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<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

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HEATHER JOSSEM, Assistant Chief Auditor
JESSICA WATTS, Senior Associate Chief Auditor

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

2 9:39 a.m.

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

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

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

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

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

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

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

21 MS. VANICH: Thank you, Chair
22 Williams, and to all of our board members for

1 joining us today. Good morning, everyone. I'm
2 Barbara Vanich, chief auditor and director of
3 professional standards at the PCAOB. As Erica
4 noted, I'm joined by Martin Schmalz, chief
5 economist and director of the Office of Economic
6 and Risk Analysis, and it's certainly our
7 pleasure to be with you today.

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

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

22 Before we get started, I'll give the

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

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

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

22 Today's roundtable will be organized

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

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

21 With that, let's get started on our
22 first panel on identification. It will be

1 organized into two topics. Topic one, the
2 threshold for the identification of laws and
3 regulations, and topic two, direct illegal acts
4 versus indirect illegal acts.

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

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

21 Christian Peo, national managing
22 partner of Audit Quality and Professional

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

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

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

1 patience.

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

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

21 As part of the proposal, the auditor
22 would identify such laws and regulations based on

1 information obtained from risk assessment
2 procedures and other procedures performed during
3 the audit of financial statements, reviews of
4 interim financial information, and if applicable
5 in an audit of internal control of financial
6 reporting.

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

21 Our first question is are there other
22 thresholds besides could reasonably have a

1 material effect that would provide sufficient
2 rigor to the auditor's identification of laws and
3 regulations relevant to the audit of the
4 company's financial statements.

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

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

16 And, you know, as I prepared for today
17 and I reflected on reading many comment letters
18 that you've received of the over 140. I had a
19 number of conversations across kind of all
20 constituents to try to understand where we are
21 here relative to the threshold, and where we are
22 relative to kind of the misunderstanding that I

1 think might exist among constituents.

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

14 So to try to reconcile all that, at
15 least as I think about it, you know, Barb, I
16 thought it might be helpful to kind of describe a
17 little bit of how we think about or how you could
18 think about the threshold. As you think about
19 laws and regs today that we focus on relative to
20 preparation of financial statements and our role
21 as auditors, I sort of start at the center
22 relative to those that are directly related to

1 the preparation of financial statements and
2 directly affect accounts and disclosures, so like
3 tax law and pension.

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

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

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

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

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

20 And by the way, to evidence that, we
21 have CAMs today related to some of those laws and
22 regs and the accruals and disclosures related to

1 them. You'll find several related to FDA,
2 Federal Trade Commission. And so clearly not out
3 of scope, focused on today, a lot of time spent
4 by auditors.

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

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

16 But I think the trouble is when you
17 get to those kinds of laws and regs, and when you
18 think about what those could be, you could think
19 about, you know, and it's going to depend
20 whether, you know, how relevant it is depending
21 on the industry that we're speaking about. But
22 it could be, for instance, from a banking

1 perspective the timeliness of responding to
2 garnishment requests or, you know, OSHA
3 violations, potential for OSHA violations that
4 don't have a direct material effect on the
5 company's operations.

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

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

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

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

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

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

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

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

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

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

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

22 What may be a little bit misunderstood

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

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

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

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

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

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

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

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

18 MS. VANICH: Thank you. Mr. Owens, in
19 the interest of time, and I know it's hard to
20 talk about some of these issues without getting
21 into everything, if we could just focus, though,
22 your remarks on the threshold in particular so I

1 can make sure that we get to all of our
2 panelists.

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

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

20 And a little bit of background there
21 for those views. In the proposed -- in the
22 proposal, Paragraph 2 of the proposed

1 requirements states that, "With respect to all
2 laws and regulations, and the statement of the
3 financial statements can arise when violations
4 occur and aren't properly presented in the
5 financial statements."

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

16 For example, the auditor would need to
17 understand the nature of the potential contingent
18 monetary effect such as the fines, the penalties,
19 the damages, or the provisions, or the allowance
20 for returns. And to make this assessment, an
21 auditor may need to obtain a specialist,
22 potentially multiple specialists to assist in

1 understanding the nature and the range or the
2 potential noncompliance and the range of the
3 potential contingent monetary effects.

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

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

19 And so if we just focus on those
20 federal and state banking laws for this
21 particular example, from a federal perspective,
22 you can go out to your favorite law library,

1 search for, you know, the federal finance and
2 banking statutes, and the results are going to be
3 numerous.

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

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

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

21 MS. VANICH: If I could pause, I mean
22 we're not trying to focus as much on what was in

1 the proposal, but what it could be. Do you have
2 any other suggestions for would a different
3 threshold work? Do you have any suggestions
4 there?

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

19 MS. VANICH: But if I can ask you,
20 we'll come back to that because I think our last
21 question the panel gets to that really
22 specifically, and I want to make sure we all have

1 something to say by the time we get there. Thank
2 you so much, Mr. Owens.

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

14 MR. COATES: Thank you, Barbara, thank
15 you to the Board for the invitation. I recognize
16 I'm not an accountant or an auditor, and so come
17 at this from a law background. So I have some
18 sympathy for the general idea that the could
19 reasonably standard has the potential for
20 creating confusion, and depending on your take on
21 it, could lead to the approach that Kyle was just
22 sketching that the sense would be list every law,

1 list every penalty, go through an elaborate item
2 by item elimination. So I take the general
3 point, but other language might be useful.

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

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

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

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

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

19 So like let's maybe get a little
20 realistic about -- on both sides of the aisle
21 here, that is those who are wanting the proposal
22 to change, but also those of you are proposing

1 it, about like what meaningfully actually could
2 be done in practice.

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

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

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

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

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

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

21 But unfortunately, what that means is
22 that I have a two-and-a-half-year-old who is a

1 little under the weather. So I may have to drop
2 off from the panel to take him to a doctor's
3 appointment. If I have to do that, I promise
4 it's not because I'm not dying to hear more about
5 NOCLAR, but because I'm required to -- I'm
6 required.

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

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

20 The question is what work, and when?
21 And that's why this conversation I think is so
22 important, and I think will be so valuable. I

1 hope will be so valuable to the Board and to the
2 profession. And again, I only have two points to
3 make about it.

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

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

20 So just to give you an example, my
21 son, as I say, he's two and a half, he thinks I'm
22 very tall. Now those of you who have met me know

1 he's wrong. His problem, the mistake he's making
2 is that he doesn't have a good baseline for
3 measurement. He doesn't know that many people,
4 so he is persuaded that someone who's 5'7" on a
5 good day is tall, but he's wrong because what he
6 should do is look at the broader population, all
7 the people and then he could see whether dad is
8 really tall, and sadly he would discover the
9 answer is no.

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

18 But the baseline is not zero for the
19 same reason I'm not tall. That is, there's an
20 existing set of work that's already happening.
21 There are other people in the world who are
22 taller. And for that reason the economic

1 analysis should focus on that distinction rather
2 than pretending as if you're building on nothing
3 because the Board is not doing that.

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

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

18 When you're writing things like risk
19 factors or doing management discussion, giving
20 context to the financial statements, the standard
21 for whether to say something about something in
22 the financial statements is not the probability

1 magnitude test of Basic because then you'd have
2 to disclose things of very low probability.

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

17 For that reason, using that as a basis
18 to focus and narrow auditor's work in this area,
19 I think might be worth considering. So I want to
20 suggest, as others have in the comment file that
21 using that MD&A standard as a way to weed out the
22 long list of laws that, as John Coates says, no

1 lawyer knows, might be a path forward here that
2 folks should talk about today because if it's one
3 that practitioners in law and accounting feel
4 they can apply, it might be a way to make this
5 standard as effective as possible for investors.

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

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

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

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

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

18 But I think that there is a very -- in
19 thinking about this panel, there's what's
20 management's responsibility. And under 302, they
21 need to make sure that there is not a material
22 omission in the financial statements. There is

1 auditors -- and they need to comply with the
2 accounting for contingencies under ASC 450.

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

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

21 So how do we use different language
22 here than in the statement with respect to

1 material misstatements. And we have sympathy
2 with respect to the fact that investors don't
3 want auditors to, one, build a list of all the
4 laws. And they don't want -- I mean investors
5 have to pay for all of this, right? So they
6 don't want auditors to do things that management
7 isn't responsible for doing first.

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

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

1 that.

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

12 I think it's the language in Paragraph
13 4 that says identify laws and regulations. It's
14 really the identify even more so than the could,
15 and maybe some merging of the language in
16 Paragraph 4A and 4B could be a possible way, and
17 I won't do that here, of saying we as investors
18 want auditors to ensure there's no material
19 misstatement from the -- of the financial
20 statements from non-compliance with laws and
21 regulations, but that doesn't include looking at
22 every single law.

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

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

16 I do think that the notion of could
17 reasonably have a material effect is a proper
18 standard. John, you mentioned you're not an
19 auditor, and Rob, I don't think you are either in
20 all due respect. But the notion of could
21 possible is a well understood auditing notion.
22 It is the exact language that's already used for

1 auditors in the standard that says you have to go
2 out and assess risk of a potential material
3 misstatement.

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

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

1 when that came out.

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

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

19 And personally, I don't care if you
20 write in the word glad or you write in the word
21 happy, and that's what we're talking about here.
22 Do you put in could possibly have a material

1 impact using language that auditors already use
2 every day of the year, and clearly understand, or
3 to help others out, do we turn around and use
4 language reasonably likely. They're the both --
5 they are both the same threshold.

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

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

22 Of course, if management doesn't have

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

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

15 So the notion of indirect and direct
16 is outdated, needs to go by the wayside. We need
17 to get everyone focused on singularly on
18 insisting having a material impact because if
19 it's having a material impact, even if you might
20 have called it indirect in the past, say OSHA or
21 say account openings like what transpired at
22 Wells Fargo, even if you were trying to say

1 that's not material and it turns out to be, you
2 got a problem. And that is an issue that the
3 PCAOB is rightfully trying to address here.

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

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

1 then I'll circle back to Doug Carmichael after
2 you. Mr. Bell.

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

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

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

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

18 MS. VANICH: Sorry.

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

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

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

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

19 MR. MARTIN: Thank you very much.
20 I'll add just two or three things. I am neither
21 an attorney or an accountant, so I can add very
22 little value to the specific issues that are

1 being discussed today, but will comment two or
2 three perspectives.

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

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

22 That's the standard by which we've

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

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

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

16 So whatever it is we are trying to
17 solve for here, I'm not really familiar with
18 being neither an attorney or an accountant. I
19 interact with and have interacted with as
20 chairman, or CEO, or a lead director hundreds of
21 investors, not once has it been raised to me this
22 is a very important gap if you will on the

1 ability to assess how a company is performing for
2 those who own it.

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

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

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

16 Words I think are extremely important.
17 I think it would be better to bring the language
18 closer to what auditors are familiar with. So I
19 would endorse what Professor Coates said
20 reasonably possible as defined in FASB, ASC 450-
21 20 because auditors are familiar with applying
22 that. They apply it not only to loss

1 contingencies all the time, but also in
2 evaluating material weaknesses in ICFR.

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

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

16 MR. CROTEAU: Thanks, Barb. I think
17 this is a great discussion relative to the
18 threshold. I did want to comment just because
19 Lynn had suggested a difference of view on the
20 threshold. Just to be clear, I didn't make any
21 comparison to likely and possible. There's
22 clarity in my mind, it's the difference between

1 those. And in light of Doug's comment, I think
2 either could be models to think about here.

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

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

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

1 think that's an important distinction.

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

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

16 One example of those procedures that's
17 not in PCAOB standards today, we have it in our
18 policies and it's in other standards is one
19 around reviewing legal expenses that companies
20 pay to make sure that we think about legal
21 letters we're sending, inquiries we're making
22 because that helps inform us as to whether there

1 could be violations of the laws or regulations
2 that we're not aware of that the company is
3 working with legal counsel on.

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

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

1 threshold difference.

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

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

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

17 So the direct versus indirect
18 threshold, Lynn suggested that it was time for
19 that to go by the wayside. That could be. I
20 don't think so. But that could be, and that's
21 certainly what the proposal says. But the reason
22 that that direct versus indirect threshold is

1 there is because that is a way for the auditors
2 to understand, sort of provide a boundary for
3 when does it relate to financial reporting, and
4 when does it tip over into compliance, the
5 detection that Brian's talking about in those
6 compliance audits.

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

19 And Paragraph 6 says and you have to
20 test that in terms of how the company prevents
21 noncompliance, now you are into an area where --
22 I'll use a different example than some of the

1 ones that have been used. Say that OSHA, which
2 OSHA violations can be material, there is a
3 reasonable possibility of having material fines
4 come out of OSHA.

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

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

21 And the only way to comply with the
22 words as written, as you move over into the

1 compliance auditing and understanding and testing
2 controls over how management prevents, among
3 other things, prevents illegal acts is to go and
4 understand those laws in great detail, and then
5 go test the controls that management has around
6 the compliance aspect. That's a very significant
7 difference, and I do wonder whether that's
8 exactly where investors want us to spend our
9 time.

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

19 MR. COATES: Thank you. Just two
20 brief comments on some of the follow-ups. One
21 thing, I do appreciate Mr. Bell's references to
22 the existing materiality standard, but I just

1 want to make what I hope is sort of a non-
2 controversial point that the threshold here
3 cannot be materiality because then there's no
4 evaluation of the risk that could lead to
5 materiality.

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

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

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

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

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

20 But then the last thing I would say is
21 let's keep in mind that some companies, and this
22 is going to touch on the manager versus auditor

1 role here, I know in principle I completely
2 agree, auditors should not be doing management's
3 work, but part of the function of audit is to ask
4 questions of management or provide information to
5 the audit committee that allows the audit
6 committee to ask questions that will move
7 management beyond what their first inclination
8 would be.

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

21 And so I particularly think we ought
22 to, as we continue the discussion, keep in mind

1 modal S&P 500 company, that's one thing. But
2 newly created public company coming into more
3 robust audits, that's a very different
4 proposition for anything compliance, even with
5 respect to clearly material risks that at the end
6 of the day will have to satisfy Kieth's test
7 about materiality on the bottom line judgment or
8 -- I'll stop.

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

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

20 And question three, and we might have
21 heard a little bit of this as well, are what
22 potential approaches could a standard take to

1 facilitate auditors in identifying laws and
2 regulations, or how do we think about factors
3 that drive the risk of material misstatement due
4 to noncompliance with laws and regulations. Just
5 in the event we might lose him, if we could start
6 maybe with Mr. Jackson on this topic.

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

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

22 Under 10 Cap A, as the question itself

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

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

21 So my own view is that drawing on
22 those existing practices in the profession is

1 what the Board should be considering doing, and
2 that those are well-established practices. We're
3 not asking or reinventing the wheel here. What
4 we're trying to do instead is draw on those
5 practices so that auditors can use management and
6 the company's existing work on these questions as
7 the starting point for getting the analysis that
8 investors will need.

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

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

20 I went back and read your proposal,
21 and the proposal had -- I didn't have any problem
22 with what was in the proposal. I thought it was

1 sound and good. I thought it did tell the
2 auditor that they were -- or could clearly rely
3 on processes and procedures at the company. So
4 the points that have been made in that regard I
5 would agree with

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

15 We certainly had a focus on patents at
16 a Fortune 150 board I was on. The company had
17 been sanctioned for illegal shipments to China,
18 so that was a focus. I audited a meatpacking
19 company, and OSHA could shut them down at any
20 minute. And you look back to J&J, a very
21 reputable company, FDA was able to shut down some
22 of their plants which had a very material effect

1 on the company, and the financial operations
2 because they weren't able to produce products.

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

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

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

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

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

22 On the other hand, if you go in and

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

5 MS. VANICH: Thank you, Mr. Turner.

6 Ms. Peters?

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

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

22 And so that distinction is really --

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

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

22 And so I guess I'm leaning more to

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

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

19 So in the end, if we need to create a
20 scope exclusion in the opinion, then maybe that's
21 what we need to do to clarify and have investors
22 ask more questions about this, which might

1 actually clarify some of the thinking. But to
2 me, I agree that management is first responsible,
3 always responsible.

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

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

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

1 alongside of it clearly is just wrong.

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

10 MS. VANICH: Thank you. Mr.
11 Carmichael.

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

19 I think it's difficult to separate
20 issues and get started on what procedures should
21 be done and so on without specifically addressing
22 that direct versus indirect separation that is

1 part of the questions in this session.

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

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

19 But the questions that arose that
20 really undermine that split between direct and
21 indirect disclosure. The auditor had a
22 responsibility. The auditing standards at the

1 time said essentially that the user of the
2 financial statements can assume the disclosures
3 are adequate unless three audit reports says
4 otherwise.

5 Very closely related to that, the
6 accounting standards. There are standards on
7 unasserted claims and asserted claims, and
8 violations of laws and regulations fall directly
9 into that. So if the auditor is testing in
10 conformity with GAAP, the auditor has to address
11 the FASB accounting standards that deal with
12 violations of laws and regulations, particularly
13 those that relate to unasserted claims.

14 Unasserted claims must be disclosed in the
15 financial statements if they are probable of
16 ascertain, and there is a lost reasonably
17 possible. So that has to be addressed.

18 And particularly then special industry
19 knowledge, and the AICPA developed the audit
20 guides, got questions from the committees working
21 on the audit guides about the shortcomings of SAS
22 54 for specialized industries. And there are

1 just a host of specialized industries, a short
2 list, mining, extractive industries, healthcare,
3 defense contractors, foods and drugs, banks and
4 other financial institutions, regulated
5 operations like utilities, casinos, waste
6 disposal, pension plans, and a host of others.
7 And in all those industries, and it's part of
8 understanding the regulatory framework and the
9 legal environment, the auditor has to understand
10 those laws.

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

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

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

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

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

15 MR. RAMANNA: Yeah. Just before we
16 hear from the auditors, and it would be very
17 helpful to hear what specific approaches they
18 would like to see in the standard that they think
19 would facilitate identification. But Brian very
20 helpfully said that he would prefer is or would
21 to could, and I just wondered if we could hear
22 from Christian and Kyle about reasonably likely

1 and reasonably possible, whether they had any
2 specific objections to either of those would be
3 helpful to know. Thanks.

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

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

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

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

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

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

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

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

17 MR. CROTEAU: Yes. And maybe a few
18 things. One, certainly agree with all the
19 comments around management first. You might look
20 to some of the words within COSO relative to
21 existing obligations, particularly as it relates
22 to contingencies. And, you know, I think a lot

1 has evolved since I was -- well, I won't say how
2 old I was, but I was alive when all of those
3 standards were written by Doug and others.

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

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

18 But I think you could even -- you
19 could still do away with it in terms of what one
20 does after thinking about compliance. And you
21 certainly have to follow 10 Cap A. I don't think
22 there's anything wrong with 10 Cap A today. It

1 serves its purpose and is important.

2 But I think the more important points
3 are not what you call a direct or indirect.

4 Christian just said it and others have said it.

5 It's what one does relative to the laws and regs
6 that don't directly relate to accounts and
7 disclosures, but instead relate to ASC 450 and
8 contingencies. And what one does around those
9 matters because there's a very wide range.

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

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

1 from occurring.

