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# PCAOB Change to Auditor Liability Standard For Individuals Becomes Effective

The Securities and Exchange Commission (the “SEC”) recently approved an amendment (the “Amendment”) to the rules of the Public Company Accounting Oversight Board (the “PCAOB”) that changes the liability standard applicable to individuals associated with a registered public accounting firm who “directly and substantially contribute” to a violation by the registered public accounting firm of any of the statutes, rules or standards enforced by the PCAOB from recklessness to negligence, and the Amendment has now become effective.

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## Background and Rationale

The Amendment relates to PCAOB Rule 3502, which governs the secondary liability of persons associated with registered public accounting firms and was proposed and adopted by the PCAOB in September 2023 and June 2024, respectively. The PCAOB filed the proposed Amendment with the SEC in June 2024, and the proposal was published for comment in July 2024 (the “Notice of Filing”).<sup>1</sup> The SEC’s order granting approval of the Amendment (the “Order Granting Approval”) was released on August 20, 2024, and the Amendment became effective 60 days later on October 19, 2024.<sup>2</sup>

PCAOB Rule 3502 holds registered public accounting firms to a negligence liability standard. The Order Granting Approval describes negligence as a “failure to exercise reasonable care or competence.”<sup>3</sup> However, the PCAOB rules treat individuals who directly and substantially contribute to the errors of such firms as distinct from the firm itself and, prior to the Amendment, held such individuals to a recklessness standard. The Order Granting Approval describes recklessness as an “extreme departure from the standard of ordinary care” that “presents a danger to investors or to the markets that is either known to the (actor) or is so obvious that the actor must have been aware of it.”<sup>4</sup>

Because of the differing standards used for registered public accounting firms and associated individuals, when the PCAOB pursued violations against firms based on negligence in the past, it was at the same time more limited in pursuing the associated persons of those firms who substantially and directly contributed to such violations because it had to meet the higher recklessness standard in order for the individuals to be secondarily liable. The

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<sup>1</sup> SEC Release No. 34-100429 “Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Amendment to PCAOB Rule 3502 Governing Contributory Liability” (<https://www.sec.gov/files/rules/pcaob/2024/34-100429.pdf>).

<sup>2</sup> SEC Release No. 34-100772 “Public Company Accounting Oversight Board; Order Granting Approval of Amendment to PCAOB Rule 3502 Governing Contributory Liability” (<https://www.sec.gov/files/rules/pcaob/2024/34-100772.pdf>).

<sup>3</sup> Order Granting Approval, *supra* Note 2, citing *In re S.W. Hatfield*, C.P.A., SEC Release No. 34-69930, at 35 n. 169 (July 3, 2013) (<https://www.sec.gov/files/litigation/opinions/2013/34-69930.pdf>).

<sup>4</sup> Order Granting Approval, *supra* Note 2.

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Amendment is intended to reconcile this distinction, thereby increasing an individual's incentive to "exercise the appropriate level of care in their audit work" and furthering the PCAOB's mission to protect investors.

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## Comments and Criticism

### *PCAOB Process*

During the PCAOB approval process, the PCAOB received 28 comment letters. While many commenters agreed that having a uniform negligence standard apply to both registered public accounting firms and associated persons would better align incentives for auditors, others felt that changing the standard to negligence was not necessary.

During the initial adoption of Rule 3502 in 2005, the PCAOB acknowledged its authority to apply a negligence standard to associated individuals but revised the standard to recklessness in response to feedback in the notice and comment process. Commenters at the time felt that negligence, as applied to associated persons, might be an "ill-suited standard 'in light of the complex regulatory requirements with which auditors must comply'"<sup>5</sup> and that associated persons who "in good faith, albeit negligently, have caused a registered firm to violate applicable laws or standards"<sup>6</sup> could be held liable. Further, commenters at that time noted the collaborative nature of accounting and expressed concerns that each individual who contributed to a decision could ultimately be held liable. Accordingly, the rule as originally proposed was revised to apply a recklessness standard to individuals and to require "direct and substantial" contribution by the associated person. In considering the present Amendment, some commenters felt that changing the liability standard, especially after extensive discussion about the same standard during the rule's original adoption, was not necessary and raised similar concerns about the potential consequences of good-faith decisions. The PCAOB, however, concluded that because the standard for primary violations is already negligence, the Amendment represents only "an incremental (albeit important) change."<sup>7</sup>

