

November 2, 2023

Via email to comments@pcaobus.org

Office of the Secretary, Public Company Accounting Oversight Board
1666 K Street, NW
Washington D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 53 Proposed Amendments to PCAOB Rule 3502
Governing Contributory Liability

Dear Secretary Brown and Members of the PCAOB:

We appreciate the opportunity to provide feedback to the Board regarding the proposed amendments to PCAOB Rule 3502. We are accounting professors from several universities located in the United States. We teach auditing and conduct research in the areas of auditor judgment and decision making and audit regulation. We also have years of collective experience in public practice. Our background leads us to care deeply about the viability and future of the auditing profession.

Overall, we support the Board’s mission to oversee the audits of public companies to protect investors and further the public interest. Academic research suggests that the Board’s inspection efforts have resulted in higher audit quality, higher financial reporting quality, and better information environments for managers and external users.¹ We also support a robust enforcement function that is focused on reckless and intentional noncompliance, as specified in the Sarbanes-Oxley Act of 2002 (“The Act,” Sec. 105(c)(5)). Consistent with this mandate, research suggests that such targeted enforcement actions can be beneficial in motivating better auditor behavior.²

However, we do **not** support the proposal to reduce the threshold standard of conduct for contributory liability from recklessness to ordinary negligence for two primary reasons. First, the proposal would place a disproportionate burden on individuals assigned quality control responsibilities within a firm’s system of quality control. Second, the proposal reflects a fundamental shift in the PCAOB’s approach to regulatory oversight, moving away from a supervisory approach and towards an enforcement approach. We are concerned that if enacted, the proposed changes would reduce the desirability of the profession for students, reduce the

¹ See, for example, Carcello, Hollingsworth, and Mastroia, 2011; Lamoreaux, 2016; DeFond and Lennox, 2017; Fung, Raman, and Zhu, 2017; Krishnan, Krishnan, and Song, 2017; Aobdia, 2019; Gipper, Leuz, and Maffett 2020; Kim, Su, Zhou, and Zhu 2020; Lamoreaux, Mauler, and Newton 2020; Shroff, 2020; He, Li, Liu, and Pittman 2021; Carlisle, Yu, and Church 2022; Christensen, Lei, Shu, and Thomas 2023.

² See Lamoreaux, Mowchan, and Zhang 2023.

likelihood that high qualified CPAs remain in the profession, and ultimately have an adverse impact on audit quality.

Disproportionate Impact on Quality Control Partners

The proposed change in the threshold for liability would place an unfair burden on national office partners responsible for a firm’s quality control functions and engagement quality review partners. National office partners typically have responsibilities for establishing and communicating policies and procedures related to audit engagements and for monitoring compliance. These individuals do not, however, typically have the authority to establish firm strategies or allocate resources. Instead, these individuals are tasked with maintaining high audit quality without control over key factors that impact audit quality.

In the executive summary, the Board argues that “It logically follows that when a registered firm is found to have acted negligently, it is likely that such negligence is attributable to a natural person’s negligence.”³ We are concerned that, based on this premise, the PCAOB will pursue enforcement actions against a single scapegoat when the firms’ partners collectively are responsible for the strategy and resource allocation decisions that led to the firm’s negligence. Recently, the SEC took enforcement action against the National Assurance Leader for a national public accounting firm.⁴ His firm’s issuer practice had grown dramatically in a short period of time and the firm’s staffing did not keep up. The firm was subject to severe disciplinary actions, including significant civil monetary penalties levied by the SEC and the PCAOB.⁵ This civil monetary penalty is borne by each of the firm’s partners and thus reduces overall firm profit available to be distributed to them. This outcome is appropriate because the partners of the firm should be held collectively responsible for the firm’s strategy and resource allocation decisions. However, in the same enforcement action the SEC also singled out one of the firm’s partners for additional disciplinary action. This additional action does not appear appropriate because although this individual was responsible for quality control, there is no indication that he controlled the firm’s strategy or resource allocation decisions.

The current proposal argues that we should not be concerned about lowering the threshold for liability because the cost of defense will be borne by the firm rather than the individual.⁶ The SEC enforcement action discussed in the preceding paragraph demonstrates the fallacy of this thinking. The individual who received further discipline could not rely on his firm to fully defend himself because the most important arguments in his defense were prejudicial to his firm. Specifically, he could have argued that the firm established the growth strategy and/or that the

³ PCAOB Release No. 2023-007, page 3.

⁴ SEC Accounting and Auditing Enforcement Release No. 4458. September 12, 2023. <https://www.sec.gov/files/litigation/admin/2023/34-98352.pdf>

⁵ SEC Accounting and Auditing Enforcement Release No. 4423, June 21, 2003 <https://www.sec.gov/files/litigation/admin/2023/34-97773.pdf> and PCAOB Release No. 105-2023-005, June 21, 2023, https://assets.pcaobus.org/pcaob-dev/docs/default-source/enforcement/decisions/documents/105-2023-005-marcum.pdf?sfvrsn=e46a22c_7.

⁶ PCAOB Release No. 2023-007, page 24.

firm failed to allocate sufficient resources to the support of the quality control function. Absent these defenses, the individual faced a significant civil monetary penalty and a bar from practice.

We are concerned that increasing the personal liability for quality control partners and engagement quality reviewers will make it difficult to attract and retain qualified individuals to these positions.⁷ While it would be preferable to fill these positions with individuals who are somewhat risk averse, the lower threshold for liability will disincentivize such individuals from seeking these positions, to the further detriment of audit quality.