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

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

19 But you very much have to know what
20 you're trying to get at further identification of
21 laws and regs that aren't already on radar
22 screen. Is it detection of matters that are

1 illegal acts? Is it the accounting and
2 disclosure under 450 and what companies are doing
3 there? Is it all of it to some degree?

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

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

17 I would also say, you know, when you
18 kind of -- when you kind of look at the, you
19 know, the procedures that we perform, I think
20 there's a lot to gain there, too. I rattled off
21 a few procedures earlier, but certainly the
22 levels of inquiry with the organization, review

1 of minutes review of contracts, review of legal
2 expenses.

3 There's all kinds of things that we're
4 doing today that aren't necessarily fully
5 articulated in the standards, and I don't know
6 that they need to be. But I think what's missing
7 there, and Sandy referenced it, there are other
8 applicable risk assessment standards that go to
9 the work that we do in that space relative to ASC
10 450 and accounting for contingencies, lost
11 contingencies, and the company's work around
12 that.

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

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

1 MR. MARTIN: Not from Martin.

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

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

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

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

20 MS. VANICH: Thank you. We're at just
21 about 11:15, and I know there are hands up. But
22 let me do this. Let me at least tee up topic

1 two, and I think we've touched on it, so I don't
2 feel as bad about being where we are timewise.

3 But our second topic, and then I'll
4 call people in the order they had their hands
5 raised, related to direct laws and indirect laws,
6 and what people thought of the distinction.

7 There's also a question that maybe I'd like to
8 get to at some point with the prepare an audit
9 committee member of how auditors and management
10 are assessing violations of indirect laws and
11 whether that differs.

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

20 MR. PEO: So maybe I'll start with
21 finishing the last topic, and then go into the
22 other. Although I think I've pretty much given

1 my thoughts on direct versus indirect. But I
2 just wanted to say from a management perspective
3 and relying on management, yes, I agree with all
4 of those comments.

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

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

20 And, you know, through the PCAOB
21 inspection program -- this is a -- this is a
22 great thing about the PCAOB. Through the

1 inspections program you can see where there are
2 inconsistencies, and, you know, you have a target
3 team program where you could get really good
4 information about where are the programs
5 inconsistent on those types of procedures, and
6 where do some firms go above and beyond those
7 normal type procedures that we do, and should we
8 bake those in and codify those into the
9 standards.

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

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

21 And again, I just think that do
22 investors really want us checking to make sure

1 the company's process will -- the OSHA warnings
2 on the break room walls, is that what we should
3 be doing because that's the path that the
4 standard is heading us down versus, you know,
5 strengthening those procedures that we were just
6 talking about. We are fully supportive of trying
7 to codify and strengthen those.

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

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

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

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

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

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

1 unintentional, that's an error.

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

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

19 And that because the standard itself
20 says, well, after explaining direct and indirect,
21 it says effectively here and after we're going to
22 call indirect just illegal acts. So when people

1 talk about the responsibility for illegal acts,
2 it's really only indirect. But I think you
3 should jettison that distinction as I made clear
4 before.

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

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

15 So we're inquiring with management to
16 understand kind of where they see the risks of
17 material misstatement related to noncompliance
18 with their financial statements, whether or not
19 noncompliance has occurred, how they think about
20 that, we're looking for board minutes to see if
21 there's things there that are being reported that
22 are indicators of noncompliance and things that

1 could potentially impact the financial statements
2 as well.

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

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

22 So I do think that distinction still

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

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

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

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

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

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

19 And, you know, I think what investors
20 are -- what investors question is is that when
21 these things come out, they've been going on for
22 quite some time, right? It's just that they've

1 become a big deal -- a big deal all of a sudden.

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

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

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

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

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

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

19 And I would also say that while it's
20 true that indirect laws and regulations can
21 result in material misstatements, it's also true
22 that direct laws and regulations generally have a

1 higher likelihood of resulting in a material
2 misstatement. So I think some type of
3 distinction and prioritization is important,
4 particularly for industries that are highly
5 regulated.

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

8 MR. BELL: Sure.

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

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

21 MR. BELL: I --

22 MS. PETERS: -- to agree with you.

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

4 MS. PETERS: Great.

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

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

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

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

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

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

1 indirect being improperly applied.

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

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

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

21 So the notion that there's an indirect
22 or direct notion, auditors don't ever see -- or I

1 mean investors don't ever see most of them, you
2 know, 99 percent wouldn't have a clue as to what
3 you're talking about. And again, I don't think a
4 lot of auditors have a clear understanding as
5 well with respect to that.

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

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

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

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

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

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

1 contingencies and accruals.

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

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

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

22 So you could do away with that

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

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

20 And when you start to look at that
21 relative to potential detection, I think that's
22 what is reasonable. It's what we do in practice

1 in many cases today, although like Christian, I'm
2 happy to do more as long as we go through the
3 right cost benefit analysis, and think through
4 the extent of it and it passes that test, which I
5 think there's room for some more.

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

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

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

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

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

22 So I think unpacking it and making it

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

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

19 And let me end with just one note on
20 prevention because it has come up a few times.
21 I'm sure it'll come again later. It's absolutely
22 right that I don't think it makes sense to write

1 anything that implies auditors or guarantors are
2 ultimately contingently liable for the non-
3 compliance of their audit clients. If that's
4 what I hear Brian worrying about, I'm with you.

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

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

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

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

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

1 way behind.

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

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

15 I have no problem with further
16 articulating that or reinforcing that. And from
17 time to time, that's been reinforced, including
18 when I was in my old role at the SEC. I think
19 that's fine. And I think that's consistent with
20 what John said. But I think the distinction
21 between all of that and otherwise being in a role
22 of preventing are two different things, and in a

1 role of detecting, there's limitations to how far
2 we can go reasonably without conducting a
3 compliance audit.

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

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

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

22 And I put the going concern in the

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

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

18 For the general public, this concludes
19 our first panel of the day. We will reconvene at
20 12:30 p.m. Again, I can't thank our panelists
21 enough for participating and sharing your views.
22 And thank you to those of you who have joined us

1 online today, and we'll see you at 12:30 on the
2 same link. Thanks so much, everyone.

3 (Whereupon, the above-entitled matter
4 went off the record at 11:45 a.m. and resumed at
5 12:30 p.m.)

6 MS. VANICH: Welcome back, everyone.

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

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

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

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

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

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

16 Back on June 6th, 2023, the PCAOB
17 proposed amendments to PCAOB auditing standards
18 related to a company's noncompliance with laws
19 and regulations. The PCAOB received over 140
20 comment letters on the proposal. From those
21 comment letters, the staff have identified
22 several topics for which we believe additional

1 information would be helpful in developing our
2 recommendation for the Board.

3 This morning we heard our first panel
4 on identification of laws and regulations. This
5 afternoon we're going to hear from two more
6 panels. The second panel goes from 12:30 to
7 2:30, and we'll talk about the assessment of
8 noncompliance in laws and regulations, and from
9 3:00 to 5:00, we'll have our panel on the
10 economic impact of the proposed standard.

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

19 Martin, Karthik, and I are here to
20 listen. We will direct specific questions to our
21 panelists in order to inform our efforts, but we
22 do want to hear from all panelists who wish to

1 speak on each topic and encourage open dialog
2 within the time allotted.

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

9 Thank you. Thank you for that.

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

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

18 Those watching online can find those
19 submissions easily by going to our website,
20 clicking on the Event page that appears on the
21 Home page, and then, selecting the Comment File
22 option on the right-hand side of the screen. The

1 most recent submissions are at the bottom of the
2 page.

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

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

13 Our distinguished panelists include
14 today:

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

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

21 Emily Fitts, Partner at Deloitte &
22 Touche.

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

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

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

9 Lynn Turner, Senior Advisor, Hemming
10 Morse.

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

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

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

20 So, the proposed requirement for the
21 auditor to obtain an understanding of nature and
22 circumstances of any noncompliance with laws and

1 regulations that the auditor identifies or
2 otherwise becomes aware of that has or may have
3 occurred is similar to the requirement under
4 existing PCAOB Auditing Standard 2405, paragraph
5 10.

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

11 The proposed requirement for the
12 auditor to determine whether under any such
13 circumstances noncompliance likely occurred is
14 consistent with the requirement under Section
15 10A. Specifically, Section 10A(b)(1) of the
16 Exchange Act requires that, if in the course of
17 conducting an audit a registered public audit
18 firm detects or otherwise becomes aware of
19 information indicating that an illegal act,
20 whether or not perceived to have a material
21 effect on the financial statements of the issuer,
22 has or may have occurred, the firm shall, in

1 accordance with Generally Accepted Auditing
2 Standards, determine whether it is likely an
3 illegal act occurred.

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

10 Let me turn to our first question
11 which is: how are auditors currently complying
12 with the existing requirements of
13 10A(b)(1)(A)(i), which requires auditors to
14 determine whether it is likely that an illegal
15 act has occurred when the first detects or
16 otherwise becomes aware of information indicating
17 that an illegal act has occurred?

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

21 MR. JONES: Thanks. Thanks, Barb.

22 I appreciate that, and I'm, obviously,

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

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

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

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

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

18 All of those are intended to help
19 evaluate the potential for whether an illegal act
20 or noncompliance occurred, as well as evaluating
21 the potential magnitude for the purposes of
22 evaluating the impact on the financial

1 statements.

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

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

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

19 But I think one other thing -- and I
20 think all of those procedures, as outlined as you
21 mentioned, both in today, as outlined in the
22 extant standard, quite frankly, as put forth in

1 the PCAOB's proposal, I think are common things
2 and expected things for audit firms to do today,
3 when executing on that requirement.

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

15 And I certainly don't want to rehash
16 the very helpful discussion this morning, but the
17 one thing I wanted to at least add to that is,
18 you know, when you think about that risk of
19 material misstatement, I do think it's helpful to
20 break it down maybe to its components. And the
21 first is the risk that noncompliance happened and
22 was not detected, and as a result, wasn't

1 appropriately considered for evaluation in the
2 financial statements.

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

12 And ultimately, the expectations of
13 the auditor on performing risk assessments to
14 evaluate the likelihood that the company's
15 compliance programs would not identify
16 noncompliance, potentially, and how they would
17 evaluate that. Ultimately, that is I think where
18 a lot of the concerns were in the context of,
19 obviously, the proposal around the nature and
20 extent of procedures that would be requested of
21 the auditors, which could highlight additional
22 areas that need to be evaluated for potential at

1 maybe a level that was in advance of where the
2 company would have otherwise been in their
3 process.

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

16 MS. VANICH: Thank you, Mr. Jones.

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

19 MS. FITTS: And first, I'd like to
20 thank the PCAOB staff for hosting today's
21 roundtable on this really important standard-
22 setting project. And I appreciate the

1 opportunity to participate in this panel.

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

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

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

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

21 Now, based on my reading of the
22 proposed requirements, the auditor would now be

1 required to perform an independent evaluation of
2 NOCLAR and make a definitive conclusion regarding
3 noncompliance. And in order to be able to make
4 the definitive conclusion, the auditor will
5 likely need to engage legal counsel and other
6 specialists to assist the auditor. And involving
7 legal counsel in every audit would be time-
8 consuming, expensive, and inoperable.

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

18 I'm concerned that the proposed
19 requirements are calling for auditors'
20 performance of a management function which would
21 be inconsistent with prevailing rules addressing
22 prohibited non-audit services. And I'm also

1 concerned that it could be seen as the
2 unauthorized practice of law.

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

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

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

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

22 But I want to maybe just speak

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

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

22 So, that, understandably, is the

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

12 MS. VANICH: Thank you so much.

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

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

18 There it goes.

19 MR. CARMICHAEL: Very good. Sorry.

20 The comments remind me of what was
21 said in the beginning when the fraud law and
22 standards were being changed; that if the auditor

1 has a responsibility to detect fraud, they would
2 have to detect all fraud. They'll have to look
3 at every transaction. They'll have to make a
4 legal judgment about whether it's under the legal
5 standards, in fact, of fraud.

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

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

16 It seems like auditors lost the notion
17 that they are always applying in their audit an
18 evaluation of the risk of material misstatement,
19 and it can be applied in the same way here. I
20 think it would be useful to look at some of the
21 areas in which auditors always deal with
22 something like environmental liabilities, where

1 audit programs typically do include more
2 procedures to try to detect environmental
3 violations and pursuing the correct accounting
4 for environmental remediation liabilities.

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

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

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

18 MS. VANICH: Mr. Turner?

19 MR. TURNER: Thank you, Barb.

20 I would agree with what Doug said.
21 And I'm curious. Emily made two statements:
22 that it would require all, quote, "all illegal

1 acts to be identified by the auditors," and two,
2 "require an independent evaluation in every
3 audit, resulting in a compliance audit."

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

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

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

20 In one situation involving Josh's
21 firm, they actually resigned from the audit; did
22 everything picture perfect. Information got

1 filed to the public through a case, and did a
2 wonderful, marvelous job.

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

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

18 Probably in the better ones that have
19 better outcomes the auditors did request the
20 company to have an investigation. In some cases,
21 they let the company do it. In other cases, they
22 requested that an independent counsel be brought

1 in and look at it.

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

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

13 So, just kind of my experience.

14 MS. VANICH: Thank you, Mr. Turner.

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

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

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

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

16 To understand that requires an
17 evaluation, I think, of the company's compliance
18 program and an evaluation of the scope of it; its
19 policies and procedures; how it identifies
20 noncompliance, and how it evaluates that; and
21 consideration as to whether there's any, I'll
22 call it, residual risk associated with that, that

1 needs to be addressed directly through the
2 performance of other audit procedures.

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

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

21 And so, that's, for better, for worse,
22 the direct/indirect dynamic today. It does allow

1 for, I'll call it, an easier way to distinguish
2 around the nature, timing, and extent of
3 procedures that auditors might do to identify
4 those things.

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

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

11 MS. VANICH: Sure. Sure.

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

18 So, it's not assessing all illegal
19 acts; it's assessing illegal acts that have a
20 material effect on the financial statements. And
21 I think we can say you need to assess all
22 material misstatements as a result of NOCLAR,

1 because, otherwise, you're leaving out some
2 material misstatements of the financial
3 statements, and you wouldn't have a basis for
4 your opinion.

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

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

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

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

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

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

1 the case I cited to.

2 MR. JONES: Yes.

3 MS. VANICH: Thank you.

4 Ms. Fitts?

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

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

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

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

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

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

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

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

7 MS. VANICH: Go ahead, Mr. Carmichael.

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

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

18 It's looking for whether a question
19 has been raised. I think auditors in a
20 specialized industry have plenty of knowledge
21 about the legal environment laws or regulations,
22 the ones that you could use a variety of words

1 that actually mean the same thing, that are
2 foundational, that are fundamental, that are
3 basic to the operation of the business and its
4 financial reporting -- things that would put the
5 company out of business; things that are critical
6 to its financial reporting.

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

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

20 MS. VANICH: Thank you, Mr.
21 Carmichael.

22 Mr. Wilson?

1 MR. WILSON: Thanks, everybody.

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

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

21 So, I think we can talk about this
22 further, but I just want to make sure we're not

1 losing sight of that, as we think about the
2 bigger picture focus that I think we're all
3 trying to address here.

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

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

14 MR. COATES: You'll start?

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

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

1 you have to find all the lawbreaking.

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

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

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

19 On the substantive question, I like
20 the particular. I always like the particular
21 better because I think, then, actually, it helps
22 illuminate the general. And so, when you get to

1 the independent items, making inquiries of
2 management, the audit committee, internal audit
3 personnel, and others, I would recommend there
4 building out what I think I heard our auditor
5 friends saying is beyond that, that they already
6 do, and that in my experience, responsible
7 auditors do already do.

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

19 So, where there is a compliance
20 function, I don't think it makes any sense to ask
21 the auditor to duplicate it in its entirety. I
22 think we have consensus on that. It's just a

1 question of being clear about it.

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

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

13 When the compliance function is either
14 inadequate or absent altogether, then, I think
15 it's fair to ask whether -- to Lynn's original
16 point -- the auditor needs to think harder about
17 how they sign off at all. At the end of the day,
18 if there is, as the best source of information,
19 just casual interaction among employees that
20 happens to bubble up, that, to me, puts pressure
21 on -- in a heavily regulated industry at least --
22 where there are material penalties that could

1 flow from noncompliance, whether, in fact, the
2 audit can be one that you can sign off on.

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

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

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

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

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

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

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

8 Mr. Jackson?

9 It's off. Thank you.

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

18 I would not have taken that read of
19 it, Emily, but, like John Coates, I have empathy
20 for a cautious professional taking a look at
21 something like that and saying, "Wow, what are my
22 obligations?" -- and wanting to know more. That,

1 I think, is why we're here.

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

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

18 That is my understanding of how 10A is
19 implemented in well-governed public companies.

20 And I don't read anything in the current proposal
21 that would require more auditors, except as John
22 says, to update quite considerably the degree to

1 which they scrutinize the policies and procedures
2 that ensure that management is aware of issues
3 around compliance with law.

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

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

1 MS. VANICH: Thank you so much for
2 that.

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

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

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

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

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

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

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

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

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

11 The nature of the auditor's procedures
12 to evaluate whether or not compliance has
13 occurred, and the expertise needed to make that
14 evaluation, as well as the potential impact on
15 the financial statements, those are often
16 different in terms of their nature, largely due
17 to the fact that, you know, auditors likely will
18 need the expertise of specialists to help
19 evaluate the nature of the matter; the relevant
20 laws to help the auditor evaluate companies; the
21 company's assessment of both the nature of the
22 act, as well as the potential significance for

1 the purposes of disclosure. So, I think,
2 fundamentally, that, you know, while the nature
3 of the procedures is somewhat different, the
4 overall objective is, obviously, the same.

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

17 Oftentimes, what auditors will do,
18 they will leverage, as I mentioned before,
19 specialists to really help them understand and
20 evaluate the nature of the companies; of the
21 investigation; the information used; the
22 considerations that they are making, as well as,

1 essentially, help the auditor really assess kind
2 of whether the results of the investigation are
3 reasonable and are sufficient to help the auditor
4 evaluate the ultimate conclusion of the matter on
5 the financial statements.

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

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

21 As I'm sure Alan will mention later,
22 in some cases, the nature and extent of those

1 interactions, there may be some tension around
2 the nature of those, and whether that's going to
3 put privilege at risk. But that is, ultimately,
4 the auditors will, ultimately, need to satisfy
5 themselves that they've got enough information
6 around the facts, the investigation, and
7 ultimately, the conclusion, to be able to satisfy
8 themselves that they've obtained enough to
9 evaluate the impact on the financial statements
10 and judgments around the timing and nature of any
11 disclosures.

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

17 MS. VANICH: Thank you, Mr. Jones.

18 Ms. Fitts?

19 MS. FITTS: Thanks, Barb.

20 And maybe just to add onto what Josh
21 said, you know, depending on the law or
22 regulation, we do have a tailored response, and

1 it's always based on the facts and circumstances
2 of the situation.

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

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

18 And then, there's also disclosures
19 related to when it's reasonably possible that
20 there's a loss contingency, but it's not
21 probable. But if those are probable and that
22 they're subject to reasonable -- they're not

1 subject to reasonable estimation -- then those
2 are disclosed. But it's important to remember
3 that remote loss contingencies will neither be
4 disclosed or recorded.

