Via E-mail: rule-comments@sec.gov
Securities and Exchange Commission,
100 F Street, N.E., Washington, DC 20549-1090.
Attention: Vanessa Countryman, Acting Secretary

July 11, 2019

Re: Amendments to the Accelerated Filer and Large Accelerated Filer Definitions
- File No. S7-06-19

Ladies and Gentlemen:

We appreciate the opportunity to comment on the Securities and Exchange Commission's (the "Commission") proposed Amendments to the Accelerated Filer and Large Accelerated Filer Definitions. Herein we provide comments and analysis relating primarily to the Request for Comments in Sections II.E and III.D of the proposed Amendments ("Proposal"). Our comments relate to the provisions of the Proposal that would eliminate internal control audits required under Section 404(b) of the Sarbanes-Oxley Act for companies with annual revenue less than $100 million.

Part I of this letter provides comment on the central premise of the Proposal. The Commission's total estimated benefit to companies—$210,000 in cost savings from foregoing internal control audits—is economically small and amounts to less than 0.1% of the average affected company's equity market value. In contrast, we interpret the evidence in the Proposal as suggesting that the elimination of internal control audits is likely to result in significantly weaker internal controls over the financial reporting system and significantly greater levels of accounting restatements (i.e., poorer financial reporting quality). Thus, the $210,000 cost savings needs to be weighed against the potentially large social costs created by weaker internal controls and elevated levels of accounting restatements.

Part II of this letter comments on various aspects of the Commission's economic analysis. We believe the analysis is incomplete for three reasons. First, the analysis quantifies the cost of internal control audits, but does not attempt to quantify the benefits of such audits. Second, the analysis focuses on the rate of restatements among affected companies and does not consider the magnitude of the restatements. A preliminary analysis of restatements announced in 2018 shows that 11 companies that the Commission proposes to exempt from internal controls audits restated over $65 million in net income and these restatements destroyed more than $294 million in shareholder wealth. This destruction in wealth, caused by only a handful of restatements, dwarfs the Proposal's total cost savings of $75 million across all 358 affected companies.

Third, the Commission's analysis does not seek to analyze the historical rate of fraud or SEC Accounting and Enforcement Actions within the set of affected companies. As of 2018, several affected companies had equity market values in excess of $500 million. In companies of this size, even one or two additional frauds resulting from the elimination of internal control audits would

adversely affect not only the company's investors, but also all of its stakeholders (e.g., employees, retirees, customers, and suppliers), and would have ripple effects throughout the US economy.

Although it might be socially desirable to encourage investment, and research and development, we believe there are ways to do so without sacrificing oversight.

Please feel free to contact Professor Daniel Taylor ([redacted]) if you have any questions about this letter or our associated analysis.

Sincerely,

Mary Barth
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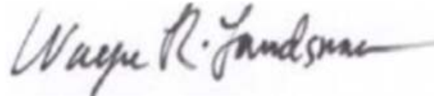

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Part I. Comments on the Proposal's Central Premise

A central premise underlying the Commission's proposal is that elimination of internal control audits required under Section 404(b) SOX: (i) will significantly reduce compliance costs and encourage capital investments that would not otherwise be made, and (ii) will not significantly affect the ability of investors to make informed investment decisions.

I.A Economic Significance of the Cost Savings

Regarding the magnitude of reduced compliance costs, the analysis in the Proposal suggests an average annual cost savings of $210,000 per year for affected companies, comprising $110,000 in audit fee cost savings and $100,000 in other internal cost savings (Proposal, p. 25). The Proposal concludes that such cost savings are large when expressed as a percentage of the company's total audit fees. However, the percentage of audit fees is an inappropriate metric against which to judge the economic significance of the cost savings—audit fees are already very low for these companies ($437,917 on average, see Proposal, p. 75). Consequently, whereas 25-60% in cost savings may seem like a significant amount, the dollar amount of savings is small.