In its proposal, the Board implies that auditors will fail to exercise due care “if they know they cannot be held individually liable by the PCAOB.”⁸ However, this argument is premised on a belief that the only incentive for due care is the threat of PCAOB disciplinary action. The reality is that firms can and do incentivize auditors to exercise due care in the performance of their responsibilities. Academic research documents that auditors’ compensation and promotion opportunities are adversely impacted by deficient audit work.⁹

Moreover, we share Board Member Ho’s concerns that “under the proposed negligence standard, the public company auditing profession will become even less attractive.”¹⁰ We are concerned that if this proposal is adopted it will further degrade the pipeline to the accounting profession more broadly, a topic of critical importance that is gaining increasing attention, as well as retention of high quality practicing CPAs.

The Shift in Regulatory Approach

When the PCAOB was established, the founding board members determined that the Board would adopt a supervisory approach to regulation. In a 2005 speech, Dan Goelzer explained that under this approach, the PCAOB would use its inspection approach to make recommendations rather than bring disciplinary actions. He said enforcement would be reserved for firms that were “unwilling or unable to follow the rules.”¹¹ The PCAOB continued to take a supervisory approach under Chairman James R. Doty. For example, in 2013, he explained that “selectivity” was the “hallmark” of the PCAOB’s enforcement program, stating “We look for cases that involve something more than mere negligence. In fact, we look for cases that involve reckless

⁷ Westermann, K., J. Cohen, and G. Trompeter. 2019. PCAOB Inspections: Public Accounting Firms on “Trial.” *Contemporary Accounting Research*. 36 (2): 694-731

⁸ PCAOB Release No. 2023-007, page 7.

⁹ For example, see Westerman et al. 2019 and, separately, Johnson, L.M., M.B. Keune, and J. Winchel. 2019. U.S. Auditors’ Perceptions of the PCAOB Inspection Process: A Behavioral Examination. *Contemporary Accounting Research* 36 (3): 1540-1574. <https://doi.org/10.1111/1911-3846.12467>.

¹⁰ Ho, C. 2023. Statement on Proposed Amendments to PCAOB Rule 3502 Governing Contributory Liability. [https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-\(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability\)](https://pcaobus.org/news-events/speeches/speech-detail/the-cost-of-unintended-consequences-accounting-talent-audit-quality-investor-protection-(statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability)).

¹¹ Speech to the Colorado Society of CPAs 2005 SEC Conference in Denver Colorado on December 15, 2005. https://pcaobus.org/news-events/speeches/speech-detail/pcaob-update-a-year-three-progress-report-and-2006-challenges_114.

disregard of the auditor’s duty.”¹² Relating to the proposed rule change specifically, Board member Duane DesParte commented on the fact that the PCAOB originally considered a negligence-based framework for Rule 3502 but after much deliberation decided to move ahead with the recklessness standard in part because of the professional judgment inherent in public company audits.¹³

Importantly, the proposed negligence-based approach to enforcement would contradict the approach outlined by the Act in Sec. 105(c)(5), specifying that “the sanctions and penalties described [in the Act] shall only apply to (A) intentional or knowing conduct, including reckless conduct...; or (B) repeated instances of negligent conduct.” Thus, the Act is clear that unless negligent conduct is repeated, sanctions and penalties under the Act—the enforcement approach—should not be applied.

We suspect that the current Board is abandoning the supervisory model to embrace an enforcement approach to regulation. We are concerned with this approach because we do not believe that it will have a positive impact on audit quality. Responsive regulation theory suggests that the PCAOB should employ penalties only after persuasion attempts have failed, i.e., the noncompliance in question was repeated.¹⁴ Moreover, the slippery-slope framework helps to explain how a coercive enforcement strategy can be counterproductive in achieving regulatory objectives.¹⁵ This academic research suggests that the PCAOB enforcement resources would be most effective when reserved for excessive auditor misbehavior that has resulted in actual investor harm or that threatens the PCAOB’s regulatory oversight (e.g., backdating workpapers in anticipation of inspection; failure to cooperate with inspectors; providing false or misleading information to inspectors).

¹² Keyser, J.D. 2023. The Regulatory Approach of James R. Doty: PCAOB Chair 2011-2018. *Abacus* (forthcoming). <https://doi.org/10.1111/abac.12301>.

¹³ Duane DesParte, September 19, 2023. <https://pcaobus.org/news-events/speeches/speech-detail/statement-on-proposed-amendments-to-pcaob-rule-3502-governing-contributory-liability>

¹⁴ Ege, M., W.R. Knechel, P.T. Lamoreaux, and E. Maksymov. 2020. A multi-method analysis of the PCAOB’s relationship with the audit profession. *Accounting, Organizations and Society* 84: 101131. <https://doi.org/10.1016/j.aos.2020.101131>.

¹⁵ Dowling, C., W.R. Knechel, and R. Moroney. Public oversight of audit firms: The slippery slope of enforcing regulation. *Abacus* 54 (3): 353-380. <https://doi.org/10.1111/abac.12130>; Johnson, L., M. Keune, and J. Winchel. 2019. US Auditor’s Perceptions of the PCAOB Inspections Process: A Behavioral Examination. *Contemporary Accounting Research*. <https://doi.org/10.1111/1911-3846.12467>

Conclusion

The existing threshold for contributory liability is adequate and should not be changed. We believe that the costs of the proposed rule change outweigh any potential benefit and we urge the PCAOB to return to the supervisory model of regulation.

Thank you for the opportunity to comment on the proposed standard. If you have any questions, please contact John Keyser at 216-368-8895.

Sincerely,

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