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

16 And the other discussion on the
17 earlier panel as well about indirect laws being
18 known by both auditors and management, and at
19 some point, those becoming disclosed in the
20 financial statements, again, that's where I think
21 it's important to go back to ASC 450 and getting
22 to that probable and reasonably estimable

1 threshold, in order to have that loss contingency
2 recorded.

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

9 MS. VANICH: Thank you.

10 Ms. McNees?

11 MS. McNEES: Thank you.

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

19 In evaluating whether, when faced with
20 a knowledge of a potential noncompliance, and
21 evaluating whether actual noncompliance has
22 occurred, I think the more important factor is

1 the nature of the subject matter versus whether
2 it's direct or indirect. I think direct or
3 indirect may have some influence on kind of where
4 it impacts the financial statements, but the
5 subject matter I think would more drive what the
6 response is in terms of, particularly, the need
7 to engage specialists or what our particular
8 procedures would be.

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

21 On question three, then, kind of the
22 extent to which the auditors would engage with

1 those employed by management, I think Josh and
2 Emily hit on this. But I would just maybe
3 reiterate: we would, certainly, auditors would
4 attempt to have as much access as possible to
5 whatever management or those they employ.

6 Whatever analysis or evaluation that they have
7 done would absolutely be important, valuable
8 information for us to obtain, subject to what we
9 may have access to. And that gets into the
10 privileged topic, which I know we're talking
11 about in a little bit. So, we certainly would
12 want to have as much access as possible and may
13 or may not get it.

14 And then, there's a question in there
15 that I just want to touch on about whether the
16 auditors would be -- you know, the extent to
17 which we would be involved in, say, planning
18 management's response or management's
19 investigation. And, of course, I'm sure that
20 depends on a number of different things, but
21 again, I think the less related to financial-
22 statement-related noncompliance matters, I think

1 the less likely that management would seek out
2 the auditors' input on their response to their
3 investigation.

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

11 MS. VANICH: Yes, sure. Thank you.

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

20 If I could start with -- well, let me
21 start with, before we turn to the attorneys, Mr.
22 Turner or Mr. Carmichael, to see if you have

1 anything on these two questions.

2 MR. CARMICHAEL: I can start.

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

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

18 MS. VANICH: Thank you, Mr.
19 Carmichael.

20 Mr. Turner?

21 I think you're muted.

22 MR. TURNER: This is a question I was

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

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

17 And where that is done, certainly, my
18 experience has been the auditors take a very
19 important role in dictating what it will take to
20 satisfy the auditor. What does it take to
21 provide the auditor sufficient competent evidence
22 that they can, then, feel good with whatever

1 opinion they decide is appropriate to issue,
2 given whatever the attorneys are telling them?

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

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

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

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

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

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

15 (Laughter.)

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

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

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

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

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

9 MR. COATES: You start this time.

10 MR. JACKSON: Okay.

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

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

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

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

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

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

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

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

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

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

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

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

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

22 And there I think, the board's

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

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

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

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

19 MS. VANICH: Please, please.

20 MR. COATES: Thanks, so --

21 (Simultaneous speaking.)

22 MR. TURNER: I wouldn't mind hearing

1 from Alan, too.

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

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

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

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

18 I think on this question, the board
19 might think about a principle, which would get at
20 some of the points that Lynn and Rob's sketch,
21 which actually were embedded in what we heard
22 from the audit firms, too, which is that the

1 degree to which you rely on lawyers, or on in-
2 house counsel, or the nature of the reliance, or
3 the nature of the inquiry, is intensely fact
4 specific.

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

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

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

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

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

20 Go down the list of things that kind
21 of go into a standard working, a good working
22 relationship. What would be a good professional

1 working relationship, lay that out a little bit.

2 I don't think this is a rule book.

3 Like just to be clear, I don't want it to be
4 written or read as a checklist.

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

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

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

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

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

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

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

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

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

18 Which is that there's a good working
19 relationship between auditor and counsel on my
20 end, throughout the entirety of the investigation
21 to ensure that you get to the end of the
22 investigation, and reach an outcome that the

1 auditors are comfortable with.

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

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

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

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

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

20 And so, I think it's helpful to think
21 of about the views of the lawyers and what
22 they're communicating to the auditors, but it's

1 also equally important to understand the
2 additional financial statement analysis, and
3 review work that's happening in parallel.

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

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

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

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

22 And, I think that there's a process

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

5 MS. VANICH: Thank you.

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

8 MR. RAMANNA: Yes, thank you.

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

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

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

21 Unless someone disagrees with that
22 point.

1 MS. VANICH: Thank you.

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

6 If you could also give, and I'll just
7 ask the auditors to do this, to answer question
8 4, which is what specific audit procedures can
9 auditors perform to identify and assess laws, or
10 the related assessment of risk.

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

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

18 MS. McNEES: Yes, thank you.

19 I have just a couple follow up points
20 from the discussion. This will be quick, but I
21 wanted to clarify as it relates to question 3 and
22 the auditor's input into management's

1 investigation, that it may not be up to the
2 auditor.

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

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

10 So, I just wanted to clarify that
11 point.

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

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

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

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

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

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

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

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

5 MS. VANICH: Thank you.

6 Ms. Fitts?

7 MS. FITTS: Thanks, Barb.

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

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

22 Again as we've discussed, there might

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

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

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

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

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

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

22 But I do think it's important to

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

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

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

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

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

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

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

21 MR. JONES: I know we're running on
22 time. I don't have a lot more, lot to add to

1 what Emily and Carole said.

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

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

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

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

20 I think as we commented in our comment
21 letter, we had some concerns around the notion
22 that you evaluate kind of all communications that

1 may be in the public, that a company may put out,
2 or may be said about the company when you
3 consider the number of jurisdictions many
4 companies operate today.

5 So probably more about degree than
6 about the procedures themselves.

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

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

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

20 MS. VANICH: Thank you so much for
21 that.

22 So, let's transition to topic 2 of

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

5 But our first question is, in light of
6 attorney-client privilege issues raised by some
7 commenters, how do audit firms currently comply
8 with requirements of PCAOB Standards, and Section
9 10A of the Exchange Act?

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

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

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

21 Which is confidentiality of client
22 obligations, our client information and

1 confidences; the attorney-client privilege; and,
2 then work-product protection.

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

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

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

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

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

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

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

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

22 And in the lawyer has formed a

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

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

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

16 And so, it covers a lot of the ground
17 without having to actually go further from the
18 auditor's perspective, in terms getting
19 information from the attorney at would
20 potentially impair attorney-client privilege,
21 work product protection, or the confidentiality
22 of the client information that's been disclosed

1 in those engagements with the client, and the
2 attorney.

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

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

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

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

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

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

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

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

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

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

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

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

22 Alan, if I could just ask you one more

1 question and again, thank you for the comment
2 letter.

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

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

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

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

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

19 The information necessarily goes to
20 the general counsel in most instances that I've
21 seen, unless the general counsel is implicated
22 and of course, in which case it's a different

1 analysis that would apply.

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

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

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

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

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

21 Then when you think about the
22 auditor's interaction, it really is a question

1 next of how the matter gets handled within the
2 company.

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

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

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

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

19 My sense is that the auditor is doing
20 procedures in parallel to also get a better
21 understanding, but will also look to the company
22 and management in the first instance given that

1 there's also the importance in maintaining
2 independence.

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

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

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

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

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

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

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

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

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

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

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

21 The, Rod Hills, Chairman at the time,
22 said that he wanted to remind both professions of

1 their professional obligations.

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

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

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

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

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

1 current audit requirements.

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

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

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

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

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

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

1 confidential.

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

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

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

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

19 And that's all.

20 MS. VANICH: Thank you. Mr. Jackson?

21 MR. JACKSON: I'll be brief, too. So
22 in preparation for the conversation I had a look

1 at the comment letter that Mr. Wilson provided.

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

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

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

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

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

22 And I think given that scope, this is

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

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

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

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

21 And I think it would be good for the
22 board to be clear about that, and hopefully that

1 will address these issues.

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

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

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

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

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

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

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

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

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

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

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

20 And ultimately, it's the court.

21 MS. VANICH: Thank you.

22 Mr. Jones?

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

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

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

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

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

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

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

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

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

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

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

21 That privilege at the sort of let's
22 call it stage 1, is that in any way different

1 from privilege or envisioning that is not a
2 problem in the stage 2, which is once you've sort
3 of, you're in the world where you have sort of
4 some suspicion and now you're making an
5 assessment?

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

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

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

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

1 helpful.

2 MS. VANICH: Mr. Wilson?

3 MR. WILSON: Yes, happy to weigh in.

4 I think Josh put it nicely, but it actually
5 really is a bigger picture point on question 4,
6 just to elaborate further.

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

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

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

20 But it's notable that the attorney-
21 client privilege protects the disclosure to third
22 parties, of confidential attorney-client

1 communications that relate to legal advice.

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

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

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

20 And it sounds like we may actually be
21 addressing that already, so perhaps that it's
22 just a misunderstanding of the actual drafting of

1 the proposal. And that solves the problem.

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

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

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

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

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

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

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

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

19 MS. VANICH: Mr. Turner?

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

1 propose on this.

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

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

13 MS. VANICH: Thank you.

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

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

22 MS. FITTS: The only point, Barb, maybe

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

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

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

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

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

18 MS. MCNEES: Yes, just a couple points
19 real quick.

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

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

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

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

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

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

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

21 But I think the discussion about
22 privilege, I think really it's not that it

1 doesn't apply to what we do today. Obviously we
2 have to manage through that in what we're doing.

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

9 MS. VANICH: Thank you.

10 Mr. Jackson?

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

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

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

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

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

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

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

19 MS. VANICH: Okay, thank you for that.

20 I think Mr. Carmichael had his hand up
21 next.

22 MR. CARMICHAEL: I just wanted to join

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

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

10 MS. VANICH: Okay, thanks for that.

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

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

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

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

11 Sorry for crunching everything into
12 the last few minutes.

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

15 MR. COATES: Sure.

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

20 Just to be clear, that would have to
21 then be client-lawyer in that set of
22 communications. They then identify something for

1 the first time as potential non-compliance.

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

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

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

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

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

22 We've got clear law breaking where

1 maybe the facts are a little unclear, but we know
2 what the law is.

3 And then we move into the zone where
4 we don't really know for sure until either more
5 investigation is done, or some lawyer finally
6 decides what they think the law is.

7 And obviously as you move along that
8 spectrum, you're introducing uncertainty, which
9 then puts pressure on anyone ever being able to
10 say well, it's definitely going to have an impact
11 on the financial segment.

12 So, while the answer is yes, it's
13 maybe not as general as you might think. That
14 would be my answer to that question.

15 One last circling back on the re-
16 proposal point. I don't know how I was talked
17 into being general counsel of the SEC, but I was.

18 And in that role, I did have to learn
19 about this issue and it's logical outgrowth is
20 the likely result of the final rule, a logical
21 outgrowth of what was proposed.

22 What I heard this morning is

1 absolutely yes because what was being discussed
2 is in effect, a scaling back of some of the more
3 worried readings of the proposal, which then
4 means it's nested within. It can't possibly be
5 greater than.

6 It's not a dramatic (audio
7 interference) --

8 MS. VANICH: Okay, I think we've lost
9 him maybe for a second.

10 Mr. Wilson?

11 MR. WILSON: I actually, I understand
12 where I think he was going and I would more or
13 less add that I think that it's just worth
14 bearing in mind with respect to the others that
15 are against re-proposal, just to take a fresh
16 look along the lines John was thinking of, as to
17 what a revised proposed Standard 4 adoption would
18 look like.

19 And understanding and taking a view
20 through --

21 (Simultaneous speaking.)

22 MR. COATES: -- if it would actually

1 be a surprise in some sense from, a departure
2 from the proposal.

3 Now if you do, if the board concludes
4 as a result of this round table, and if they do
5 want a dramatic departure that would actually be
6 a surprise in some sense from -- sorry.

7 MS. VANICH: Yes, sorry about that.
8 Thank you.

9 I'm sorry, Mr. Wilson, do you want to
10 go ahead?

11 MR. WILSON: I think just to wrap up,
12 I think where John was going with this is just
13 taking a look at whatever revised version of the
14 Standard the board is looking to adopt, and
15 taking a view of that proposal before adopting
16 and considering whether re-proposal makes sense
17 from the logical outgrowth perspective.

18 And would emphasize that I think the
19 point Emily made, which is to say that if there
20 are a number of significant changes that flow
21 through, it's taking a hard look at whether or
22 not it in fact, revised the proposal to be

1 substantially different from what was actually
2 proposed.

3 Whether in fact, there are reductions
4 in the scope that's envisioned particularly as it
5 relates to the attorney-client privilege, just
6 the point I made earlier to make sure that people
7 are thoughtful about that to the extent that it
8 actually has ramification throughout the way in
9 which the revised draft looks.

10 MS. VANICH: Thank you.

11 Mr. Jones?

12 MR. JONES: Yes, I don't have much more
13 to add to question 4 than what Alan said. I'm
14 not sure I couldn't even play an attorney on TV.

15 But I guess going back to the re-
16 proposal kind of comment, I guess look, I just
17 want to make sure everyone appreciates.

18 I mean, speaking for myself, I think
19 speaking for the profession, we very much
20 understand and hold true our obligation to
21 support investors in providing information,
22 quality information to the capital markets.

1 And, we want to do what's necessary
2 and what's expected for us. And part of that is
3 understanding what is expected with the clarity
4 that is necessary to do it; to do it well; and,
5 to do it consistently.

6 I think that's, those are similar
7 objectives everybody on this round table kind of
8 hold.

9 And I think what you've heard, at
10 least what I've heard today is while lots of
11 commentary around a ways to evolve the proposal,
12 you also heard what that was based on is some
13 divergent views on what was intended.

14 And in some in a very meaningful kind
15 of way, and I guess would challenge at the risk
16 of having unintended consequences and lack of
17 clarity in what's expected, whether another go-
18 round from a proposal perspective wouldn't be
19 helpful.

20 Not because we aren't interested in
21 complying with whatever the expectations are as
22 soon as reasonably possible, but to make sure we

1 do it right for the benefit of investors.

2 And so that's really where we're all
3 coming from, I think, from that perspective, and
4 why I think you heard Emily say what she said,
5 which I wholeheartedly agree with, as well.

6 MS. VANICH: Thank you.

7 Mr. Turner?

8 MR. TURNER: Barb, just a couple quick
9 points. On question 4, I have seen those come up
10 through privileged communications.

11 Things where people are self-reporting
12 like on FCPA, and more importantly, the growing
13 number of cybersecurity attacks and hacking, I
14 think there's going to be more and more of that
15 occur.

16 And people find out about it, and in
17 places where I was that we had to worry about
18 cybersecurity, we did have the attorneys attached
19 to us at the hip.

20 And so, I think you're going to see
21 continued self-reporting companies doing the
22 right thing, and those do come up not unusually

1 through those type of communications.

2 With respect to Carole made a comment
3 about the auditors being challenged in some cases
4 with respect to what they can request, or not
5 request.

6 There's a flip side to that. When
7 people reject the auditor's request, then the
8 auditor typically has a scope limitation.

9 And those conversations, I've been in
10 many of them and those conversations have been
11 two-sided in that one, you can decide what you
12 will or will not give us; and two, then we'll
13 decide what opinion we'll give depending upon
14 what you tell us.

15 So, that's actually a two-sided
16 conversation and the auditors do have some
17 leverage in that regard.

18 And then finally, time and time again
19 we've seen investors' survey where the number one
20 issue with respect to someone making an
21 investment, certainly I've had this on a personal
22 level as well as on two asset manager boards I've

1 sat on, is the integrity of management and
2 NOCLAR, there's nothing like NOCLAR that runs to
3 the integrity of management and tells you a lot
4 about those.

5 That's the number one issue. And so,
6 this is a material item, and material information
7 for investors.

8 And, investors need to know that the
9 auditors are doing the right thing and providing
10 to the auditors, or to investors important
11 material information that they have with respect
12 to NOCLAR, and integrity of management.

13 MS. VANICH: Thank you.

14 I don't see any other, Mr. Jackson,
15 you had your hand up. Did you take it down
16 intentionally, or?

17 Okay. Well, I will take this chance
18 then to thank you all so much for our time and
19 input. We really do appreciate it.

20 It's time to conclude our second
21 panel. Again, we look forward to seeing some
22 additional comment letters come in to the file.

1 We will now take a short break and
2 reconvene at 3:00 p.m. Again, thank you
3 panelists for participating today and sharing
4 your views, and to those who have joined us
5 online.

6 And I'll look forward to seeing you
7 all back here, or the people that need to be back
8 here, at 3:00 p.m. Thank you.

9 (Whereupon, the above-entitled matter
10 went off the record at 2:29 p.m. and resumed at
11 3:01 p.m.)

12 MR. SCHMALZ: Welcome back to our last
13 session today. I'm Martin Schmalz, Chief
14 Economist and Director of the Office of Economics
15 and Risk Analysis. I'm joined by Barbara Vanich,
16 Chief Auditor and Director of Professional
17 Standards. Barb and I are joined by Karthik
18 Ramanna. Karthik is a professor of business and
19 public policy at the University of Oxford's
20 Blavatnik's School of Government, who has taken a
21 partial public service leave to advise the PCAOB.

22 We would like to welcome our

1 panelists, board members, and the public back to
2 this staff-hosted roundtable on the auditors'
3 responsibility for a company's noncompliance with
4 laws and regulations.

5 Before we get started I want to issue
6 the standard disclaimer for myself, Barb, and
7 Karthik one last time for the day. Our views are
8 our own and do not necessarily reflect the views
9 of the Board, individual board members, or staff.

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

17 On June 6th, 2023, the Public Company
18 Accounting Oversight Board proposed amendments to
19 PCAOB auditing standards related to a company's
20 noncompliance with laws and regulations and other
21 related amendments. The PCAOB received 140
22 comment letters on the proposal. From those

1 comment letters the staff have identified topics
2 for which we believe additional information will
3 be helpful in developing our recommendation for
4 the Board.

5 The purpose of today's roundtable is
6 for staff to obtain the perspectives of our
7 panelists on specifics of the NOCLAR proposal
8 that the Board issued in June of last year.
9 Additional background information on the topics
10 and questions we are covering during today's
11 roundtable is available in the staff briefing
12 document available on the event page that you
13 will find linked to the home page of the PCAOB
14 website.

15 Barb, Karthik, and I are here to
16 listen. We will direct specific questions to
17 Board panelists in order to inform our efforts as
18 we work toward a final recommendation to the
19 Board. Our objective is to hear from all
20 panelists who wish to speak on each topic and to
21 encourage open dialogue among the panelists
22 within the time allotted. We have two hours.

1 As a reminder, if you would like to
2 say something, please just use the raise your
3 hand function. If that's not working, just type
4 something in the chat function. No need to write
5 down your question. Just say call on me, or a
6 few characters, whatever works, and we'll do our
7 best to get to everyone. In the event that we
8 run out of time, we welcome all panelists to
9 submit additional comments to the comment file.

10 If you have any technical difficulties
11 during the meeting please contact Brian
12 Goodnough. Thank you in advance for your
13 patience.