Commenters also noted a variety of other enforcement mechanisms under which individuals associated with registered public accounting firms are held accountable, some of which might make a negligence standard unnecessary or even harmful. One comment letter raised concerns about the use of a negligence standard for finding secondary liability when certain findings of primary liability (of the accounting firms) require intentional conduct. The PCAOB noted the concern and stated that in general it did not anticipate charging associated individuals with negligence "when the firm's primary violation requires more than negligence." Other commenters noted that existing state regulatory regimes, SEC proceedings, and the PCAOB inspection program provide oversight and that standards such as the QC 1000 (Quality Control) standard set clearer expectations than the Amendment. The PCAOB acknowledged that QC 1000 might overlap with the Amendment in some cases, but noted that because QC 1000 only applies to individuals in quality control roles, the Amendment would apply more broadly. Further, the PCAOB emphasized that the monitoring of the same or similar conduct under different regimes would increase the likelihood that violations would be detected.<sup>8</sup>

Similarly, commenters noted that the PCAOB's own inspection process relies on a cooperative dynamic with accounting firms. The increased potential for individual liability, commenters argued, would threaten this dynamic.

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<sup>5</sup> Notice of Filing, *supra* Note 1 at 8.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 26.

<sup>8</sup> *Id.* at 13 -15.

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The PCAOB emphasized that individuals are already held to a negligence standard for certain *primary* violations, and that the Amendment does therefore not represent a radical change by imposing a negligence standard for *contributory* violations and that the PCAOB would continue to exercise discretion when bringing charges.<sup>9</sup>

### SEC Process

During the SEC approval process, the SEC received only one comment letter. The primary issues raised were (i) whether the PCAOB has the proper authority to enact such a standard, (ii) the potential adverse effects of the Amendment in terms of cost, and (iii) potential adverse effects on the continuation and growth of the auditing profession.

The SEC noted in the Order Granting Approval that the PCAOB has authority to adopt ethics standards applicable to registered public accounting firms under Section 103(a)(1) of the Sarbanes-Oxley Act of 2002 (“SOX”) and to impose sanctions on firms and associated persons under Section 105(c)(4) of SOX.

With respect to the potential costs of the Amendment, the SEC noted that the duty to refrain from acting negligently and contributing to a registered public accounting firm’s violations of established standards already exists elsewhere in the law (such as in the context of cease-and-desist orders or civil penalties)<sup>10</sup> and accordingly is not a new burden with the implementation of this Amendment. Instead, the Amendment gives the PCAOB further means to enforce this standard.<sup>11</sup>

Regarding the potential adverse effects the Amendment might have on the accounting profession more generally, the SEC stated that while the new negligence standard imposed on associated persons might encourage some registered public accounting firms and/or associated individuals to exit the profession, such departures may consist of lower quality auditors—presumably those who are not willing or able to comply with the new negligence standard—thereby leading to higher overall quality of service in the field.<sup>12</sup>

Concern over the effect of the Amendment on the auditing profession was also noted by SEC Commissioner Hester M. Peirce, one of the two dissenting Commissioners in the SEC approval process. She suggested that, rather than simply pushing lower quality auditors out of the profession, the Amendment represented another reason “talented individuals” might avoid the auditing profession at a time when recruiting is waning and that the SEC, state licensing boards, and accounting firms themselves already have the means to react to an associated individual’s negligent contributory conduct.<sup>13</sup>

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### Emerging Growth Companies

In the Order Granting Approval, the SEC addressed the application of the Amendment to audits of Emerging Growth Companies (“EGCs”). Under Section 103(a)(3)(C) of SOX, additional rules adopted by the PCAOB do not apply to EGCs unless such requirements are in the public interest “after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.” The SEC concluded the

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<sup>9</sup> *Id.* at 12.

<sup>10</sup> Order Granting Approval, *supra* Note 2.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> Statement from SEC Commissioner Hester M. Peirce, *Three from the PCAOB* (August 20, 2024) (<https://www.sec.gov/newsroom/speeches-statements/peirce-remarks-pcaob-082024>).

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Amendment applies to audits of EGCs, noting that because EGCs are companies with limited history for investors to assess, audits of such companies may play a more important role in investment decisions. Further, the SEC suggested that the higher quality audits that may result from the Amendment may increase investor confidence and could reduce the cost of capital to EGCs.<sup>14</sup>

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## Conclusion

The Amendment has been approved and went into effect on October 19, 2024. Beginning on such date, persons associated with registered public accounting firms who directly and substantially contribute to violations by registered public accounting firms can be held liable for their negligence. Given the potential for increased liability, the Amendment may very well continue to be challenged.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to call or email authors Daniel Anderson (partner) at [danderson@cahill.com](mailto:danderson@cahill.com) or 212.701.3819, Geoffrey E. Liebmann (senior counsel) at [gliebmann@cahill.com](mailto:gliebmann@cahill.com) or 212.701.3313, or Sarah E. Busby (associate) at [sbusby@cahill.com](mailto:sbusby@cahill.com) or 212.701.3472; or email [publicationscommittee@cahill.com](mailto:publicationscommittee@cahill.com).

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<sup>14</sup> Order Granting Approval, *supra* Note 2.

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