updated since 1988 when George Michael was --

MR. SCHMALZ: I apologize Mr. Rees, I just have to move on. My German genes are trickling through. So I'm sorry to regret having agreed to call on Ms. Posner and Professor Zingales, but let's get to them.

MS. POSNER: I'll be very quick. I wanted to make the point that with regard to SOX, that in addition to the costs, you can also look at the specific benefits. And there's been quite a bit of studies done demonstrating the number of restatements and how they have gone down considerably as a result of SOX.

And also the size of restatements has gone down considerably as a result of SOX. Both are economic benefits to legislation, which I think was considerably broader in scope, quite frankly, than what this is asking to do. But I think is perhaps a good proxy if we're going to look at the cost of SOX.

The second point I wanted to make was just in response to what some of the accounting folks were saying. It is of course true that whether there is a large difference between what the rules require now and what this requires with this change, there might not be a demonstrable difference.

I think the problem is that the rules as required now are not being followed, despite the fact that that's what everyone was assuming, which is what is precipitating the need for the update in the rules.

And then the last point I just wanted to make the point that -- or Professor Karpoff was making about transfers. There's a lot of economic papers out there that are contrary to the view that he just expressed, that it is not simply a transfer of wealth from one set of investors to another.

I think it is absolutely an appropriate proxy for the harm to investors to look at actual securities fraud cases, whether some companies don't want to believe that they are actually reflective of fraud or not, you know, I'll leave it to them to say.

But I think we can all agree that at least some portion of them is reflective of actual fraud.

MR. SCHMALZ: I never thought I would get to say Professor Zingales, but please keep it short with your final comment.

MR. ZINGALES: To what Laura said, I think that what Carole is missing is precise the fact that if the rule today is not enforced, it doesn't work. So what this -- I think the PCAOB is forced to create new standards because the old ones don't work.

So I have a very simple alternative. So why don't we keep the rule as they are. However, every time we find out, like we found out in the case of the Wells Fargo and in the case of Colonial, etc., that the auditor had some information and they didn't raise a flag, then we do two things.

Number one, we revoke the license to operate for that particular engagement partner for life. Number two, we charge a billion-dollar fine on that audit firm.

Now this, the beauty of this system is according to you guys, the cost of this thing is zero, because you are saying that everybody already applied. So because in equilibrium this would be applied, the cost of this enforcement mechanism is zero, and the benefits are going to be large.

So if you really think that everybody follow the rule, you're going to sign up to my alternative proposal. Thank you.

MR. SCHMALZ: Thank you very much. Now I see Chair Williams in the screen. I'm aware we didn't get to what everybody wanted to say. My last plea to please submit any additional comments in the file. We read those and value them very highly in how we update the rule and the proposal.

Thank you very much for that. Let me

just make sure the comment file is open until March 18. And while we welcome all comments, the staff are particularly interested in the subset of comments of course concerning the round table topics and any points raised during the round tables, including follow-ups we didn't get to.

I also want to say the video of today's round table will be archived and available on the PCAOB website.

And with that, I would like to turn the floor back to Chair Williams to close us out. Thank you very much.

MS. WILLIAMS: Thank you, Martin, Barb, Karthik, and all of your colleagues who made today's event possible, including Brian Goodnough and Awilda Santiago and the Office of Communications and Engagement for managing the Webex.

And thank you to all of our panelists for taking time to share your valuable insights with us. You've given us a lot to think about.

I also want to thank the public that

is watching today. And as Martin said, the public comment period is open until March 18, and we look forward to hearing from you.

Thanks very much.

(Whereupon, the above-entitled matter went off the record at 5:03 p.m.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Roundtable Discussion

Before: Public Company Accounting Oversight Board

Date: 03-06-24

Place: teleconference

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate complete record of the proceedings.

Court Reporter