14 A note to those watching online.
15 Panelists were asked to submit any new data or
16 analysis they plan to present here today to the
17 comment file ahead of today's meeting.

18 To ensure all panelists have time to
19 speak, we will not be able to accommodate slide
20 presentations from individual panelists, but we
21 encourage the panelists to reference any such
22 submissions to the comment file.

1 Those watching online can find those
2 submissions easily by going to the PCAOB website,
3 clicking on the event page that appears on the
4 home page and then selecting the comment file
5 option on the right-hand side of the screen. The
6 comments are ordered by date, helpfully. The
7 most recent submissions therefore are at the
8 bottom of the page.

9 With that, let's get started for our
10 last panel of the day on economic impacts of the
11 proposed standard. We have 10 distinguished
12 panelists with us. There is Brian Croteau, who
13 is a U.S. Chief Auditor and Auditing Services
14 Leader of PwC; Colleen Honigsberg, Professor of
15 Law, Stanford Law School; Jonathan Karpoff, who
16 is the Washington Mutual Endowed Chair in
17 Innovation and Professor of Finance at the
18 University of Washington; Dennis McGowan, who is
19 Vice President, Professional Practice at the
20 Center for Audit Quality.

21 We have Carole McNees, who is a CPA
22 and Director of Quality Management, Ethics and

1 Assurance Policy at Plante Moran. There's Laura
2 Posner, who is a partner at Cohen Milstein; Tom
3 Quaadman, who is Executive Vice President at the
4 U.S Chamber of Commerce Center for Capital
5 Markets Competitiveness, the Chamber Technology
6 Engagement Center, and the Global Innovation
7 Policy Center.

8 We are glad to have Brandon Rees, who
9 is Deputy Director of Corporations and Capital
10 Markets at AFL-CIO, as well as Bob Temple, who is
11 General Counsel and Secretary at NuScale Power
12 Corporation. And finally, Luigi Zingales,
13 Distinguished Service Professor of Finance at the
14 University of Chicago.

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

17 We have one topic for this panel which
18 is the benefits and costs of the proposal. By
19 way of introduction to the topic the expected
20 benefits of the proposal include improving
21 financial reporting quality by requiring auditors
22 to better identify, evaluate, and communicate a

1 company's noncompliance with laws and regulations
2 which can lead to more timely intervention by
3 companies to seize and remedy noncompliance
4 thereby reducing the harm to investors and the
5 public at large caused by noncompliance.

6 To the extent that investors currently
7 expect that auditors play a larger role in
8 identifying noncompliance than they actually do,
9 as some commenters have indicated, the proposal
10 would help reduce the expectations gap between
11 investors and auditors which can raise -- which
12 can increase investor confidence in financial
13 statements and the capital markets generally.

14 The proposal identified costs of the
15 proposed standard to firms that would include
16 certain fixed costs related to updating audit
17 methodologies and tools and training staff.
18 Variable costs for firms would include efforts to
19 identify the relevant laws and regulations,
20 assess risks of material misstatement due to
21 noncompliance, and develop audit responses. The
22 magnitude of the costs will likely depend on the

1 nature of the company and its operations and the
2 related regulatory environment. The proposal
3 also highlighted that the likely cost of the
4 proposed standard to companies would include
5 engaging with the auditor to respond to
6 information requests and increased audit fees.

7 I want to briefly tee up all the
8 questions that we want to ask. We have six
9 questions. We will try to go in order, but just
10 in case we will have panelists respond to costs
11 and benefits jointly, I want to just tee up all
12 of them at the beginning.

13 Our first question is what do
14 panelists or commenters perceive as the economic
15 benefits and costs of the proposals and how do
16 they differ from the status quo, both
17 quantitatively and qualitatively? We discussed
18 earlier today what the status quo is and what
19 additional work is required and we're interested
20 in finding out what that quantitatively means.
21 I'll add to that I'm particularly interested also
22 in the methodology, if you can explain that, that

1 you would have used to assess these costs and any
2 justification of that methodology.

3 So whenever possible we would also be
4 interested in hearing responses separately by
5 firm size. So perhaps they differ by large or
6 medium or small firms as well as perhaps
7 different responses to different stakeholders;
8 for example, preparers versus firms. That is
9 the first question.

10 The second question regards any
11 additional data or studies that would clarify the
12 economic impacts of the standard. So if you're
13 aware of additional data or studies on the
14 current cost of unidentified noncompliance with
15 laws and regulations to investors or the public
16 at large we would be interested in hearing about
17 that.

18 The third question is whether -- what
19 the panelists or commenters perceive as the
20 impact of the proposal on small and medium-sized
21 audit firms and whether such an impact can be
22 quantified differently.

1 The fourth question is what broader
2 impact you may have identified of auditors'
3 identification of noncompliance with laws and
4 regulations that could reasonably have a material
5 effect on the financial statements. So that's
6 question 4, Brian. So that could have a material
7 effect on the financial statements on capital
8 formation or more broadly the macro socioeconomic
9 environment. Add to that the environment, the
10 proverbial chemical in the river.

11 Are there any data and studies that
12 would help us estimate those impacts? For
13 instance, is there evidence to suggest that
14 capital costs would be lower if investors had
15 greater confidence that auditors would identify
16 noncompliance with laws and regulations that
17 could reasonably have a material effect on the
18 financial statements?

19 The first question is to the extent
20 panelists and commenters provide additional
21 alternatives to the proposed standard if there's
22 any data or studies that can help us estimate the

1 benefits and costs of any of these alternatives.

2 And finally, the last question we want
3 to address will be in light of the discussion of
4 costs and benefits we will witness how investors,
5 issuers, and auditors view the justification of
6 the proposal overall.

7 So in discussing these costs and
8 benefits we strongly encourage the panelists to
9 be prepared to discuss the quantitative impact of
10 the proposal on audit fees; on issuers' internal
11 costs as a result of identification, evaluation,
12 and communication of information indicating that
13 noncompliance with laws and regulations has or
14 may have occurred; auditors' existing reliance on
15 compliance work and legal analyses already
16 carried out by issuers; and potential costs
17 associated with the auditor's use of specialists.

18 Now, let's go back to question 1 now
19 that we've teed up the entire spectrum of what we
20 intend to discuss in the next hour-and-forty-five
21 or so. The first question again is what the
22 economic benefits and costs of the proposal are

1 relative to the status quo, both quantitatively
2 and qualitatively ideally split up by different
3 sizes?

4 So I saw that on Monday Professor
5 Honigsberg submitted an additional comment letter
6 that speaks of both costs and benefits, so let's
7 start with that.

8 MS. HONIGSBERG: So, thank you guys
9 for having me here today. And yes, when I was
10 thinking about the broader sort of costs and
11 benefits I actually went through the comment
12 letters. And so I went through the comment
13 letters to just get a sense of what are potential
14 direct and indirect costs? Also what are the
15 broader potential unintended consequences, which
16 I think would be more severe here than perhaps
17 the direct and indirect costs. And then
18 separately on the benefit side, what are some of
19 those benefits that we would want to consider
20 that are potential, direct, indirect, unintended,
21 however they may come out?

22 So I can kind of go through and just

1 describe what are we thinking for the direct
2 costs and indirect costs? Well, obviously we
3 have direct fees in terms of auditors, lawyers,
4 IT, software. Higher potential litigation
5 exposure a number of people noted and I assume
6 we'll discuss that in more detail from some of my
7 colleagues on the panel.

8 In terms of the unintended
9 consequences though I think these are just -- in
10 my view cannot be quantified. And so I'm happy
11 to discuss them, but it's like there are sort of
12 broader comments about maybe we have fewer public
13 companies or maybe we have more consolidation in
14 the audit industry that may or may not occur and
15 that I think just I personally would not be
16 comfortable quantifying because it would require
17 too many assumptions.

18 So I'm happy to actually go through
19 and read out the unintended consequences, Martin,
20 if you think that would be helpful, but I -- yes?
21 Is that -- okay.

22 So the first one, greater demand for

1 those with specialized expertise, making it
2 difficult and expensive to recruit and retain
3 qualified personnel. That one seems fairly
4 direct.

5 We also have potential reduction in
6 audit quality because you have auditors who are
7 being squeezed of fees. That one though of
8 course that's a potential benefit too so I don't
9 think we know exactly which way that's going to
10 go.

11 So risk of violating PCAOB and SEC
12 auditor independence rules. This one I believe
13 came up this morning, and there was certainly
14 pushback on whether that would occur.

15 So increase time to perform an audit
16 because there would be more work and perhaps more
17 demand for particular specialists.

18 Reduction in number of public
19 companies.

20 Potentially weakened attorney/client
21 privilege, again something that was discussed
22 this morning and that I think there was a fair

1 amount of pushback on.

2 Increased risk of market concentration
3 for the audit firms.

4 Increased information overload for the
5 audit committees because there would just be more
6 information communicated to them.

7 Perhaps real effects on business
8 operations like inability to justify continued
9 operations in certain areas.

10 Greater tension between auditor and
11 management.

12 And then increased stickiness between
13 the audit firm and the issuer because we would
14 have an audit firm that would have -- to bring in
15 somebody new would be greater fixed costs,
16 greater up-front costs right away.

17 Now on the potential benefits of
18 NOCLAR though, I think you've already hit on a
19 number of them, but I think our main one would be
20 reduce frequency of detected and undetected
21 fraud, which I am guessing my colleagues here on
22 the panel are going to discuss, but it is when

1 we're thinking about the effect of fraud on
2 market cap, it's huge. And so I assume we'll get
3 into that a little bit more.

4 Certainly we can try to cost out what
5 the effect of fraud on market cap would be, and
6 I'm guessing some of my colleagues might have
7 some insight there. But obviously that one is
8 really, really difficult to quantify. So
9 certainly a huge cost, but very difficult to
10 quantify.

11 Also potential reduction in
12 information asymmetries between investors and the
13 audit committee or the managers. And then also
14 the audit, auditor, and audit committee.

15 Improve compliance environment within
16 the firm, so allowing for better decision making.

17 Improve data quality and better
18 alignment of investor expectations and auditor
19 behavior.

20 So again we have a lot of potential
21 costs and benefits that I think -- in my view, in
22 the comment that I submitted, I think we can try

1 to anchor some of those numbers, but can I come
2 to a number that I feel like I can really
3 quantify the cost of the proposal? No. Do I
4 feel like I can really quantify the benefits of
5 the proposal? No.

6 MR. SCHMALZ: Thank you very much,
7 Professor Honigsberg.

8 May I call on Mr. Quaadman next whose
9 comment letters have quantified the cost of the
10 proposal?

11 MR. QUAADMAN: Sure, Martin. Thank
12 you very much and appreciate the Board having
13 this roundtable today.

14 Let me just give a few thoughts,
15 answer the question, just a couple other general
16 thoughts as well.

17 So first off, in writing for a
18 unanimous court in TSC v. Northway, Justice
19 Thurgood Marshall rejected the theory of
20 materiality that would require disclosure of a
21 fact that might be important to an investor.
22 Instead Justice Marshall held that a fact is

1 material if there is a substantial likelihood
2 that a reasonable investor would consider the
3 importance of a fact viewed within the total mix
4 of information to an investor in deciding how to
5 vote. In a later case, *Basic v. Levinson*, the
6 Supreme Court reiterated that TSC materiality
7 standard and extended it in fact to investment
8 decisions.

9 Those Supreme Court decisions are
10 important as financial statements provide
11 material information for investors. Auditors
12 provide the assurance that those statements could
13 be relied upon. The almost-50-year standard on
14 illegal acts with its direct/indirect test
15 regarding financial statement impacts work
16 seamlessly within that TSC's rubric.

17 The Chamber's long-called for updating
18 the auditing and accounting standards. Indeed we
19 have written to past SEC, FASB, and PCAOB chairs
20 with proposals on financial reporting forms.
21 However, any updates or reforms must be evidence-
22 based and follow appropriate legal procedures for

1 due process and transparency. the NOCLAR process
2 here falls short on all those points and we again
3 call for its withdrawal.

4 Furthermore, under the Sarbanes-Oxley
5 Act PCAOB standards must be submitted for
6 approval and directs the SEC to follow the
7 process under Section 19 of the Securities
8 Exchange Act. If the SEC were to attempt to
9 approve the NOCLAR standard, it would violate the
10 various holdings of the courts -- the holdings of
11 various courts from our challenge of the mutual
12 fund rules in 2005 all the way towards a
13 successful challenge of the Stock Buyback Rule
14 last year.

15 In coming days we're going to file a
16 comment letter as well as a study outlining in
17 detail the process flaws and cost/benefit
18 deficiencies that the NOCLAR proposal suffers
19 from. Let me just name a few.

20 First, the Board has failed to share
21 a rationale for changing well-settled policy that
22 has worked in the past or provided any evidence

1 for the need of a change. The Board also has
2 failed to consider reasonable alternatives.

3 Second, the Board has failed to
4 provide any cost-benefit analysis to NOCLAR for
5 commenters to comment on. To be clear, benefits
6 cannot be understood unless relevant consequences
7 are considered and costs are qualified. Simply
8 stating that a proposal will benefit investors
9 doesn't make it so.

10 Using data from audit analytics, the
11 Chamber, in its comment letter, estimated that
12 NOCLAR will drive up audit costs by at least
13 \$36.4 billion. Public companies and their
14 investors will have to bear those costs
15 diminished return.

16 This will accelerate the decline of
17 public companies, and in fact I'll submit it,
18 this is a University of Chicago chart showing the
19 number of public companies in the United States
20 since 1996. That is a downward trend. That will
21 increase. It will also endanger the global
22 leadership of the United States in public capital

1 markets. On its face NOCLAR fails to meet the
2 SEC's legal mandate of competition in capital
3 formation.

4 The Board also failed to take into
5 account increased litigation risks for public
6 companies and audit firms. The Board failed to
7 consider the legal expertise and subject matter
8 experts that would have to be hired by audit
9 firms.

10 The Board does not consider how
11 auditors would have to deal with conflicts of law
12 issues. This is interesting since the first
13 congressionally-mandated resource extraction rule
14 was thrown out by the courts on exactly that
15 point. The NOCLAR proposal seeks to replace the
16 objective direct/indirect test with a subjective
17 standard. So for example, NOCLAR uses the term
18 reasonableness in the matter that the Supreme
19 Court rejected in the use of might in TSC.

20 Furthermore, as stated in our 2015
21 letter to the SEC and PCAOB on internal firm --
22 on internal control reforms, I just want to cite

1 what SEC management guidance states. The concept
2 of reasonableness of necessity contemplates --

3 MR. SCHMALZ: Mr. Quaadman? Mr.
4 Quaadman --

5 MR. QUAADMAN: Yes?

6 MR. SCHMALZ: -- I wonder if I can
7 direct you to the question on the costs and
8 benefits?

9 MR. QUAADMAN: Martin, please, let me
10 finish because there's a number of different
11 issues. I want to make sure I cover and I'll be
12 finished in a second.

13 The concept of reasonableness of
14 necessity contemplates the weighing of a number
15 of relevant factors including the costs of
16 compliance, which you have not provided anything
17 on. So that is troubling.

18 So, and you know, I can get into some
19 other things later on, but I would have to say
20 based on the data, I would also have to say based
21 on the change in capital formation markets with
22 interest rate increases as well as deficits, it

1 is much harder to raise capital. And that has
2 not been taken into consideration by the Board as
3 well.

4 Lastly, I would just say the Board
5 also fails to take into account how FASB moved
6 away from its loss contingency proposal years ago
7 because of the same issues that were raised
8 regarding attorney/client privilege and
9 litigation risk. So just want to put that out
10 there.

11 MR. SCHMALZ: Okay. Thank you. So I
12 didn't hear anything on substantiation of the
13 cost estimate or on benefits here.

14 MR. QUAADMAN: Well, Martin, with
15 all --

16 MR. SCHMALZ: I wonder if Mr. Temple
17 might speak to that. Can I call on Mr. Temple on
18 that?

19 MR. QUAADMAN: Martin, will all due
20 respect, you have to provide that and we have to
21 react to that. There are court cases holding
22 that. And if we're not going to do it here,

1 we're going to do it in the SEC rulemaking
2 process.

3 MR. SCHMALZ: So may I please call on
4 Mr. Temple, if he would like to speak to the cost
5 estimate?

6 MR. TEMPLE: Well, and I guess to
7 Tom's point, the PCAOB bears the responsibility
8 to project the likely cost of compliance with its
9 proposal, not only to inform the public but our
10 comments as well.

11 My company is an issuer, which is a
12 small emerging growth company for which full SOX
13 404(b) compliance is still in our future, but
14 near future. Simply stated, expanded auditor
15 scope and requirements impose a cost to my
16 business that I can ill-afford.

17 As a public company we already receive
18 appropriate auditor inquiries about compliance
19 with laws to management and to directors under
20 the current auditing standards compelling
21 auditors to become specialists in business lines
22 and having them perform compliance reviews would

1 impose additional costs, but I cannot be certain
2 as to what those are, Martin. I just have not
3 studied it enough to tell you.

4 We spent all of our million dollars on
5 our audits last year, and I expect certainly with
6 SOX 404(b) testing starting in 2024 for us our
7 audit expense will increase based on that alone.
8 Having additional requirements, having a broader
9 inquiry, having new specialists required that
10 understand our business and have legal
11 competence, they have to impose additional costs.
12 I just don't know what those are.

13 Whoops, Martin, you're still muted.

14 MR. RAMANNA: You might need to un-
15 mute, Martin.

16 MR. SCHMALZ: Ah, excellent. Thank
17 you very much for the bailout.

18 Thank you very much, Mr. Temple.

19 I wonder if Professor Zingales could
20 speak to costs and benefits?

21 MR. ZINGALES: Yes. First of all,
22 thank you very much for inviting me. Can you

1 hear me?

2 MR. SCHMALZ: Yes.

3 MR. ZINGALES: I think that
4 noncompliance with law regulation can be
5 extremely expensive for investors, and I think
6 that the costs can be mostly of three nature.
7 One is firms get caught and pay large fines and
8 sometimes have been punished in damages. So I
9 think that those are important costs.

10 Second, and even if they're not
11 caught, the extent that the market perceives that
12 there is a noncompliance, and so there's
13 something going wrong. There might be an
14 important lemon discount, at least this is a term
15 we use in economics, some form of reluctance to
16 deal with a firm, and from the point of view of
17 all the stakeholders, whether these are
18 investors, these are customers, or these are
19 employees.

20 And of course there are important
21 externalities. So if I am an oil company that
22 bribes an African government, I create an

1 enormous amount of instability in the African
2 country as a result of the corruption. And
3 that's something very, very hard to measure, but
4 can be really first order.

5 Now with two co-authors I tried to
6 measure the first two of these costs and we had
7 some novelty methods to try to calculate how many
8 of these noncompliance go unnoticed because they
9 often the research focuses only on the one that
10 we do notice that tend to be the visible part of
11 the iceberg and not the other.

12 And why we limit our analysis to large
13 firms, more than 750 millions in sales? I think
14 that in -- we find that roughly 10 percent of
15 these firms are noncompliant in a way that is
16 sufficiently material to generate a non-trivial
17 lawsuit. So these are not a small noncompliance,
18 but a large noncompliance, and they are quite
19 pervasive among large firms. And on average
20 these noncompliance tend to destroy 16 percent of
21 the value of equity.

