

The ‘Controversial’ NOCLAR Proposal

Are Stakeholders in Favor of Change?



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On June 6, 2023, the PCAOB published an exposure draft requesting comments about the auditor's role with respect to noncompliance with laws and regulations (NOCLAR). The exposure draft ("Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations," <https://pcaobus.org/about/rules-rulemaking/rulemaking-dockets/docket-051>) is extensive in its potential scope and

<https://www.cpajournal.com/2024/06/12/the-controversial-noclar-proposal/>

requirements. If adopted as drafted by the PCAOB and approved by the SEC, the guidance will require auditors to perform procedures to identify circumstances of NOCLAR, assess the impact of such events on the financial statements, and evaluate whether material and relevant NOCLAR events have been disclosed in the financial statements. It is worth noting that, since 2017, firms have been required to report on NOCLAR in accordance with the International Code of Ethics for Professional Accountants as issued by the International Ethics Standards Board for Accountants (IESBA).

The impetus for this proposed guidance was stated in the opening remarks delivered by PCAOB Chair Erica Williams at a Board meeting:

A company's noncompliance with laws and regulations, including fraud, can have devastating consequences for investors. (emphasis added)
("Statement on Proposed New Standard Regarding Noncompliance With Laws and Regulations," by Erica Y. Williams, PCAOB Open Board Meeting, Jun. 7, 2023, para. 2, <https://tinyurl.com/mpku89a8>).

In the original proposal, no other stakeholders were named as the reason to make a change. Later, the PCAOB added auditors, companies, and the public as "stakeholders," too. Still, it appears that the PCAOB, true to its mission, is putting forth an audit standard that, at its core, is for the benefit of its constituents—the investing public.

The comment period initially ended on August 14, 2023, and in total 129 comments were received. Subsequent to the closing of the comment period, the authors performed an analysis of the comment letters, and selected a series of attributes and reasoning that could paint the picture of how the proposed NOCLAR audit standard was received, as well as the possible reasons for respondents' reactions. (Subsequently, the comment period was re-opened; an additional 10 comments received were not analyzed by the authors.) This analysis suggests that this is not a controversial issue. The comment letters, with a confidence level above 99%, were against this issue and found no redeeming qualities for issuing a standard or changing the status quo.



Methodology

The tabulation methodology included two passes of reading. In the first pass, 10 randomly selected responses were read in full. This provided the ability to establish approximately the points being argued for or against the proposed rule. In the second pass, all 129 comment letters were read in summary, meaning that the executive summary or general comments were mostly considered, without focus on the more detailed analysis that followed. This allowed the research to be more streamlined, but also focused on the issues at hand—the argument that each respondent was putting forth.

In general, most comment letters were divided into some form of summary or general comments, followed by specific comments and responses to some or all of the 50 questions that the PCAOB had put forth. Approximately 10% of the comment letters were more informal, in the form of a letter or an e-mail message.

The authors also tabulated the type of respondent. Although not all respondents identified themselves as, for example, a “CPA” or “regulated industry,” we used their responses, our general knowledge, and research of publicly available information to determine what type of stakeholder each respondent was, and more importantly, what type of stakeholders the respondents were likely to represent.

Next, the authors tabulated the general gist of each comment letter. Although many respondents started their general comments or executive summary by supporting the PCAOB and its mission, after that introductory language one could generally find the overall sentiment of the respondents: for or against the proposed NOCLAR rule.

The reasons each respondent gave “for” or “against” the proposed rule were tabulated. In total, seven arguments were raised by respondents: five classes of reasons against the proposal, and two classes of reasons for the proposal.

Two arguments that were not considered for each response were a) the language of the proposal was unclear, and b) the proposal created consistencies or inconsistencies among other audit standards (most notably, the auditors’ responsibility to detect fraud). We excluded these two types of responses because unclear language is what, in part, the detailed response section is for, and also because this article is not an analysis of the audit standard per se, but rather an analysis of the respondents and their motivations and arguments.

Finally, the authors performed a respondent validation, whereby another set of 11 responses was selected at random, independently of the first set, and evaluated as to the tabulation performed.

The authors conducted a statistical analysis using a chi-square test based on the total number of responses. If this topic was controversial, the comment letters would be expected to be 50% *for* and 50% *against*; thus, the null hypothesis was that the PCAOB’s proposal was a “controversial topic.”

Results: For or Against? Is this a Controversial Topic?

The first attribute to be evaluated was a general “for” or “against.” Here, as discussed in the methodology, was the substance of the response. The results are clear: approximately 20% of the respondents were for the proposed rule and nearly all of these respondents were persons or associations related to compliance or compliance officers. It is interesting to note that approximately half of the responses appeared to be a repetition of language and reasoning by earlier respondents. We also noted that the other half used unique arguments with original formats.

This suggests that there was a concerted effort among the “compliance officer” stakeholder group to simply “increase compliance” without much more discussion. It may be worth

noting that compliance officers, as represented by the data, apparently feel that compliance in general is not receiving its just attention, validation, or resources.

In contrast, approximately 80% of respondents were “against” the proposed NOCLAR rule.