The economic significance of the cost saving should be measured in dollar terms, or relative to the company's size. Standard & Poor's Capital IQ has data for 5,124 filers in calendar year 2018. Of these, we estimate 385 would be affected by the Proposal.[1] These companies have average revenue of $43 million and market value of $231 million. Thus, to the average affected company, the cost savings amounts to 0.48% of revenue and 0.09% of market value.[2] These low percentages suggest that, for the average affected company, the costs savings is economically insignificant and is unlikely to affect the average company's investment decisions or decision regarding whether to be publicly listed.[3]

I.B Economic Significance of the Cost Savings—Bunching

In justifying the $210,000 proposed cost savings as burdensome, the Proposal states:

> "studies have demonstrated that smaller reporting issuers find the total compliance costs associated with the ICFR auditor attestation requirement to be significant by providing evidence that non-accelerated filers may seek to avoid crossing the $75 million public float threshold and becoming accelerated filers. (p. 70)"

The Proposal specifically refers to evidence in Iliev (2010), which finds companies sought to avoid internal control audits in 2004 by staying below the $75 million float threshold that would trigger

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[1] Henceforth "affected companies" refers to Accelerated Filers with < $100 million in revenue, excluding Emerging Growth Companies. The 385 affected companies we identify in 2018 is similar to the Commission estimate of 358 affected issuers in 2017.

[2] 0.48% = 210,000 / 43,000,000. 0.09% = 210,000 / 231,000,000.

[3] For example, the Wall Street Journal reports that the median employee salary for biotechnology companies—an industry that the Proposal suggests has displaced spending because of Section 404(b) compliance costs (p. 26)—is approximately $91,000 (Wall Street Journal, "Biotech Is Place to Be for Top Salaries, May 9, 2019). This suggests that the Proposal is likely to have a minimal effect on the hiring of new scientists.

mandatory internal controls audits, a phenomenon commonly referred to as "bunching."[4] The Proposal interprets bunching as evidence that managers sought to avoid the audit because of significant compliance costs. This interpretation is unfounded.

The existence of bunching indicates that managers sought to avoid the audit—it does not speak to their motives for doing so. It could be that managers seek to avoid audits in order to save shareholders money (as the Proposal claims) or it could be that managers seek to avoid audits for opportunistic reasons. For example, managers might seek to avoid an audit because they are engaging in opportunistic behavior, and the audit would increase the probability such behavior would be detected.

Interestingly, the Iliev (2010) study also reports that those companies that avoid the audit by bunching below the float threshold also have greater levels of earnings management.[5] This finding is not mentioned in the Proposal and is consistent with the opportunistic explanation for avoiding the audit. Thus, although the dissent by Commissioner Jackson finds no evidence of bunching in 2017, the existence or absence of bunching is moot—evidence of bunching does not speak to the motives for bunching, and thus does not speak to the cost of internal control audits.[6]

I.C Do Internal Control Audits Provide Useful Information to Investors?

The Proposal contends that elimination of internal control audits will not significantly affect the ability of investors to make informed investment decisions (Proposal, pp. 22-23). Perhaps the best way to judge the relevance of internal control audits for investor decision-making is simply to ask sophisticated users of financial statements whether they use such information.

The academic literature does just that. Brown, Call, Clement, and Sharp (2016) surveyed 344 buy-side analysts from 181 investment companies about the "red flags" of intentional misreporting.[7] Strikingly, 60 percent of analysts responded: "material internal control weaknesses are definitely a 'red flag' of management intent to misrepresent financial results." (p. 151). The existence of a material internal control weakness was the most common 'red flag' for misrepresentation, followed by weak corporate governance. Consistent with this survey evidence, the academic literature consistently finds that internal control weaknesses are associated with lower quality financial reporting (e.g., Ashbaugh-Skaife, Collins, LaFond, and Kinney 2011).[8]

The Proposal also suggests that internal control audits and financial statements are less relevant for investors in high-growth, low-revenue companies—those companies the Commission proposes to exempt from such audits: "[W]e note the financial statements of low-revenue issuers may, in