22 And so on average basically the

1 noncompliance of publicly-traded firms destroy
2 1.6 percent of market capitalization per year
3 that the current value is \$800 billion per year.
4 So these numbers are very, very large.

5 Now you're saying why do we care about
6 this number? It's because the aim of this
7 regulation is reduce this number. Now how much
8 this regulation will be reduce this number? I
9 think is very hard to estimate on an exact basis.
10 I think I encourage the PCAOB to structure the
11 system so that we could measure.

12 And one ideal situation is for example
13 to introduce it separately for large firms first
14 and small firms later so that we have a beautiful
15 discontinuity that allows us researchers to
16 identify the impact of this for the results. So
17 that is something that kills two birds with one
18 stone because, number one, allows you to get a
19 good estimate exposed, and number two, make it
20 less costly for small firms to have this
21 procedure.

22 But I think it's fairly easy because

1 the question, the way I take it, is not that we
2 need to measure precisely what are the benefits
3 and what are the costs? We need to determine
4 whether the cost are bigger than the benefits.
5 And this can be done in a much more approximate
6 way.

7 So my simple calculation is if we look
8 at the cost of the introduction of SOX -- I look
9 at the SEC numbers for cost of audit before and
10 after SOX and if I got the number right, there is
11 an increase of 62 percent. Now that's very, very
12 large. I don't expect this regulation to have
13 this cost, but imagine that this is the cost of
14 regulation. So again, if I did that right, audit
15 fees of publicly traded for companies are roughly
16 6 billion, so a 65-percent increase in this would
17 represent 3.72 billion. Let's be generous.
18 Let's say \$4 billion. Okay?

19 So now what I say is as long as this
20 regulation can increase the probability of
21 detecting fraud or reduce the cost of fraud by an
22 amount equal to the ratio between the 4 billion,

1 which is the cost, and the amount of fraud which
2 is 800 billion, so by 0.5 percent, then this
3 proposal is viable. So if you tell me that audit
4 firms are able to spend 4 billion and not reduce
5 this probability by 0.5 percent, I think we
6 should rethink audit overall because we're
7 wasting our money.

8 So I think that by any reasonable
9 number, even a number that Tom floated, the
10 American Chamber of Commerce, 36 billion, I can
11 tell you with my calculation that as long as you
12 can reduce the fraud by 4 percent -- and I am
13 pretty sure that the good enforcement of
14 noncompliance with the law or regulation rule
15 will be able to reduce by more than 4 percent,
16 but as long as it is reduced, this proposal is
17 valuable.

18 And by the way, and I will postpone to
19 a second intervention, I have not factor in the
20 fact that, as was pointed out this morning, the
21 baseline is already very high. So here we are
22 taking enormous costs without factoring in that

1 most of what this regulation requires is already
2 requested. And so the cost must be very minimal.

3 And by the way, if you're interested,
4 I can provide a perfect solution with no expected
5 cost of regulation or the benefits, but I leave
6 the substance for the end on how I can do that.

7 MR. SCHMALZ: Thank you very much,
8 Professor Zingales.

9 I wonder whether Mr. Rees could speak
10 from the perspective of investors on the same
11 question of costs and benefits?

12 MR. REES: Thank you, Martin. It's a
13 great opportunity to be here to share our views.
14 I'm Brandon Rees, Deputy Director of Corporations
15 and Capital Markets for the AFL-CIO. I also
16 serve as a trustee of our pension plan. All
17 together union members have over a trillion
18 dollars in retirement savings through their
19 pension plans and are significant investors in
20 corporations. They're also -- workers are also
21 stakeholders in companies and have an interest
22 ensuring that illegal acts are deterred and

1 detected to prevent accounting fraud.

2 As other speakers highlighted, I want
3 to make three points: One, that the value of the
4 NOCLAR proposal is first to prevent fraud. As we
5 all are aware, the track record for auditors for
6 detecting fraud, fraudulent accounting, has --
7 could be improved and I believe having a specific
8 explicit duty to consider illegal acts by clients
9 and to have the internal reporting mechanisms as
10 proposed are entirely appropriate, and frankly,
11 what investors already think their auditors are
12 already doing.

13 I had the pleasure of attending the
14 Wells Fargo stakeholder meeting in 2017 after the
15 cross-selling sales fraud came to light. And the
16 investors were demanding, retail investors in the
17 audience said where was an auditor? Why were
18 these illegal acts not detected? And the CEO
19 correctly (audio interference) accounting rules,
20 replied, well, it wasn't their job. It wasn't
21 their job to detect it and it went undetected.

22 Secondly, it's my belief that by

1 having a specific obligation to consider and
2 report legal and regulatory violations will have
3 a therapeutic effect of deterring bad acts.
4 Locksmiths have a saying that doors have locks to
5 keep honest people honest. And it's the idea
6 that if auditors have a duty to consider
7 potential illegal acts that that can help deter
8 and keep people -- keep executives from feeling
9 the temptation to bend the rules, so to speak.
10 And so that is beneficial.

11 And then thirdly is maintaining
12 investor confidence in our capital markets.
13 Since the Sarbanes-Oxley Act was passed in 2002
14 we've seen the S&P 500 increase fivefold. And a
15 large part of that is trust and confidence in our
16 accounting process in 404, for example, and
17 because investors believe that auditors are
18 providing that insurance. And it's frankly hard
19 for me as an investor to understand how an
20 auditor can provide assurance that the financial
21 statements are accurate if they're not doing a
22 risk assessment for the potential for illegal

1 acts to have occurred.

2 And so, I just want to remind everyone
3 what this proposal is doing. It's updating and
4 replacing the AICPA standard that was adopted
5 back in 1988. I was 14 at the time, so I had to
6 go back and look up what happened in 1988 to
7 refresh my memory, but that was -- George Bush
8 was running against Dukakis for the president,
9 Gorbachev had just introduced perestroika in the
10 Soviet Union, and George Michael's song Faith was
11 the top of the Billboard charts. So it's been a
12 long time since these rules have been updated.

13 And they were only adopted by the
14 PCAOB as an interim step for final rulemaking.
15 It's my understanding that the AICPA has actually
16 outdated their own standard and so there's
17 actually a higher standard in place for private
18 companies compared to public capital markets that
19 we as investors, that working people have their
20 retirement savings invested in.

21 So I just want to reiterate our strong
22 support for this proposed rule. And in terms of

1 the benefits if you're permitting just one
2 corporate-earnings scandal, one WorldCom, that
3 was \$175 billion in value that was destroyed with
4 that -- the collapse of WorldCom.

5 And then there are the second order
6 effects on the economy that are not even
7 concerned as narrowly looking at the cost to
8 investors. What about the 30,000 WorldCom
9 employees who lost their jobs? What about the
10 communities that company operated? Those are
11 economic impacts that this rule, the NOCLAR rule
12 will help prevent that type of accounting fraud
13 from hurting not just investors, but also
14 employees and other stakeholders.

15 MR. SCHMALZ: Thank you, Mr. Rees.
16 That already goes to what is at question 4 that I
17 was going to ask, but that's why I asked all the
18 questions ahead of time, assuming that some of
19 these responses might get bundled. So thank you
20 very much for that perspective.

21 I see Mr. McGowan has the hand up.
22 The CAQ has also provided a cost estimate and

1 he's also here to speak about the ACC estimate.

2 And again I would very appreciate if
3 you could briefly outline what the methodology is
4 by which these estimates were arrived at as well
5 as any justification for these methodological
6 choices. Please take it away.

7 MR. MCGOWAN: Sure. Thank you, and I
8 appreciate being here this afternoon to talk
9 about this important issue and just kind of
10 reacting to also -- to picking up a little bit on
11 what Mr. Rees said about the standard not having
12 been updated since 1988. I can assure you from
13 my work with our task force members that we
14 certainly are supportive of modernizing this
15 standard, and that was our position in our
16 comment letter.

17 I do think though that based on the
18 conversations we've heard this morning as well as
19 comment letters that were submitted to the PCAOB
20 -- I think we all -- we're not all on the same
21 page in interpreting that this standard is just a
22 minor update to bringing it up to what the AICPA

1 or FASB updated their standards to be. So I do
2 think that what's proposed where we all are
3 interpreting, some are interpreting, right, as
4 more substantial. And I think that's where,
5 right, the importance of data and understanding
6 the economic costs and benefits of the proposal
7 is absolutely important to whatever the path
8 forward is for this particular project.

9 And I do think that from -- picking up
10 a little bit on what Mr. Quaadman was saying
11 earlier around the PCAOB's requirements around
12 what they need to do from an economic analysis
13 standpoint, we certainly in our comment letter
14 were of the view that further study and
15 evaluation were certainly needed. I think that
16 in my view the PCAOB has not sufficiently studied
17 the cost, benefits, and alternatives in the
18 proposal that was put forth last summer.

19 I think that in our analysis of the
20 comment letters submitted to the PCAOB we
21 certainly saw many commenters question the
22 robustness of the economic analysis that was

1 included in the proposal. I do think that you're
2 right we did try to quantify what we thought
3 perhaps the costs of the proposal could be, but I
4 think that in doing that, right, we the CAQ are a
5 little bit more limited in what data is available
6 to us.

7 I think that the PCAOB likely has
8 access to a bit more data than us and I'd be
9 curious to understand what outreach could have
10 been done with the accounting firms or audit
11 committees or issuers to understand what some of
12 those costs could be. Agree with some of what
13 Colleen was -- Professor Honigsberg was saying
14 earlier about what some of those costs could be
15 like the costs of implementing the rule.

16 So we did look to -- for purposes of
17 our comment letter we looked at what the costs
18 were of implementing facts looking about -- we
19 thought that there was about 59-percent increase
20 in audit fees from 2003 to 2004 as a result of
21 SOX. If you applied that 59 percent to audit
22 fees in 2021, we came up with a potential \$9.1

1 billion increase.

2 But I think the difference we thought with
3 this proposal compared to SOX is -- depending on
4 how you interpret the proposed requirements and
5 what those requirements would be if they did
6 require more of a legal expertise that that would
7 even make probably the costs even more expensive
8 and perhaps different than the costs implement
9 SOX.

10 And we did find a study from Wolters
11 Kluwer that had on average what companies were
12 spending -- paying, large companies were paying
13 their legal counsels. And kind of we used that
14 percentage to try and estimate what we thought
15 the potential increased costs could be from a
16 legal expertise needed. And I think that we --
17 assuming that it wouldn't be exactly the same as
18 what companies incur, which was about \$148
19 billion, if it was even some subset of that, say
20 half, you'd get to 74 billion.

21 So again, I think we attempted to use
22 publicly available data to come up with a number.

1 I think, right, holes I'm sure could be poked at
2 that estimate, but certainly I think that we came
3 to the consensus that the costs could be in the
4 billions.

5 Looking at the benefit side of the
6 equation, right, that's just the cost. I mean, I
7 think that to me, when I think about the
8 proposal, and while it does make reference to
9 large dollar losses in connection with a couple
10 of events that occurred, to me it doesn't provide
11 evidence that company -- NOCLAR is widespread and
12 prevalent. And I think to think that any one
13 regulation could prevent one-off events -- like
14 some of the large events were mentioned in the
15 proposal. I just think that perhaps this is a
16 solution that's overcorrecting perhaps.

17 Now, maybe there is some tweaking that
18 can be done that modernize it but doesn't
19 fundamentally change the responsibility of the
20 auditors, but I do think that those are real
21 things that we need to think about. And I even
22 think probably in addition to economic analysis,

1 which I know is the point of this discussion, but
2 I also think it's -- whatever the alternatives
3 are, whatever the final requirements wind up
4 being, I think demonstrating how that those
5 requirements will prevent some of the large
6 events that were referenced in the proposal or
7 perhaps help us understand what's being solved
8 for here.

9 MR. SCHMALZ: So, thank you very much.
10 I appreciate speaking to the methodology. You
11 mentioned that there could be data the PCAOB that
12 you imagine we could be using to inform the
13 costs. If you have any specific data in mind, we
14 would welcome a pointer to that.

15 Also I wanted to follow up. You
16 mentioned that in terms of the legal costs
17 companies presently incur, if one takes say half
18 of those -- I wonder if there's any explanation
19 of who you arrived at the halfway mark in order
20 to address that. I'll ask the follow-on question
21 I wanted to ask after that just to give you more
22 time in case you need to.

1 And I did want to ask Professor
2 Honigsberg and Professor Zingales on taking SOX
3 as a baseline. So I heard Professor Honigsberg
4 say that she does not feel comfortable
5 quantifying and I heard much more optimism from
6 Professor Zingales. So I wanted to hear what the
7 disagreement there is.

8 And on the question of the one-off
9 event you had just brought up I will want to call
10 on Professor Karpoff, who has studied the
11 prevalence of these items as well. And I see Mr.
12 Croteau's hand up. And Ms. Posner has studied
13 various of these events as well. So I want to go
14 in that order, if I may, but first back to you,
15 Mr. McGowan, in case you want to respond to these
16 specific queries.

17 MR. MCGOWAN: Sure. I mean, in terms
18 of data the PCAOB has, I mean I think a bit of
19 this came up this morning with the baseline
20 understanding of what auditors are doing today
21 with respect to the requirements and what is the
22 incremental effort being proposed and what costs

1 do the accountants think they're going to incur
2 with respect to those. So that's what I was
3 referring to is that the baseline of what's being
4 done today and the costs of that.

5 In terms of our assumption around --
6 that was really more of an -- I mean, more just
7 trying to get at -- we're recognizing that the
8 auditors wouldn't incur the same level of legal
9 expense that companies do recognizing, right,
10 that they're employing lawyers for a whole lot of
11 things beyond compliance with laws and
12 regulations. And so that was simply meant to
13 represent that it would be a subset of dollars
14 spent related to certain laws and regulations.
15 So there's no magic science behind that. Again,
16 we were simply trying to quantify a dollar amount
17 for purposes of our comment letter.

18 MR. SCHMALZ: Appreciate that. Thank
19 you very much.

20 Let me contradict what I previously
21 said and go backwards and start with Mr. Croteau,
22 who might be able to inform the question as well.

1 MR. CROTEAU: Yes, thanks very much.
2 I've been listening to the dialogue here, ad
3 first of all, appreciate being invited back to
4 this panel as well. And you have a very
5 difficult task here.

6 But when you think about the
7 discussion on the last two panels and then what I
8 hear now, the starting point for this has to be
9 agreement on what it is you are trying to
10 accomplish. And I worry that that dialogue is
11 incomplete at the moment. And even as I hear
12 some of the discussion around fraud, and WorldCom
13 for example, which was an accounting fraud,
14 plenty has been done relative to the standards
15 around fraud for accounting fraud. When you
16 think about the risk assessments standards and
17 the work of the PCAOB, SOX 404, and 302 certs,
18 lots of things have been done. Certainly I think
19 it's an area where incremental attention and
20 focus is warranted.

21 We have as a firm our own initiatives
22 which we're calling our actions to enhance

1 confidence in the profession. We're focusing
2 incremental efforts around things like the
3 whistleblower program, not that we don't today,
4 but incremental efforts there, fraud risk
5 assessment and the like, voluntarily, beyond
6 what's required in the standards. And you can
7 read about that in our audit quality report. I
8 mention that because I think those are good
9 topics to spend time on, but I don't think that
10 has anything to do with the proposal.

11 And then when you talk about what's in
12 the proposal, it's back to being up front about
13 what it is we think we're going to accomplish
14 with the proposal because I don't believe that
15 the proposal or any proposal for auditors can
16 stop entirely illegal acts from occurring. And
17 so --

18 MR. SCHMALZ: Mr. Croteau, I apologize
19 for interrupting. I promise I'll let you finish
20 whatever else you wanted to say, but I do want to
21 jump in here. I don't think the argument is
22 necessarily that they would stop the entirety of

1 it, but Mr. Zingales previously calculated a
2 small fraction thereof.

3 MR. CROTEAU: Yes.

4 MR. SCHMALZ: Can you speak to whether
5 you think there is a chance it would be a small
6 fraction --

7 MR. CROTEAU: Yes.

8 MR. SCHMALZ: -- that could be
9 prevented? I just wanted to clarify that. I
10 will let you finish. Go ahead. Sorry.

11 MR. CROTEAU: Yes, yes. Sure, sure,
12 sure. And I'm not sure it's quantifiable per se,
13 but I do think that there's an indirect benefit
14 that could occur like there is from a lot of
15 things that auditors do that could be somewhat
16 preventative or help with earlier detection. But
17 again, I think you've got to identify up front
18 how much you're expecting auditors to do, back to
19 the discussions this morning, relative to
20 identifying matters beyond what management's
21 already identified. And there are costs to that
22 and risk assessment.

1 You think about risk assessment
2 procedures and how far one goes. There are costs
3 to that and decisions need to be made around
4 that, and obviously informed by economic
5 analysis. I think you've got a lot of data from
6 a standard-setting perspective, or from an
7 inspections perspective that should inform
8 standard setting here relative to -- even in
9 hindsight relative to the work that auditors are
10 performing today and where it might be helpful to
11 be additive.

12 Also the baseline discussions this
13 morning were hugely important because the
14 baseline is not what's in the current standards
15 today. Auditors are doing more because they're -
16 - there are a lot of reasons auditors are doing
17 more, but certainly at least the large firms are
18 doing more because of what's in the ASCs and in
19 incremental things that we've done over time
20 because of other PCAOB standards that affect the
21 work that we do on ASC 450 around loss
22 contingencies. And I don't think that's been

1 factored in. So the increment may not be so
2 large for some of what's being asked for here,
3 but I think referring back to the earlier
4 discussions, it's hugely important.

5 If done right, in my view and kind of
6 what I was at least describing this morning, and
7 I think it accomplishes what many investors want
8 -- probably not some of what we're hearing right
9 now that probably is not accomplishable -- but
10 the unintended consequences around specialists or
11 quality or independence or the amount of time,
12 privilege, all those things -- I think all those
13 things are manageable, but those are all really
14 risks depending on where you land relative to
15 decision making here.

16 So I think it's important to step
17 back, get those things right, think about the
18 potential benefits in a reasonable way relative
19 to the incremental efforts that you're thinking
20 about.

21 I also just wanted to mention the idea
22 of writing this in a way that would be phased in.

1 If it's done right it should be scalable. And I
2 think you do need to think about small and large
3 firms, different size audits, but if done right,
4 what we were describing this morning can be done
5 in a scalable way. If you have to phase it in, I
6 think you've done something wrong, in my view.

7 And then I just want to add the point
8 on -- this dialogue does show to me at least that
9 audit standard setting is different than certain
10 rulemaking. And I don't want to get into all of
11 the discussion about whether you re-expose or
12 not; you guys will figure that out, but it
13 requires a less insular approach where these kind
14 of debates around the words in the standard can
15 happen and inform the process. And I think this
16 demonstrates that, what's happening here today
17 when you think about the proposal, the range of
18 the way people read the proposal.

19 So whatever you do next with this and
20 your cost/benefit analysis, I would get some
21 sunshine on it before it goes anywhere else
22 because it may not be read as you intend it and

1 this demonstrates that.