Deeper Insight into the Responses

For a deeper analysis, the authors did not count the number of respondents but the number of responses. In other words, if a response from Stakeholder A included three reasons against the proposed rule, it was counted three times, one for each reason. In total, 356 responses were received, with 25 reasons *for* the rule, and 330 *against*. (One response was classified as “unstated.”) The analysis below refers to the 355 total responses. [Exhibit 1](#) illustrates how responses visualized groups’ capability with respect to NOCLAR. [Exhibit 2](#) illustrates the categories of objection to the proposal.

Exhibit 1

Visualization of Capabilities with respect to NOCLAR

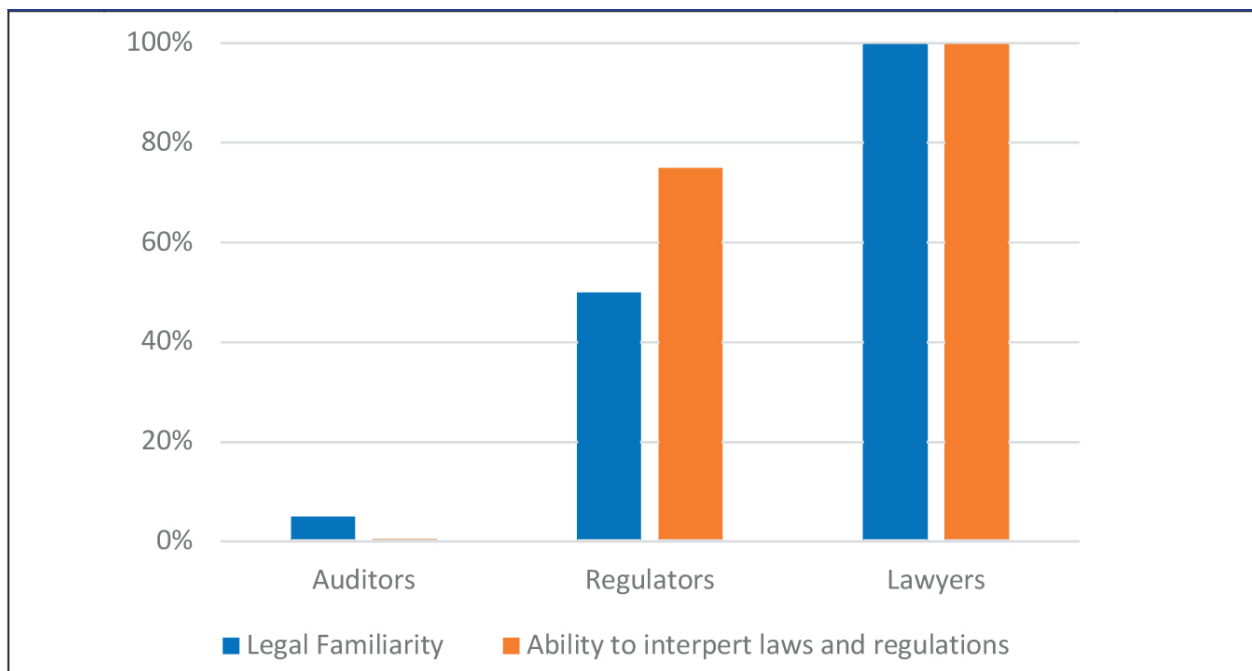
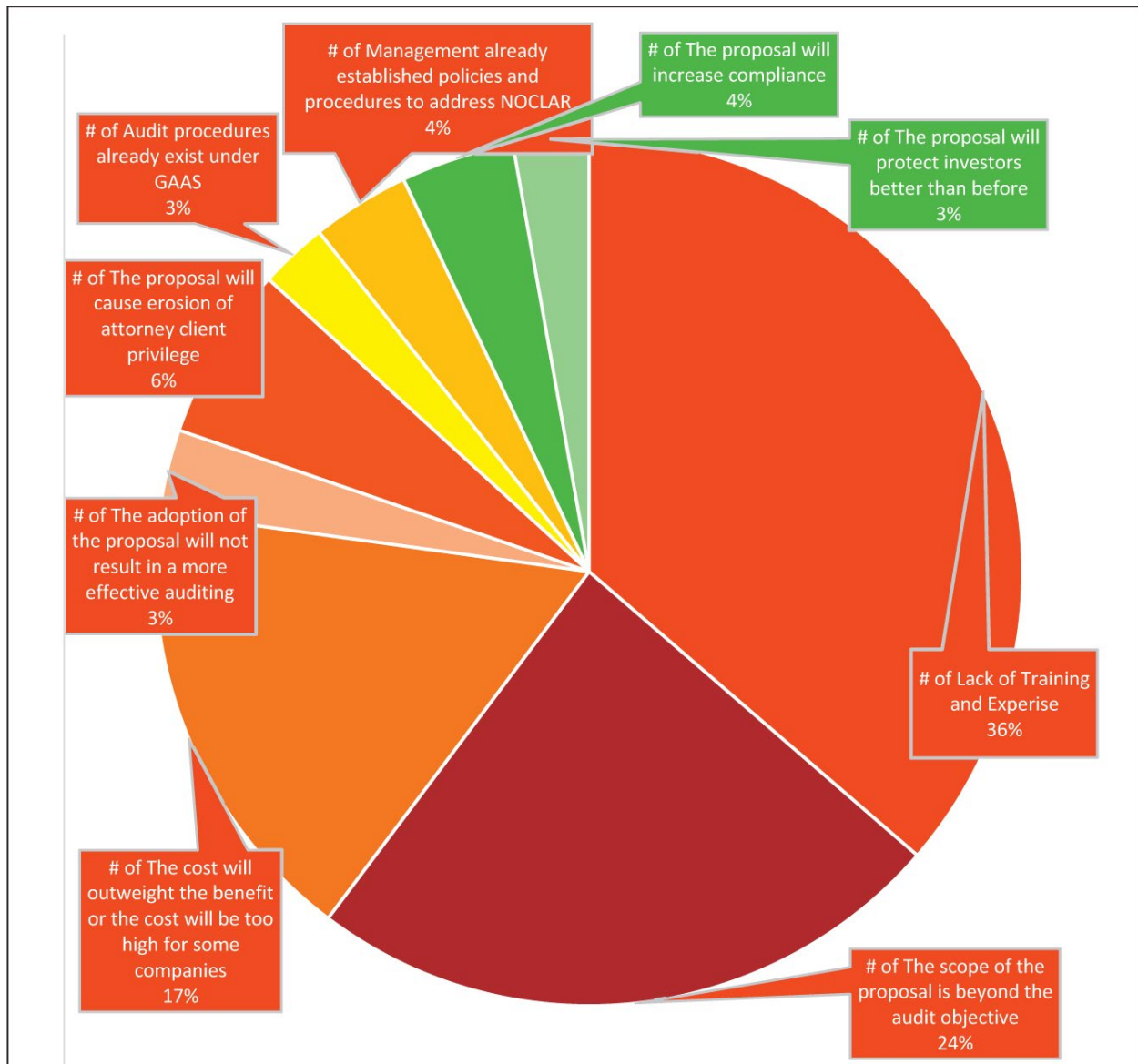