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[4] Peter Iliev, *The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices*, 65 JOURNAL OF FINANCE 1163-1196 (2010).
[5] *Supra* note 4.
[6] https://www.sec.gov/news/public-statement/jackson-statement-proposed-amendments-accelerated-filer-definition
[7] Lawrence Brown, Andrew Call, Michael Clement, & Nathan Sharp, *The Activities of Buy-side Analysts and the Determinants of their Stock Recommendations,* 62 JOURNAL OF ACCOUNTING AND ECONOMICS 139-156 (2016).
[8] Hollis Ashbaugh-Skaife, Daniel Collins, William Kinney, & Ryan Lafond, *The Effect of SOX Internal Control Deficiencies and their Remediation on Accrual Quality,* 83 THE ACCOUNTING REVIEW 217-250 (2008).

many cases, be less critical to assessing their valuation given, for example, the relative importance of their future prospects." (p. 27).

We agree that for high-growth low-revenue companies, future performance is more relevant for valuation than historical performance. Consequently, low-revenue companies typically have large price-to-revenue ratios. For example, our analysis suggests the price-to-revenue ratio for the average affected company in 2018 is 93 (by comparison, the average company with revenue greater than $100 million has a ratio of 2.47). The larger is the ratio, the greater is the valuation benefit of $1 in inflated revenue, and hence the greater is the incentive for a manager to inflate revenue, e.g., $1 of inflated revenue results in $93 of inflated market value. For this reason, academic research shows theoretically and empirically that the likelihood of fraud is most pronounced in high-growth companies with large ratios—precisely those companies the Commission proposes to exempt from internal control audits.[9] The greater the likelihood of fraud, the more important is the need to verify the quality of internal controls that are used to generate financial statements.

I.D. Do Internal Control Audits Do More Than Just Provide Information to Investors?

Extant academic research suggests internal control audits serve at least two purposes. First, they provide information to shareholders about the quality of the company's internal controls. We refer to this as the "***information role***" of audits. Second, audits detect deficiencies in internal controls. We refer to this as the "***detection role***" of audits. The combination of these two roles—detection of weak internal controls and corresponding disclosures to stakeholders—provides incentives for managers to adopt best-practice internal control systems. This is the "***incentive effect***" of internal control audits. These audits do not simply report the state of the company's internal controls, they also incentivize managers to take actions to implement high quality internal controls (e.g., Schroeder and Shepardson, 2016).[10]

Under the Proposal, accelerated filers with less than $100 million in revenue would switch from a regime in which they have both a Section 404(b) internal control audit and Section 404(a) management assessment to a regime in which they only conduct a Section 404(a) assessment. Academic research suggests that improvements in internal control system quality, and consequently financial reporting quality, do not occur in the Section 404(a)-only regime, but occur only when companies are required to have both a 404(a) assessment and a 404(b) internal control audit.[11] The reason for this is the absence of the incentive effect. Thus, we would expect exempting these companies from 404(b) internal control audits to result in significant declines in the quality of internal controls and increases in restatements.

The Commission's analysis is consistent with these expectations. Table 13 reports data on managements' assessment of the quality of their companies' internal controls separately for companies below the $100 million revenue threshold, "low-revenue" companies. The results are

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[9] See e.g., Messoud Beneish, *The Detection of Earnings Manipulation*, 55 FINANCIAL ANALYSTS JOURNAL 425-457 (1999) and Paul Fischer & Robert Verrecchia, *Reporting Bias,* 75 THE ACCOUNTING REVIEW 229-245 (2000).
[10] Joseph Schroeder & Marcy Shepardson, *Do SOX 404 Control Audits and Management Assessments Improve Overall Internal Control System Quality?* 91 THE ACCOUNTING REVIEW 1513-1541 (2016).
[11] *Supra* note 10.