2 MR. SCHMALZ: Thank you very much for
3 that and also responding to the large versus
4 small firm perspective.

5 So I'll take that opportunity to once
6 more contradict my plan and call on Ms. McNees,
7 who is representing a relatively small firm, and
8 in particular just ask as a starter whether she
9 agrees with the idea that large firms already do
10 more than the standards, and if that's also true
11 for small firms or whether that might give rise
12 to a difference in the costs, relatively
13 speaking, to large versus small firms, and any
14 other aspect that would shed light on the small
15 firm question, of course.

16 MS. McNEES: I would not be able to
17 speak to knowledge of what larger firms are doing
18 necessarily, so I don't know if other firms or
19 large firms are doing more or less per se.

20 And I don't know that I would
21 characterize our current audit approach as doing
22 more than what's in the standard, but I do agree

1 with -- I think Brian made a couple of points of
2 there are things outside of the NOCLAR standard,
3 fraud standard for instance, where a lot of the
4 concepts that are being discussed today are
5 really taking place under that standard. What
6 we're doing really just in terms of auditing
7 assertions related to completeness of
8 liabilities, including contingent liabilities,
9 and incorporating things into there.

10 So I think some of the concepts that
11 are being discussed as perceived as being missing
12 from what auditors are currently doing are
13 actually taking place perhaps in other -- with
14 respect to other requirements from the audit
15 standards.

16 And I do think we've talked at length
17 throughout the day today in the different panels
18 about there may be some perception that there's
19 ignoring of indirect effect laws and regulations,
20 and I think that's just not true based on the
21 current standards as well. So I think there may
22 be some misunderstanding of, as Brian said, kind

1 of the baseline where we're starting from based
2 on that.

3 And I'd like to maybe just also concur
4 with one other thing that Brian said that I think
5 is a really important point. I've edited my
6 notes since the panels this morning because I
7 think the cost element of this really -- we need
8 to further define the scope. So when I think of
9 what do I think the cost is, I think it depends a
10 lot on everything that was discussed particularly
11 in Panel I, Panel II to some extent as well, and
12 really then what does the final standard
13 incorporate into the scope? Because I heard a
14 wide range of understanding and -- understanding
15 of the words that as written and the intention of
16 what the expectation was. And so I think really
17 to be able to quantify in any way the cost I
18 think we need better definition of what the scope
19 is.

20 MR. SCHMALZ: Very good. Thank you
21 very much.

22 So, Brian, I'll just refer to you as

1 Brian because of my inability to correctly
2 pronounce the last name. I apologize for that.

3 You refer to inspections data that we
4 might be able to use. I wonder if you had any
5 specific data in mind there.

6 MR. CROTEAU: Yes, so I mean, I think
7 that -- well first of all, I think this would be
8 a great area that your target team could spend
9 time on in even a more specific way than is
10 already covered in inspections, and probably in
11 fairly short order, to make sure that there's a
12 thorough understanding across the profession of
13 the procedures being performed today and how to
14 the extent -- and in the extent to which those go
15 beyond existing standards. That will at least
16 give you help with your baseline relative to
17 existing performance.

18 I also think there's work that could
19 be done, and maybe some of this has -- I can't
20 presume what's been done by inspections already
21 or not other than what I know from my own firm,
22 but I presume that there's a fair amount of data

1 relative to inspection comment forms today, where
2 there's obligations today relative to ASC 450 and
3 our audit work relative to loss contingencies.

4 Are firms doing enough there? Are we doing
5 enough relative to assessing accruals and
6 disclosures that are being made today? Are those
7 not being made timely and the audit work around
8 that not sufficient?

9 The PCAOB has the benefit of hindsight
10 when they're looking at that work from an
11 inspections perspective. And so I think there's
12 presumably a fair amount of information and data
13 that will help with all kinds of things. First
14 of all, it will help with what are the various
15 points in the process today that you want to make
16 improvement and being clear about that so that --
17 for lots of reasons -- to inform the economics
18 around this, to inform what we actually do going
19 forward and the public policy decisions that are
20 being made.

21 So, and again, without knowing all of
22 the things that are done inspections, I know that

1 this is an area that gets looked at as part of
2 inspections today. So I presume there's all
3 kinds of data that would be available that could
4 be very informative. And sharing some of that in
5 the rulemaking and the cost-benefit analysis
6 relative to what's working well, what can be
7 improved is I think hugely important.

8 MR. SCHMALZ: Thank you very much.

9 Now I'll catch up with my promise and
10 want to call on Professor Zingales and Professor
11 Honigsberg on their view on SOX as a baseline and
12 the ability to quantify.

13 MR. ZINGALES: So, Colleen, go first.

14 MS. HONIGSBERG: Well, so I'm actually
15 so happy that I went after Brian and after Carole
16 because I feel like they really outlined exactly
17 where I was going. When I was going through the
18 comment letters there were -- most common
19 comparison was SOX and that people were saying,
20 well, let's take the cost of SOX as a sort of
21 anchor point. And it wasn't clear to me why
22 people were picking that because I think what you

1 would want to do is, exactly as sort of Carole
2 and Brian were describing, first let's figure out
3 what auditors are currently doing, whether --
4 what sort of overlap do we have with loss
5 contingencies or with the Exchange Act
6 requirements?

7 And then let's better understand what
8 is going to be incremental. And then let's
9 understand the team that's going to staff those
10 incremental tasks, what sort of specialists and -
11 - are we going to need for that. How many hours
12 are we going to need? And let's get a comparison
13 of what this sort of additional work is going to
14 look like and who's going to perform it relative
15 to what we have now. And once we have that we
16 can better understand -- all right, let's take an
17 average cost per individual and do at least some
18 baseline calculations there.

19 It wasn't clear to me from any of the
20 comment letters that people were really taking
21 that approach and that they were really comparing
22 what we're going to have in the future under

1 NOCLAR versus what we have now. It was more
2 like, hey, the last big thing we had in audit was
3 SOX, so let's start with SOX and let's kind of
4 sometimes use cost of SOX. Sometimes we'll say
5 SOX doubled. Sometimes we'll say triple the cost
6 of SOX. It just wasn't clear to me how they were
7 getting those numbers.

8 So in terms of like methodology I
9 think I would suggest really what Brian and
10 Carole were doing and let's understand what
11 incremental is going to happen and who needs to
12 staff that. And then that will give us a better
13 sense of like is SOX a comparison or how do we
14 calculate the cost of this?

15 The other thing too -- but I would
16 notice even if we're using SOX, it's unclear to
17 me whether we should be using the cost of SOX
18 when it was originally implemented or if we
19 should be using the cost of SOX now? And I think
20 this actually really gets to Brian's point about
21 sort of scalability and how we're implementing
22 it.

1 Because the cost of SOX, as I believe
2 sort of -- I think Dennis mentioned earlier -- if
3 we just compare what happened in 2003 to 2004 and
4 the increment increase in audit fees, we're
5 talking 59 percent. And thus, you end up with an
6 estimate for additional audit fees of over 9
7 billion. But if you look at the cost of SOX over
8 time, it's actually gone down.

9 So for example, Professor
10 Coates, who was on the earlier panel, actually
11 has a paper on this where he talks about once
12 people
13 got more comfortable with SOX, you had more
14 people who were able to perform the tasks, you
15 saw a decrease in costs.

16 So for example, there was a survey
17 published in 2013, which surveyed almost 3,000
18 companies-- found that the total mean cost of
19 compliance was 1.2 million and the median was 0.5
20 million. The SEC's ICFR rule, the requirement
21 where they rolled back SOX -- ICFR for low-
22 revenue companies -- admittedly there they were

1 talking about low-revenue companies, so smaller
2 companies here, but they suggested that it would
3 save approximately 210,000 per year comprised of
4 approximately 110 per year, would action audit
5 fees. So quite a big difference from that
6 initial 59 percent.

7 So I think we should think about do we
8 do SOX at implementation? Do we do SOX now? And
9 especially to Brian's point about scalability,
10 well, if you are able to delay it, you give time
11 for implementation and hopefully you can avoid
12 that initial huge ramp up. So that was the --
13 even if we do us SOX, I think are we using the
14 initial cost or are you we using once people get
15 a little bit more established, because those
16 numbers are going to be different.

17 MR. SCHMALZ: Thank you very much for
18 pointing to these studies.

19 I want to just reiterate the request
20 and invitation from the proposal and other places
21 to please point us to specific data and studies
22 that would help us with the quantification of

1 these costs and benefits and submit them to the
2 comment file. This is of course for the
3 panelists, but also for all listeners and viewers
4 online.

5 With that, let me get over to
6 Professor Zingales, please, to speak to that.

7 MR. ZINGALES: So I completely agree
8 with Colleen that it's much better to do a detail
9 study than do a rough calculation. What I wanted
10 to show is that do all the thesis that you want,
11 but when the potential benefits are so large,
12 they're second order.

13 So if you have time to spend, go
14 ahead, and I think it's going to be a fantastic
15 job. But to me, as an academic, I try to invest
16 the resources where there is some value, other
17 investing. And it seems to me that the value
18 added is limited.

19 This is -- I disagree slightly with
20 your characterization of measuring the increment.
21 If you go down the path of measuring the
22 increment, you should not measure the increment

1 between what they spend now and what they spend
2 in the future. You have to measure what they
3 should have spent now.

4 Because we know by evidence that they
5 under-performed the role of bringing up a red
6 flag of fraud as for 10(a) of the Securities
7 Exchange Act. And I can tell you actually two
8 personal experiences when I board of large
9 companies that were trading on the NYSE, where
10 the auditors completely failed their
11 responsibility of bringing up to the audit
12 committee some clearly red flags.

13 So one case was a \$300 million payment
14 in -- for intermediation done to a company
15 without a website. We said this smells like
16 bribery so far away. And they didn't bring up to
17 their audit committee. This seems to me like a
18 blatant violation of Section 10(a).

19 The other one was a tax fraud done at
20 the expense of the Italian Government, but using
21 the company I was on the board of, which end up
22 paying hundreds of millions of dollars in fines.

1 And was enough this was done by a
2 subsidiary that in one year was doing one-third
3 of the sale to one company located in Austria.
4 For those of you who are not European, Austria is
5 a shady place from a fiscal point of view and a
6 business point of view.

7 And if you do any analysis of the
8 phone call, they had one billion euro in revenues
9 of phone calls. Every phone call lasted either
10 53 seconds or 1 minutes and 22 seconds. So any
11 analysis -- any analysis would say wait a minute,
12 the viability of the business of the subsidiary
13 depends for a third on one company?

14 If you are an auditor you want to
15 check what the one company is doing and how
16 reliable. This was not brought to the attention
17 of the board.

18 Even looking at the evidence from the
19 United States in recent years, look at the
20 Colonial Bank case. The Colonial Bank case, the
21 auditors were not doing that. And were not
22 pointing out that a lot of the mortgage were

1 fraudulent.

2 And we're not talking, Brian, about
3 accounting standard, we're talking about old-
4 fashioned fraud. Corruption, sort of a fraud,
5 tax fraud.

6 And Wells Fargo, KPMG revealed that in
7 2013, they knew they were overdoing with
8 incentive contest. They didn't say anything to
9 the board or the SEC.

10 So I think personally that we would
11 not be here with NOCLAR if the audit firms had
12 done their job under Section 10(a). The only
13 reason why we're here is because they don't do
14 it.

15 Now, using the benchmark that they
16 don't do anything, you say, oh, it's very costly
17 to do something. It seems like completely
18 preposterous. Thank you.

19 MR. SCHMALZ: Thank you very much for
20 that passionate perspective. I see two hands up,
21 but we haven't heard at all from Ms. Posner and
22 Professor Karpoff. So if I may combine questions

1 two as a prompt to them --

2 MR. QUAADMAN: Excuse me, Martin?

3 MR. SCHMALZ: No, no, so that's --

4 MR. QUAADMAN: I've had my hand up for
5 a while, and you've gone back to several people a
6 few times. Do you mind if I?

7 MR. SCHMALZ: Yeah, I would like to
8 hear from Ms. Posner and Professor Karpoff first,
9 and then we'll get back to you.

10 So I would like to ask --

11 MR. QUAADMAN: I'd just assume that
12 you're not as interested in the public company
13 perspective.

14 MR. SCHMALZ: No, I'm interested in
15 questions, in answers to the questions we're
16 posing.

17 MR. QUAADMAN: Well, I was hoping to
18 answer a few, which is why I've had my hand up
19 for over a half hour.

20 MR. SCHMALZ: Thank you. So I want to
21 reiterate the second question, which is on
22 additional studies or data to clarify the

1 economic impact, and the submission of Professor
2 Karpoff points to that. And I'd also like to
3 call on Ms. Posner on that.

4 The fourth question points to the
5 broader macro socioeconomic environment, in
6 addition to capital formation, firms' cost of
7 capital, and so forth, if there was more trust in
8 financial markets.

9 So Professor Karpoff, let's have you
10 go first, given that in your submission, you're
11 referencing several studies and data on the
12 topic.

13 MR. KARPOFF: Just as things start to
14 heat up. So I, so my comments are going to be,
15 if I can use first names, overlapping and similar
16 to Colleen's and Luigi's. Although my
17 conclusions are very much closer to Colleen's and
18 very different from Luigi's in that I think we
19 don't have reliable numbers on which to assess
20 the benefits of the proposal.

21 So Martin, I think, tasked me
22 originally with trying to think through a

1 framework with which to think about the cost and
2 benefits from a social or society point of view.
3 And that's what the comment that I submitted does
4 and which I'll follow.

5 And I think in doing this, I want to
6 point out that the terms "fraud," "misconduct,"
7 "noncompliance" get used somewhat
8 interchangeably, both here and in the literature.
9 And the empirical literature treats these various
10 types of unsavory activities differently and
11 draws from different types of them.

12 So, for example, this'll be important
13 because if we're looking at empirical estimates
14 of, say, financial misrepresentation-related
15 cost, that could be very different from the
16 potential benefits of reducing noncompliance
17 associated with, say, workplace safety
18 activities. So the data that are available have
19 to be interpreted with that in mind.

20 So in thinking about this, I think
21 there are four buckets or types of costs that we
22 want to consider. And the first is the direct

1 compliance and cost of the regulatory
2 bureaucracy.

3 And this is the bucket I think a lot
4 of the discussion so far has focused on, trying
5 to estimate how much the extra audit fees are
6 going to be and how that redounds to investors.

7 But the idea is to risk increasing
8 that cost associated with fraud and fraud
9 management in exchange for a benefit of reducing
10 the social cost of fraud in three other buckets.
11 And the first of these three other buckets is for
12 detected fraud.

13 And here, my estimate of the cost of
14 detected fraud is somewhat similar to the numbers
15 that Luigi cites in the paper that he mentioned.
16 And what are those costs? Well, they're the
17 incremental cost of investigations and the legal
18 process, including lawsuits. There's a loss to
19 reputational capital.

20 And in a project I was involved with,
21 we estimate these costs to be quite significant,
22 up to a quarter of market cap of the fraudulent

1 companies. And what does that mean? Decrease in
2 reputational capital means a decrease in the
3 value of the assets the firm has that help bond
4 the firms' contractual performance of the
5 counterparties.

6 And it shows up with things like
7 higher cost of capital. So a paper by Graham and
8 Lu in the JFE in 2008 show this. Papers by
9 Chava, Murphy, and all, in JFQA, JFE show that
10 you have these specific types of costs that we
11 lump together and measure in total as being about
12 25% of market cap.

13 They're also firm-level disruptions
14 for detected frauds. A paper by Fich and
15 Shivdasani shows that there's director overturn -
16 - or turnover, I should say.

17 A paper I've been involved in shows
18 that 93% of named respondents at firms that are
19 targeted for enforcement action by the SEC for
20 13(b) violations, that is, misrepresentation, 93%
21 of these people do leave the firm. Which is a
22 measure of the type of internal disruption.

1 Then you have cost of undetected
2 fraud. And here's where my thoughts on this
3 differ significantly from Luigi's. What are the
4 costs of undetected fraud?

5 What would the cost be, say, if we had
6 a firm that was misreporting its earnings for two
7 years, it was never detected, and then goes back
8 to truthful reporting? Well, some people might
9 argue no harm, no foul.

10 On the other hand, I think we do know
11 that there are substantial costs. There are the
12 costs of resources burned up simply to maintain
13 and cover up the fraud. More importantly, during
14 the period in which the books are in error,
15 you're going to have price distortions.

16 And the price distortions are going to
17 lead to suboptimal investment to the extent that
18 managers of the target firm and other firms use
19 price signals to help guide investment decisions.
20 And they'll have suboptimal portfolio formation
21 as investors bear risk suboptimally because
22 they're dealing with distorted prices.

1 Now, my estimate of the size of the
2 price distortions come from an exercise in which
3 we used various types of machine learning models
4 to try to understand about how much undetected
5 fraud is going on at any given time.

6 And here we're talking about financial
7 misrepresentation. And without getting into the
8 weeds, you know, the exact estimates depend on
9 things, like how you tune the model. That means
10 how you weight the cost of type one and type two
11 errors in classifying firm or not firms.

12 And they depend on things like how
13 long you assume violations are going on. But in
14 a base case estimate, it looks at any given time
15 on average, you have a large number of firms, up
16 to 24%, that are engaged in accrual management
17 that distorts prices.

18 And that price distortion averages
19 about 10%. That is, these firms prices are
20 inflated by 10% compared to a benchmark in which
21 we -- this hypothetical benchmark where you have
22 full information.

1 But the damage doesn't stop there.
2 Investors, knowing that there's some fuzziness in
3 the information that they're getting, are going
4 to apply a discount to all firms. So even non-
5 fudging firms are going to have a price effect.

6 And we estimate the average effect to
7 be about a 3.3% decrease or distortion in the
8 prices of the shares of firms that are not
9 fudging or pushing the books.

10 MR. SCHMALZ: But that's like an
11 asymmetric information discount, is that the
12 right way of thinking about that?

13 MR. KARPOFF: That is, yes, that on
14 average, you know, investors are not on average
15 going to overpay for shares. So they're going to
16 discount all shares accordingly.

17 MR. SCHMALZ: So can I ask you, in the
18 interest of time, to also speak to any societal
19 tradeoffs. So not just on investors, but perhaps
20 the environment, social capital, and so forth.
21 What does the literature say there?

22 MR. KARPOFF: If I can, here's -- I

1 should point out why I disagree with Luigi's
2 estimate on the effects of the undetected fraud.
3 And Luigi knows this, I wrote an extensive note
4 once about this. That he -- on which he's
5 relying.

6 It draws from another paper that shows
7 that in the firms that the author of that paper
8 think are misrepresenting firms, they experience
9 a decrease in share price performance of 11%
10 compared to other firms. And if you apply that
11 11% number as a measure of cost fraud, you get
12 the numbers that Luigi was presenting.

13 And I just think that is not at all
14 related to the cost of fraud at undetected firms.
15 I think it gets cause and effect backwards. But
16 so that's a hopefully good faith, honest
17 disagreement with that particular measure and why
18 my angle on this is different.

19 You mentioned societal spillovers.
20 Here I think there's a lot of really important
21 work that we're so far not giving much attention
22 to, and that is to the extent that you can

1 decrease the incidence of fraud, there's a lot
2 work showing that the decrease -- a decrease in
3 fraud or the perception of fraud increases trust
4 in social capital.