Exhibit 2

Objections to the NOCLAR Proposal

<https://www.cpajournal.com/2024/06/12/the-controversial-noclar-proposal/>



As discussed above, two primary reasons were analyzed from the respondents that broadly stated that they were *for* the proposed NOCLAR rule: First, these respondents stated that the proposal would “increase compliance” of the registered companies; second, that the proposal would protect investors better than before. These two reasons were expressed in a total of 10% and 7% of responses, respectively. Of the 15 respondents for the compliance argument, 11 were compliance officers; of the five respondents for the investor protection argument, all of them were an “investor association,” a class of stakeholders that represent investors in the broadest way (e.g., AARP, AFL-CIO).

Of the opponents to the proposed SEC rule, there were more responses and thus more diversity in the stakeholder categories. The largest group opposing the NOCLAR proposal

came from regulated segments, such as energy or healthcare companies. A “regulated industry,” as classified here, included companies or associations for an industry that experiences high degrees of regulation. Technology companies were excluded as a “regulated” industry because it is historically less regulated than, say, healthcare, although an argument can be made to the contrary.

Of the responses *against* the proposal, regulated industries opposed at 28%, followed by CPA firms (regardless of size) at 19%, and industry associations at 17%; 3% of responses from CPAs stated that audit standards already address NOCLAR sufficiently. On the industry side, 2% of the regulated industries (including associations) argued that there are already corporate governance policies and procedures in place.

CPA stakeholders, including professional associations such as the NYSS-CPA, cited the following as the primary reasons for opposing the proposal: what accountants called “scope creep” (10%) and “lack of training,” which was most often expressed with the term “auditors are not lawyers” (8%).

Finally, the results of a chi-square test performed on the 355 responses indicated that this PCAOB proposal was not controversial at all. The chi-square of 270.7 is higher than the critical value (with one degree of freedom) of 6.635 at the $p < .01$ level; this indicates a high probability that there is a significant difference between the expected and actual responses, assuming the null hypothesis. The sample data did not fit the expectations of the null hypotheses (assuming the responses were from a normal distribution of responses). Therefore, the chi-square test indicates that one should reject the null hypothesis of controversiality and say that the PCAOB’s NOCLAR proposal was not controversial—because most response did not find it acceptable.

Limitations

Internal validity.

The research sample was significantly large in order to avoid sensitivity to other variability, and provide more confidence that the relationships studied were not influenced by other factors or variables.

External validity.

Assuming the respondents were representative of the nonrespondents, one can generalize the findings of this research to the broader population affected by this proposal.

A Lack of Support

The NOCLAR issue poses a pragmatic question to the PCAOB. Although its objective, and the broader SEC mandate, is to protect investors, the NOCLAR proposal does not do this. The above research clearly indicates that this proposal is not supported by the stakeholders and constituents of the PCAOB and SEC. Under the circumstances, the PCAOB should consider going back to the drawing board to devise guidance that addresses the practical issues raised by the international implementation of NOCLAR guidance in a form that would be more positively received by its constituents.

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