striking. For low-revenue companies that **currently are required** to have internal control audits (low-revenue accelerated filers), Column 1 indicates only 7.5% of companies' managers report that their internal controls are ineffective. The Proposal would relax the requirement of internal control audits for these companies. For low-revenue companies that **currently are not required** to have internal control audits, Column 2 (Column 3) indicates 26.9% (34.3%) of companies' managers report that their internal controls are ineffective. Thus, low-revenue companies not subject to mandatory internal control audits report control failures at a rate 4x that of their peers. Thus, in the absence of internal control audits, we expect the low internal control failure rate of 7.5% would climb toward that of their peers without internal control audits, which we would expect could result in a 258% to 357% increase in internal control deficiencies among affected companies.[12]

Table 13 also shows the incentive effects of internal control audits are most pronounced for low-revenue companies. For companies above the $100 million revenue threshold, "high-revenue" companies, managers report similar internal control failure rates regardless of whether they are required to have an internal control audit (9.2%, 9.5%, and 9.2% in Columns 1 – 3). These rates suggest that the positive incentive effects of internal control audits—to implement high quality internal controls—are most pronounced in low-revenue companies, the very companies that the Proposal would exempt from internal control audits.

Table 14 reports the rates of accounting restatements for low-revenue companies. Of the low-revenue companies that **currently are required** to have internal control audits, Column 1 indicates 6.5% restated their financial statements. The Proposal would relax the requirement of internal control audits for these companies. Of the low-revenue companies that **currently are not required** to have internal control audits, Column 2 (Column 3) indicates 8.2% (11.2%) restated their financial statements. Thus, in the absence of the requirement for an internal control audit, we would expect the low restatement rate of 6.5% would climb toward that of their peers without internal control audits, which we would expect to result in a 26% to 72% increase in restatements among affected companies.[13]

Part II. Comments on the Proposal's Analysis

Evidence-based policymaking necessitates that policymakers consider a cost-benefit tradeoff. Consequently, we encourage the Commission to weigh the $211,000 estimated average cost savings from foregoing an internal control audit against the benefits of such audits.

II.A Quantifying the Estimated Benefits of 404(b) Audits

Although the Commission quantified the cost savings from foregoing internal control audits, it did not seek to quantify the benefits of these audits. Ge, Koester, and McVay (GKM, 2017) seek to do so.[14] GKM estimate exemption from mandatory internal control audits would reduce audit fees

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[12] 258% = (26.9/7.5) – 1, 357% = (34.3/7.5) –1.
[13] 26% = (8.2/6.5) – 1, 72% = (11.2/6.5) –1.
[14] Weili Ge, Allison Koester, & Sarah McVay, *Benefits and Costs of Sarbanes-Oxley Section 404(b) Exemption: Evidence from Small Firms' Internal Control Disclosures,* 63 JOURNAL OF ACCOUNTING AND ECONOMICS 358-384 (2017).

by approximately 35.7 percent (approximately $73,165 per company). However, the benefit of such audits is more complex. GKM estimate foregoing internal control audits entails a $1.7 million loss (per company) in future earnings and $2.2 million in foregone market value (per company) from failure to detect and remediate deficient internal controls, and consequently relying on bad internal data when making corporate decisions. Thus, GKM's findings suggest that the benefit of a 404(b) audit for the average company is at least $3.9 million, which far exceeds its cost.[15]

II.B Magnitude of Restatements

The Commission's analysis indicates that exempting low-revenue companies from internal control audits will increase the number of restatements. Thus, it is important to balance the total estimated $75 million annual cost savings from the Proposal ($210,000 x 358 affected issuers in Table 22), against the total shareholder wealth destroyed by such restatements. To do so, one must consider the magnitude of the restatements.

Although the Proposal considers the rate of restatements, i.e., what proportion of affected companies restated their financial results in a given year (Tables 11 and 14), it does not consider the magnitude of these restatements. In failing to do so, the Proposal treats all restatements the same, regardless of their size. We caution against this approach: the magnitude of restatements is important for assessing the potential cost to exempting companies from internal control audits.