5 And here, I just criticized Luigi.
6 Let me praise the leading work that he and his
7 authors have done in a number of papers that help
8 show, along with others, that higher trust and
9 social capital are associated with high use of
10 credit, financial market development,
11 industrialization, trade and economic growth.

12 Increase in fraud or the perception of
13 fraud decreases stock market participation.
14 Quentin Dupont has a paper that shows that the
15 effect is to decrease households' investment in
16 the stock market and ex post measures of the
17 impact on their wealth is in low six figures
18 measured over time.

19 So again, I think, we have some way to
20 start to get some traction on these -- on these
21 measures.

22 If I can point to one last thing. I

1 left out an important area that we -- we've been
2 talking about the direct cost of the regulatory
3 process in compliance. There's one more aspect
4 of that that I think should be considered, and
5 that is the cost of regulatory burden overall.

6 And here I want to refer to a couple
7 papers by Joseph Kalmenovitz and co-authors,
8 where they have this interesting data-intensive
9 measure of regulatory burden that I think is
10 persuasive and in which they're able to show that
11 regulatory burden is associated with higher cost
12 of goods sold, more overhead spending, less
13 investment, more lobbying expenditures.

14 And even the -- being in the pipeline,
15 having regulations in the pipeline such as this
16 one is associated with higher political
17 uncertainty and lower investment. So again, a
18 big cost of doing this type of proposal, but also
19 big cost of fraud that hopefully you might be
20 able to make some traction on.

21 MR. SCHMALZ: Thank you very much for
22 that perspective and all the references to

1 studies and data. Now let's go in the planned
2 order of Ms. Posner, then Mr. Quaadman. And then
3 I do see the other hands up as well.

4 MS. POSNER: Thanks, Martin. So I'm
5 not an economist, so I'm not an accountant. I
6 occasionally kind of play one on TV in the course
7 of litigation that I bring on behalf of
8 institutional investors against companies that
9 commit fraud.

10 So I'm pretty well-versed in the kind
11 of fraud we see, both by corporations, but also
12 occasionally by accounting firms. And I thought
13 I'd start by addressing a couple of the comments
14 I heard with regard to the cost of litigation and
15 then turn to the benefits.

16 With regard to the cost, I thought
17 what Brian said was -- and then Colleen
18 reiterated this perhaps or expanded on it -- I
19 think understanding the incremental difference
20 between what the rules already require auditors
21 to do and what this rule change would require
22 them to do is a really important quantification.

1 Quite frankly, I have a hard time understanding
2 how what this rule requires of accountants is all
3 that different than what is already required via
4 other aspects of the rules in terms of risk
5 assessment and otherwise. So I do think
6 understanding that delta is a really important
7 one so they understand whether the costs kind of
8 outweigh those benefits.

9 And when you have a handle on what
10 that is, I think addressing some of these
11 comments about what the cost flowing from that
12 change would be are kind of easily dispensed
13 with, or at least negated in some material
14 respects.

15 So for example, one of the things I
16 heard was oh, there'd have to be significant
17 additional consultation with subject matter
18 experts. That's something that the accounting
19 rules already require, particularly with regard
20 to the areas that are the material subject of the
21 financial report.

22 So I would hope that in most instances

1 the accounting experts are consulting with those
2 subject matter experts on a regular, ongoing
3 basis in order to fulfill their obligations under
4 PCAOB standards to begin with.

5 Same thing with regard to
6 communicating with legal experts. I just read an
7 article a week or two ago talking about the fact
8 that the Big Four accounting firms receive
9 billions of dollars in revenue every year from
10 the legal services that they provide to their
11 clients. They are the largest law firms in the
12 world.

13 So the idea that somehow there is not
14 this internal legal expertise is kind of baffling
15 to me, and certainly exists for them to consult
16 with to the extent it's necessary.

17 We heard a little bit about the fact
18 that somehow these rules lead to less IPOs and
19 less public companies, and that the costs of
20 rising capital will be impacted by the change in
21 these rules.

22 I don't see any connection to the

1 specific rule change being offered here. And
2 more importantly, it's the same charts and the
3 same arguments I see in response to every single
4 rule change proposed by the SEC or the PCAOB, no
5 matter the subject matter or topic.

6 I've heard the same testimony, I've
7 seen the same charts at least I don't know, 100
8 times in the past five or six years. It's the
9 same arguments that are raised in the Fifth
10 Circuit when the Chamber challenges every single
11 rule change the SEC and PCAOB make.

12 It'd be nice if we saw some kind of
13 specific direct connection to the actual change
14 that is being proffered here and how that might
15 be affected by it.

16 Talking now just with regard to the
17 benefits. So just to give kind of a slice of
18 what we're talking about here, between 2018 and
19 2023, so just a six-year period, we saw 608
20 securities fraud class actions that were settled
21 for approximately \$27.5 billion. It's a little
22 less than \$5 billion a year.

1 Now, the amount of the settlement
2 obviously does not necessarily reflect the total
3 cost to investors as a result of that fraud.

4 On average -- and by the way, I'm
5 getting all of these numbers from the Cornerstone
6 Group. Cornerstone Group is -- uses professors
7 who defend corporations in securities fraud. So
8 this is not a liberal think tank by any stretch.
9 These are the folks who defend corporations for a
10 living.

11 They assess that this number is a very
12 small fraction of actual simplified tiered
13 damages in securities cases. They average --
14 they say that the number ranges from less than
15 20% of damages in the smallest of settlements, so
16 under \$25 million, to about 2.5% of the largest
17 damages -- largest settlement, so \$1 billion-plus
18 settlements.

19 I can tell you last year, since it's
20 come up a couple times, I settled the Wells Fargo
21 case. We settled that case for a billion
22 dollars. We actually received 25% of our

1 estimated damages in that case on behalf of
2 investors.

3 There is no comparison to that. That
4 is like off the chart, not even in close to what
5 is ever recovered in securities cases,
6 particularly securities cases of that size. And
7 that was just a quarter of the estimated damages
8 in that case.

9 So while 27.5 billion is a lot of
10 money already, just over a six-year period, the
11 number of actual damages and loss suffered by
12 investors as a result of securities fraud is
13 infinitely higher than that number. That also
14 assumes, of course, that every valid securities
15 case survives a motion to dismiss.

16 For those who are litigators on this
17 case -- on this call or listening in, know that
18 surviving a motion to dismiss in a securities
19 fraud case is extremely hard. Approximately 50%
20 of cases survive a motion to dismiss.

21 That doesn't necessarily mean that the
22 other 50% were not sufficient or did not mean

1 that there was an actual fraud. It just means
2 that they weren't able to meet the extremely high
3 standard in securities fraud litigation. So it's
4 under-counting the number of cases in that regard
5 as well.

6 It also assumes that every instance of
7 fraud is detected, and that a lawsuit is brought
8 in the first instance.

9 But I don't think we even need to
10 quantify that undetected fraud, as we kind of
11 heard this debate going on, to know that just
12 based on the detected fraud, the extreme impact
13 on investors from fraud that is detected. Often
14 by the way not detected by auditors. It's
15 detected because it comes out through other
16 mechanisms of action, unfortunately.

17 So I think that's a really important
18 kind of numerical way to measure the benefits
19 here of what a very small percentage of detecting
20 fraud could mean for investors. Just a small
21 percentage change would have a huge impact on
22 investors.

1 The other thing I thought I would talk
2 about is something a little bit more amorphous
3 that I can't necessarily put numbers on, but
4 perhaps Brandon could speak to this a little bit
5 as well, which is that the reason institutional
6 investors invest in the U.S. markets is because
7 they believe the U.S. markets are generally as
8 free from fraud as they can be.

9 That they are better than other
10 markets around the world. That because we have
11 the SEC, because we have private enforcement,
12 that there are opportunities here to ensure that
13 their investments are safe.

14 And if they do not have that comfort,
15 if they do not believe that they are getting the
16 benefit of paying the additional cost to invest
17 in U.S. markets and that the folks who are
18 supposed to be the gatekeepers for our markets
19 are not doing their job, they will not invest in
20 U.S. markets, or at least not to the same degree
21 as they currently do.

22 And at a time at which the markets

1 across the world are considerably more available
2 to institutional investors in particular, and
3 that they are widely deciding to invest abroad
4 and not just in the U.S., the idea that we
5 wouldn't want to have those added protections
6 here seems to me to be something that
7 corporations and the Chamber would be concerned
8 about.

9 That you would want to have the added
10 protection that these types of provisions allow
11 so that you have investors who want to invest in
12 your companies, as opposed to going elsewhere.

13 MR. SCHMALZ: Thank you very much for
14 that perspective.

15 Mr. Quaadman, please.

16 MR. QUAADMAN: Yes, and that's why we
17 did not support any legislative changes to SOX
18 404(b), so that businesses had the certainty to
19 grow from small to large.

20 So to go up to cost for a second, with
21 our estimates, as I said before, we used audited
22 analytics data. And the reason why SOX was used,

1 and other commenters have used SOX as a baseline,
2 is because between 2002 and 2003, audit fees
3 doubled.

4 So if you take a look at what we did
5 is, in using the data from 2023 -- sorry, 2021,
6 updating that for inflation and just doubling
7 that number, that's how you get to \$36.4 billion.
8 It does not include increased litigation risk, it
9 does not include things like increased broker-
10 dealer fees.

11 So actually in our view that, just
12 based on history, that's even an underestimate.
13 Additionally, when you take a look at the SEC's
14 cost-benefit analysis in SOX 404, they were off
15 before reforms by 4.67, a factor of 4.67. And
16 even after reforms, they were off by 3.67.

17 So SOX in and of itself is instructive
18 as to what that could mean here. Additionally,
19 as we had in our comment letter, this, the NOCLAR
20 proposal, has the potential to continue the
21 concentration in audit firms that has been
22 occurring, as I said, over the last six years.

1 I would also have to note, I know
2 there's been a discussion about societal
3 spillovers. I have to note, earlier morning, the
4 SEC refused to include any sort of a double
5 materiality consideration with its climate
6 disclosure rule. It is not within the ambit of
7 the SEC or any organization that falls under it
8 to take societal issues into account.

9 And I would just raise as well, if
10 anybody meets with companies that could go to the
11 IPO process, look no further than the JOBS Act
12 and the creation of the emerging growth company
13 category, which Congress had to act in order to
14 deal with some of the issues there, because
15 companies felt that they could not be able to
16 scale some of the requirements around that.

17 And the two issues that are often
18 raised why companies will not go public is proxy
19 advisory firms and some of the PCAOB standards
20 that are just not relevant to that model. And as
21 Brian notes from his previous experience, it took
22 over 15 years to get those SOX 404(b) issues

1 factored out.

2 And I would also have to see too, just
3 with our cost estimate, again, yes, there are a
4 lot of different resources within audit firms,
5 there are a lot of different resources within
6 companies. But this is going to require
7 additional lawyers and additional subject matter
8 experts in different areas that are non-legal in
9 order to deal with some of the issues that are
10 going to be raised here.

11 MR. SCHMALZ: Okay, thank you very
12 much for the perspective. Now just to tally
13 things up, we have a bit less than half an hour
14 to go. We have two questions to go and lots of
15 hands. I do think I kept track of the order of
16 the hands.

17 I just wanted to remind us of the
18 question. So one is the extent -- to the extent
19 there are alternatives on the table, whether they
20 are studies or data that could help us estimate
21 the benefits and costs of those. I haven't heard
22 any so far, we can skip the question if there are

1 no responses to that.

2 But then also the overall question of
3 in light of the discussion that we've heard so
4 far, whether there are any updates to the views.
5 Again, if that's already implicitly covered, I'm
6 happy to essentially skip these questions.

7 But with that, I'll go in order.
8 Professor Zingales, I think was first and might
9 want to respond to the comments that Professor
10 Karpoff made, or anything else of course. Please
11 take it away.

12 MR. ZINGALES: Yeah, no, I appreciate
13 John's comments. And I think I want to make it
14 clear where the disagreement is, in a sense that
15 half of the cost that I describe comes straight
16 from the probability of that in fraud and the
17 cost of fraud that both of us agree on.

18 So even if we were to put at zero the
19 cost of undetected fraud, which I don't think is
20 zero because honestly, if this was zero, we
21 should abolish auditing. In this way, we are
22 sure that nobody's caught.

1 I think the only one. Yes, you see
2 the PCAOB altogether. So we know it is caught.
3 And everybody lives happily ever after, so.

4 But even if we take that extreme view,
5 which of course I'm not taking, you still are at
6 400 billion a year, which is a very, very large
7 number. And so all our argument goes to even
8 under this extreme, extreme assumption.

9 And I want to be very clear, because
10 I think that there is often a confusion, and John
11 I think played on that confusion, we're not just
12 talking about financial means of presentation.
13 We're talking about fraud. And the example I
14 brought of Colonial, of Wells Fargo, and the two
15 other companies that we're describing is exactly
16 of that type of fraud.

17 So I think that that's pervasive.
18 That's very costly. And I think that the
19 benefits of reducing it is very large and can be
20 obtained with very little. In the cases that I
21 described, if the auditor had done their job
22 normally, would have been avoided and saving all

1 the legal cost.

2 I think that all the legal cost that
3 Dennis estimates, I think that if -- that's a
4 wrong estimate. Because those legal costs will
5 not occur, because those are to patch the
6 problem. If you fix the problem to begin with,
7 you don't have those costs.

8 So in fact we have to say that
9 introducing this save corporation all the cost
10 that he estimated. So instead of being a cost of
11 this regulation, this will be a benefit of that
12 regulation.

13 MR. SCHMALZ: Thank you, Professor
14 Zingales. And we'll hear from Mr. Temple and Ms.
15 Shortly as well. I first wanted to make sure Mr.
16 Quaadman, your hand is still up, whether you got
17 to say everything you wanted, or whether there
18 was --

19 MR. QUAADMAN: No, I just wanted -- it
20 actually goes to one of the two questions you
21 were thinking of skipping. Some of the academic
22 studies that are in the file, in the comment

1 file, in support of NOCLAR actually also look at
2 not-for-profits as well as non-public companies.

3 And it's really inappropriate to use
4 that as a data set to justify an audit standard
5 for public companies.

6 MR. SCHMALZ: Thank you for that. And
7 the next on my list was Mr. McGowan. I hope I
8 the order right.

9 MR. MCGOWAN: Thank you, yes. So just
10 picking up a little bit on something that Ms.
11 Posner mentioned about institutional investors.
12 We did do a survey of institutional investors
13 just to so -- to see a cue from time to time do
14 you know, interviews and surveys with
15 institutional investors.

16 And given that the primary thrust and
17 underpinning for the PCAOB's proposal is investor
18 protection, in January we asked institutional
19 investors about the NOCLAR proposal.

20 And some of the things we found was
21 that according to this survey, most investors
22 responded, about 88% responded that the

1 information available today on NOCLAR meets most
2 or some of their needs.

3 So I think our reaction to that was
4 that, you know, that might suggest that investors
5 are not looking for the substantial changes to
6 requirements that the PCAOB has proposed. And
7 perhaps, you know, as Ms. Posner was mentioning
8 earlier, that the attractiveness of the markets
9 and the gatekeepers maybe are working here.

10 And so it doesn't, again, you know,
11 maybe there needs to be some modernization, some
12 updating, but not substantial changes.

13 When we asked them about, you know,
14 who they believe, who these investors believe
15 were most responsible for better detecting
16 noncompliance and fraud, only 17% of investors
17 responded that public company auditors could do a
18 better job.

19 And nearly seven in ten of the
20 investors believe that the costs associated with
21 the PCAOB NOCLAR proposal reporting requirements
22 are too high to justify the updated rules. While

1 our survey showed that investors would support
2 some increase in costs to bolster auditor
3 responsibilities on company NOCLAR, the majority
4 said a 30% increase in costs or less.

5 And so I think that -- and I think we
6 heard even this morning from the gentleman from
7 the Fedex board, you know, mentioning that he's
8 not getting a lot of -- he meets with hundreds of
9 investors a year and is not getting questions
10 about NOCLAR.

11 So I mean, I do think that there's
12 probably an opportunity here for the PCAOB to
13 engage with investors more broadly. And then
14 perhaps, you know, there were some investors that
15 did submit letters into the comment file.

16 And I think hearing from them as to,
17 you know, those that I know we heard this morning
18 from some that were supportive. But I think it's
19 equally important to hear from those investors
20 that were not supportive of the proposal.

21 And I think that brings me to kind of
22 my, one of my final points, which is just I think

1 that multi-stakeholder dialog is really needed to
2 drive to a consensus on a standard that's
3 practicable.

4 I think, you know, given the differing
5 views and interpretations we heard in the panels
6 this morning, and even the discussion this
7 afternoon I think just underscores kind of the
8 need for really transparent and robust dialog.

9 You know, based on our analysis of the
10 comment letter to submitted to the PCAOB, 19
11 commenters, or 14%, said that the proposal should
12 be rescinded or withdrawn. Twenty-two suggested
13 that the PCAOB hold further dialog. So, very
14 pleased that this round table is happening today.

15 I do think that this, you know, I do
16 think it's going to take more than one virtual
17 round table I think to really, you know, debate
18 these issues and really come up with a path
19 forward that is practicable and is solving for
20 the problem that we need to solve for. And that
21 an auditing standard and the auditors' behavior
22 is the right mechanism for solving that problem.

1 Because if the request is for more
2 information about company NOCLAR, you know, an
3 auditing standard may not be that solution.

4 MR. SCHMALZ: Thank you, Mr. McGowan.
5 Mr. Croteau, I did my best.

6 MR. CROTEAU: Thank you. Back to the
7 earlier comments that I made that, you know, the
8 difficult problem here to solve relative to
9 economic analysis.

10 I mean, the discussion we're having
11 now again demonstrates I think that there's a
12 range of things that people are focused on here.
13 And I do think that we have to be clear.

14 If there are aspects of the auditors'
15 responsibilities on fraud that we want to focus
16 on, we certainly should. There's been a lot done
17 in that space today. More could be done.

18 I think Luigi, one of the first of the
19 conversations you and I ever had together where
20 you were trying to convince me auditors weren't
21 responsible for fraud today, and certainly we are
22 at a reasonable assurance level relative to

1 financial reporting and misappropriation of
2 assets. I think that's important, a lot's been
3 done in that space. More could be done.

4 In fact, the SEIAG subcommittee, which
5 I sit on, on emerging issues, and I'm speaking
6 only for myself in this regard, but we're working
7 on some recommendations in that regard. And
8 there's been dialog from a CI perspective. And I
9 mentioned our actions to enhance confidence as a
10 firm.

11 But you know, again, you know, a lot
12 of this discussion is not well-linked or
13 sufficiently linked, even to the range, the wide
14 range of things we were discussing this morning.
15 And so you think about the range in which people
16 are reading the existing proposal, and some of
17 this is outside of that. Although some of it's
18 already addressed I think in existing standards.

19 But this I think just demonstrates the
20 real need to have clarity on what it is that
21 we're trying to accomplish. And it doesn't, I
22 don't -- when I say that, I really don't mean

1 that there's not things we shouldn't do. I
2 really do think there are.

3 But I don't think there's clarity in
4 some of these discussions that can sufficiently
5 inform actions for the board. Or the staff, I
6 should say.

7 And I did just want to comment on,
8 just to be sure, in the U.S. accounting firms, it
9 would be illegal for us to, speaking of really
10 lax, illegal for us to practice law. So
11 accounting firms in the U.S. are not practicing
12 law or making revenues from doing that. That
13 would be illegal.

14 The other thing I just wanted to
15 mention was a few of the examples that have been
16 given demonstrate that either 10-A have not been
17 followed or there are circumstances where perhaps
18 enforcement was warranted relative to some
19 particular set of facts and circumstances. And I
20 think those are informative examples perhaps
21 relative to is there something to do.

22 In response to that, you look at the

1 nature of it, the frequency of it, what generally
2 the performance is. There's a lot of factors one
3 would consider. But just because we can find an
4 example of something I don't think means
5 necessarily that that's justification necessarily
6 by itself.

7 It could be, but it may not
8 necessarily be. So again, I think that's where
9 the inspections process in addition to
10 inspections enforcement and all the information
11 that the board has relative to thinking again
12 carefully about what problems do we think we're
13 solving, what do we think the attendant benefits
14 would be. Because this is a very, very broad
15 discussion.

16 And then I'll just close by saying the
17 proposed -- well, let me -- two data points. One
18 is the IAG letter, which says we believe such
19 costs to investors are significantly more than
20 cost derived from ensuring companies are not
21 engaged in illegal acts including fraud, ensuring
22 that.

1 And then, you know, when you look at
2 the PCAOB's proposal, there's a reference to harm
3 over 20 times. Only four of those that I could
4 find referenced risk of material misstatements.
5 So now we're talking about prevention of, I
6 think, the illegal act to begin with.

7 So and some of this I think goes
8 broadly to all kinds of fraud, which is again,
9 kind of handled separately. So again, don't take
10 any of this, don't -- to mean I don't suggest
11 that there's good things that can be done, and
12 I'm supportive of advancing the current
13 standards.

14 But I do think that this is a pretty
15 wide-range discussion that we're having that, you
16 know, you've got a lot to think about here.

17 MR. SCHMALZ: Thank you very much.
18 The order that I have on my sheet here based on
19 when the hands went up is on -- Professor
20 Honigsberg, Mr. Temple, Ms. McNees, Professor
21 Karpoff, and Mr. Rees. So Professor Honigsberg
22 first, please.

1 MS. HONIGSBERG: I'll be quick, I know
2 we have a lot to get through. So I just had two
3 points to add.

4 First, in addition to when Professor
5 Karpoff had an excellent summary of like the
6 consequences of fraud, one other paper I wanted
7 to mention is the effects of fraud on employees,
8 to the degree that you are considering the sort
9 of effects more broadly as opposed to just on
10 investors.

11 But so after fraud, employees had on
12 average about 9% lower wages and were 18% higher
13 to have a separation from the firm. So if you
14 then just kind of conceptually can think about
15 it, you have about 17,000 people who lose their
16 job in one month after WorldCom.

17 Many of them are located in the same
18 region. They all have to find a new job at once.
19 And the jobs they find are often, you know,
20 something they have to find quickly that is going
21 to pay lower than what they had previously.

22 And one thing to note about the study

1 is that they found the effects were really
2 concentrated on lower income workers because they
3 just had less savings and so were less able to
4 wait to find a new position. Whereas higher
5 income workers were able to hold out for several
6 months until they could find something else.

7 The other point I would make is, so
8 I'm not sure we're actually going to get to the
9 question on sort of small and medium issuers.

10 One thing to note, and I think this actually goes
11 to just what Brian was talking about, is like
12 what are we really trying to achieve.

13 Because the latest data that I see
14 from Audit Analytics on restatements from 2021,
15 so of the restatements, 73% were U.S. filers who
16 were non-accelerated filers. And then an
17 additional 10% were non-accelerated foreign
18 filers. So I think we can sort of say that the
19 non-accelerated filers are where we'd be most
20 concerned.

21 And if we're thinking about the cost-
22 benefit analysis, well, the way the conversation

1 was going earlier, it seemed like there was some
2 inclination that maybe we'd want to you know,
3 have a loop -- have a carve-out for smaller
4 firms. Maybe that makes sense, I don't mean to
5 say it doesn't make sense.

6 But then I would note those are also
7 the firms that are mostly likely to have
8 restatements. So you know, it's a little
9 concerning.

10 And this, actually to what Laura was
11 saying too, is like if we really want
12 institutional investors to be comfortable
13 investing in all firms, well, those are the ones
14 who perhaps need the protection the most. And
15 the additional, you know, sort of comfort that
16 NOCLAR might provide.

17 I would also finalize by Luigi, I am
18 an Austrian citizen and I did not appreciate your
19 comments. So thanks.

20 MR. SCHMALZ: Thank you very much.
21 Mr. Temple.

22 MR. TEMPLE: Just with deference to

1 the security litigation plaintiff's bar, the
2 settlement of claims and securities litigation is
3 not a measure of fraud despite the threshold to
4 bring such litigation, the Private Securities
5 Litigation Reform Act of 1995. And it is a
6 business decision to settle such claims in cases
7 where no fraud has been substantiated.

8 So but speaking as a smaller issue,
9 the compliance function within my company is
10 robust. The proposal in many regards is
11 duplicative of that function, which would not --
12 is not adequate -- acknowledged in NOCLAR.

13 Moreover, the 302 certification
14 process I'm sure as the self-identified
15 compliance issues are disclosed by management to
16 our CEO and CFO before they certify financials
17 and are reported to our auditors.

18 But PCAOB standards without NOCLAR are
19 already sufficiently broad to cover what is
20 needed. Thank you for the opportunity to
21 participate on this panel. I look forward to
22 PCAOB reevaluating the need, scope, and precise

1 nature of NOCLAR and supporting that with a well-
2 funded -- founded cost-benefit ration.

3 I need to jump off, I need to hop on
4 a board call. But thank you very much, Martin.

5 MR. SCHMALZ: Thank you very much for
6 coming on the panel and the perspective.

7 I saw Ms. Posner's hand go up. I did
8 put you in the queue, so if you can hold on,
9 we'll go in the order. Ms. McNees was next in
10 line.

11 MS. McNEES: And I wanted to hit on
12 some of the points from question three as it
13 relates to small, medium-sized firms in
14 particular.

15 So I think it's probably quite obvious
16 as it relates to the cost component of the
17 equation here that to the extent a firm that has
18 a smaller public company audit practice incurs
19 overhead cost related to this proposal, certainly
20 basic math would tell you that cost is spreading
21 over a fewer number of clients, and they would be
22 disproportionately impacted there, as opposed to

1 larger firms.

2 There would be overhead costs
3 associated with implementing the standard. But I
4 also want to point out in addition to that I
5 agree with some of the points in Ms. Honigsberg's
6 presentation that she shared on some of the
7 unintended consequences.

8 Smaller -- small and medium-sized
9 firms are less likely to have internal expertise,
10 would be more subject to seeking out external
11 experts, subject to availability of those
12 experts. Perhaps a limited, you know, pool of
13 experts that we could call upon.

14 So I would encourage in the cost-
15 benefit analysis and thinking about the impact of
16 small medium-sized firms, that we're not simply
17 assuming all firms that are serving public
18 company clients have Big Four accounting level of
19 resources available to them.

20 I also want to highlight, too, that I
21 think the other aspect of this, and this was
22 commented on to some degree already by Mr.

1 Temple, but that our client base that we serve,
2 having a, you know, a smaller practice, tends to
3 be smaller public companies, the non-accelerated
4 filers that internally have less resources, less
5 robust systems and controls, etc.

6 I'm not necessarily advocating for,
7 you know, scoping out or anything like that. But
8 I think it's important to understand that as we
9 talked about in some of the earlier panel
10 discussions about, you know, really starting
11 with, you know, looking at what management is
12 doing and if you imagine, you know, a Fortune 500
13 company that has this really elaborate compliance
14 department that you could go to as an auditor and
15 you know, see all of the different programs that
16 they have and use all of that information to
17 identify risks of noncompliance with material
18 effect.

19 To the extent you don't have that
20 sophisticated system, I think that that puts more
21 burden on the auditor. And again, that may be
22 the right answer, but that will increase the cost

1 necessarily for the audit fees. And I think that
2 would be disproportionate -- disproportionately
3 adding more cost to the audits of those smaller
4 companies because of that.

5 MR. SCHMALZ: Thank you very much.
6 Yeah -- I hope I didn't interrupt. Please
7 continue.

8 MS. McNEES: Yeah, sorry. I think
9 that covers for the most part. There's probably
10 more but I know we're tight on time. I just
11 wanted to maybe address a couple other comments
12 that have been made in the discussion that I
13 wanted to highlight.

14 I've heard some comments that, you
15 know, either the proposed standard is really not
16 that different for auditors, like we should be
17 doing all these things anyway. We should be
18 seeking out subject matter experts, we, you know,
19 that there's not much incremental impact.

20 And I would question then if the,
21 obviously that has all to do with the discussions
22 from earlier on what truly is the scope of the

1 requirements. And I think there's a lot of
2 uncertainty with that.

3 But if the intention is really not to
4 substantially change what auditors'
5 responsibility is for, I would question then why
6 we would expect a significantly different outcome
7 and result, and that suddenly now we're
8 preventing, you know, billions of dollars of
9 losses due to noncompliance as a result if we're
10 saying well, no, this is really all the same
11 thing auditors should be doing anyway.

12 So that seems like a dichotomy to me
13 and I can't quite reconcile sort of how those two
14 things are -- would fall in line.

15 MR. SCHMALZ: Thank you very much.
16 And I saw Professor Zingales' hand go up. I
17 don't know if we have enough time to get to it
18 because we still have to get through various
19 hands and close the meeting.

20 But I just want to reiterate that if
21 there's any evidence, data, or studies on such
22 unintended effects that Ms. McNees just

1 reemphasized, please do submit them and refer to
2 them in the comment file. It's very important
3 for us to really hear on them.

4 So I have Professor Karpoff, Mr. Rees,
5 Ms. Posner, and if we get to it, Professor
6 Zingales to close out on it.

7 MR. KARPOFF: Quick, I guess three
8 quick comment prompted by the discussion just for
9 things for the PCAOB to consider as you move
10 forward on this.

11 One is if you look at the compilation
12 of the types of cost and benefits that we want to
13 think about that I submitted and I think also
14 you'll find the same thing on the list that
15 Colleen submitted, you don't see a line item for
16 legal settlements or regulatory fines. And the
17 reason for this is that such settlements are
18 transfers.

19 And if you're trying to take the
20 perspective of you know, cost and benefits to
21 society, you'd want to consider the cost to the
22 payer of this transfer. And also the benefit to

1 the receiver of the transfer.

2 And so I encourage the board to only
3 consider such settlement or regulatory fine
4 amounts as measures of the cost of fraud only if
5 you could somewhat persuasively tie it to some
6 real deadweight loss.

7 Second, my comments sort of swing both
8 ways in terms of whether they favor the proposal
9 or not. But similar to the comment that Ms.
10 McNeese was just making, I have a genuine question
11 about the effect of tasking auditors to a higher
12 standard and to look into more areas of a firm's
13 operations.

14 On the one hand, Luigi's examples
15 point to, you know, are great examples which
16 suggest that maybe if auditors were so tasked,
17 they would have stopped some of those frauds.
18 The counter argument is that they didn't stop
19 them with existing rules and they are violations
20 of existing rules.

21 So would the failures happen anyway?
22 You know, really, what is the delta of the impact

1 on fraud detection. That's a genuine question.

2 I don't know of any work in that area.

3 And my third comment is sort of a
4 large one. It's about whether this, considering
5 social spillovers are part of the purview of the
6 PCAOB. And I think there's an important
7 distinction. And I think -- I think I probably
8 agree with Mr. Quaadman about the SEC's rule that
9 it's been considering.

10 But I don't think that undermines the
11 mandate that the PCAOB has in considering rule
12 changes to consider cost and benefits for the,
13 you know, for the broader community.

14 It's different to mandate a firm's
15 social outcomes than it is to simple consider the
16 broad social impacts of the PCAOB's -- of acting
17 within the PCAOB's mandate and jurisdiction.

18 MR. SCHMALZ: Thank you very much.
19 And you all know from my accent that I'm German,
20 and Germans get very nervous when it gets close
21 to the final time and there's a risk we'd run out
22 of time. So I just ask you to keep it as short

1 as you can.

2 But Mr. Rees and Ms. Posner, then
3 Professor Zingales. And then we have to close
4 it.

5 MR. REES: This has been perhaps one
6 of the most frustrating conversations I've had to
7 participate in as an investor. To be lectured by
8 the audit, representative of the auditor and
9 prepared community about what investors think
10 about NOCLAR is just really unfortunate.

11 From an investor's perspective, the
12 cost of compliance with the NOCLAR rule is money
13 well spent. And you don't need to take my word
14 for it, you can look at it in the comment file.
15 There's letters from the SEC investor advisory
16 group, from CalSTRS, the Council of Institutional
17 Investors, Consumer Federation of America and the
18 AFL-CIO all strongly supporting this rule.

19 This rule will also benefit capital
20 formation. If you're going to talk about the
21 costs of SOX compliance, you also have to look at
22 the benefits of SOX compliance. And as I said in

1 the beginning, the stock market has increased
2 five-fold since SOX was adopted in 2002.

3 The decline in public company
4 listings, the number of public companies, is not
5 -- is completely immaterial because the value of
6 public companies today as a proportion of our
7 capital markets is as high as ever.

8 This rule is vital to ensuring
9 investor confidence in our capital markets
10 because investors already think this is what
11 auditors are doing. Our capital markets are the
12 deepest and most liquid in the world precisely
13 because of that trust, and we need to have strong
14 rules in place to ensure that we honor that trust
15 that investors, including working people such as
16 my grandfather.

17 He grew up during the Great
18 Depression, before we had federal securities
19 laws. He hid his money, his life savings, buried
20 in his trailer. Because of the PCAOB, because of
21 the SEC, because of SOX, we now have investor
22 confidence where working Americans trust their

1 retirement savings in the U.S. stock market.

2 And my last point is whether it's
3 appropriate for the PCAOB to consider impacts of
4 financial wrongdoing and fraud on other
5 stakeholders beyond investors, of course they do.
6 Because the PCAOB has a duty to protect the
7 interests of the end-users of financial
8 statements. And that's not just the
9 institutional investor community.

10 Creditors, business partners,
11 employees use financial statements to assess the
12 financial strength of the companies that they're
13 doing business with. The spillover effects of
14 this rule are tremendous. They're not limited to
15 the investor community.

16 But that being said, based on
17 everything I've heard today, even if we're able
18 to prevent just one WorldCom, just one mega fraud
19 from happening in the future, then this will be
20 money well spent.

21 And so I strongly urge the PCAOB to
22 move forward in adopting this long overdue rule.

1 A rule, which by the way, as I said in my
2 introductory remarks, has not been updated since
3 1988 when George Michael was --

4 MR. SCHMALZ: I apologize Mr. Rees, I
5 just have to move on. My German genes are
6 trickling through. So I'm sorry to regret having
7 agreed to call on Ms. Posner and Professor
8 Zingales, but let's get to them.

9 MS. POSNER: I'll be very quick. I
10 wanted to make the point that with regard to SOX,
11 that in addition to the costs, you can also look
12 at the specific benefits. And there's been quite
13 a bit of studies done demonstrating the number of
14 restatements and how they have gone down
15 considerably as a result of SOX.

16 And also the size of restatements has
17 gone down considerably as a result of SOX. Both
18 are economic benefits to legislation, which I
19 think was considerably broader in scope, quite
20 frankly, than what this is asking to do. But I
21 think is perhaps a good proxy if we're going to
22 look at the cost of SOX.

1 The second point I wanted to make was
2 just in response to what some of the accounting
3 folks were saying. It is of course true that
4 whether there is a large difference between what
5 the rules require now and what this requires with
6 this change, there might not be a demonstrable
7 difference.

8 I think the problem is that the rules
9 as required now are not being followed, despite
10 the fact that that's what everyone was assuming,
11 which is what is precipitating the need for the
12 update in the rules.

13 And then the last point I just wanted
14 to make the point that -- or Professor Karpoff
15 was making about transfers. There's a lot of
16 economic papers out there that are contrary to
17 the view that he just expressed, that it is not
18 simply a transfer of wealth from one set of
19 investors to another.

20 I think it is absolutely an
21 appropriate proxy for the harm to investors to
22 look at actual securities fraud cases, whether

1 some companies don't want to believe that they
2 are actually reflective of fraud or not, you
3 know, I'll leave it to them to say.

4 But I think we can all agree that at
5 least some portion of them is reflective of
6 actual fraud.

7 MR. SCHMALZ: I never thought I would
8 get to say Professor Zingales, but please keep it
9 short with your final comment.

10 MR. ZINGALES: To what Laura said, I
11 think that what Carole is missing is precise the
12 fact that if the rule today is not enforced, it
13 doesn't work. So what this -- I think the PCAOB
14 is forced to create new standards because the old
15 ones don't work.

16 So I have a very simple alternative.
17 So why don't we keep the rule as they are.
18 However, every time we find out, like we found
19 out in the case of the Wells Fargo and in the
20 case of Colonial, etc., that the auditor had some
21 information and they didn't raise a flag, then we
22 do two things.

1 Number one, we revoke the license to
2 operate for that particular engagement partner
3 for life. Number two, we charge a billion-dollar
4 fine on that audit firm.

5 Now this, the beauty of this system is
6 according to you guys, the cost of this thing is
7 zero, because you are saying that everybody
8 already applied. So because in equilibrium this
9 would be applied, the cost of this enforcement
10 mechanism is zero, and the benefits are going to
11 be large.

12 So if you really think that everybody
13 follow the rule, you're going to sign up to my
14 alternative proposal. Thank you.

15 MR. SCHMALZ: Thank you very much.
16 Now I see Chair Williams in the screen. I'm
17 aware we didn't get to what everybody wanted to
18 say. My last plea to please submit any
19 additional comments in the file. We read those
20 and value them very highly in how we update the
21 rule and the proposal.

22 Thank you very much for that. Let me

1 just make sure the comment file is open until
2 March 18. And while we welcome all comments, the
3 staff are particularly interested in the subset
4 of comments of course concerning the round table
5 topics and any points raised during the round
6 tables, including follow-ups we didn't get to.

7 I also want to say the video of
8 today's round table will be archived and
9 available on the PCAOB website.

10 And with that, I would like to turn
11 the floor back to Chair Williams to close us out.
12 Thank you very much.

13 MS. WILLIAMS: Thank you, Martin,
14 Barb, Karthik, and all of your colleagues who
15 made today's event possible, including Brian
16 Goodnough and Awilda Santiago and the Office of
17 Communications and Engagement for managing the
18 Webex.

19 And thank you to all of our panelists
20 for taking time to share your valuable insights
21 with us. You've given us a lot to think about.

22 I also want to thank the public that

1 is watching today. And as Martin said, the
2 public comment period is open until March 18, and
3 we look forward to hearing from you.

4 Thanks very much.

5 (Whereupon, the above-entitled matter
6 went off the record at 5:03 p.m.)
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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

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Court Reporter

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