There are two common ways to assess the magnitude of a restatement. The first is to consider the restatement's effect on net income. For example, a restatement that reduces net income by $1 million is less severe than a restatement that reduces net income by $10 million. The second is to consider the restatement's effect on market value. For example, a restatement that destroys $1 million in market value is less severe than a restatement that destroys $30 million in market value.

It is beyond the scope of this letter to conduct a comprehensive analysis of the magnitude of restatements of all affected companies. Nevertheless, we conducted a preliminary analysis using data from Ives Group Audit Analytics.[16] Our preliminary analysis uncovers over 100 affected companies (Accelerated Filers with < $100 million in revenue, excluding Emerging Growth Companies) that restate a total of approximately $295 million in net income over the past five years, 2014-2018. In 2018 alone, our analysis uncovers 11 affected companies that announce restatements totaling more than $65 million in net income.[17]

Next, we assess the change in market value associated with the 11 restatements in 2018. We find that these restatements wiped out more than $294 million in market value (!).[18] This loss in

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[15] GKM's analysis does not consider costs associated with 404(b) audits other than audit fees, and ignores benefits associated with 404(b) audits related to reduced costs of equity and debt capital, and externalities of higher quality reporting. In this regard, the estimates represent lower bounds.

[16] This is the same data provider used by the Commission in its analysis of restatement rates.

[17] We measure the magnitude of each restatement using the absolute value of the effect of the restatement on the company's net income, cumulated over all restated years. For example, we would measure a restatement announced in 2018 that lowers 2017 net income by $10 million and 2016 net income by $5 million, as a $15 million restatement in 2018.

[18] For each restatement announcement, we obtain the company's market value beginning three days prior to the announcement and ending three days after the announcement. The change in market value over this seven-day interval

shareholder wealth—for only 11 restatements—greatly exceeds the Proposal's total annual cost savings of $75 million. This loss also calls into question the wisdom of exempting these companies from internal control audits, especially given the Commission's own analysis that suggests the Proposal will significantly increase the number of restatements.

Our analysis was by no means comprehensive, and it considered only a fraction of the restatements by affected companies in the Commission's analysis. In this regard, we emphasize that although these number are large, they are lower bounds on total magnitude of restatements among companies that the Commission proposes to exempt from internal control audits. Nevertheless, our analysis highlights that the Commission's focus on restatement rates can be misleading regarding the economic effects of restatements. We urge the Commission to consider the magnitude of restatements prior to proceeding with the Proposal.

II.C Extent of Fraud and Disclosure Irregularities in Affected Companies

Internal control audits are designed to detect and prevent financial reporting fraud and non-fraudulent material misstatements. Yet, the Proposal and associated analyses do not consider how eliminating internal control audits will affect fraud or the social cost of fraud. For example, the average affected company has a market value of $231 million in 2018, and several affected companies have market values in excess of $500 million. In companies of this size, even one or two additional frauds as a result of eliminating internal control audits would adversely affect not only the company's investors, but also all of its stakeholders (e.g., employees, retirees, customers, and suppliers), and would have ripple effects throughout the US economy.

The Commission, more than any other outside individual or agency, is in the best position to quantify the extent of fraud and suspicious or misstated filings for the set of affected companies. Given its extensive expertise in this area, we were surprised the Commission's analysis did not include: (i) the historical rate of fraud; (ii) the incidence of SEC Accounting and Auditing Enforcement Releases; (iii) the incidence of Wells Notices; or (iv) the incidence of formal SEC investigations. We caution the Commission against exempting companies from internal control audits without examining the rates of these outcomes—all of which potentially speak to the quality of the company's internal controls.

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is an estimate of the effect of the restatement on the company's market value. Adjusting for the market return over this interval results in an even greater estimate of value destruction—$308.58 million. For reference, the average buy-and-hold return for these companies in the seven-day interval is –6.14%, and after the market adjustment it is –6.48%.