

Comments on S7-06-19 ‘Amendments to the Accelerated Filer and Large Accelerated Filer Definitions’

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Introduction: The purpose of our communication is to formally comment on SEC Release No. 34-85814 (File No. S7-06-19) ‘Amendments to the Accelerated Filer and Large Accelerated Filer Definitions.’ This proposed rule seeks to amend the accelerated filer and large accelerated filer definitions. The release notes that “as a result of the amendments, certain low-revenue issuers would not be required to have their assessment of the effectiveness of internal control over financial reporting attested to, and reported on, by an independent auditor” (p.1). This auditor-provided assessment is currently required under Section 404(b) of the Sarbanes-Oxley Act of 2002 (hereinafter “404(b) attestation”).

Our primary comment: We do not support an increase in the number of issuers exempt from 404(b) attestation – a stated result of the proposed rule.

Basis for our comment: Based on our understanding of, and contributions to, a large body of research on the costs and benefits of 404(b) attestation, we believe that exempting additional issuers would negatively impact capital markets and fail to achieve the proposed rule’s stated goal which is “to promote capital formation for smaller reporting issuers” (p.1).

Although our research contributing to this literature is first cited in the release on page 62 (footnote 177), we believe the second reference to our study on page 71 provides a fuller description of our findings:

“One study attempts to quantify and compare certain costs and benefits of exempting non-accelerated filers from the ICFR auditor attestation requirement, focusing on those costs and benefits that the study deems to be measurable, and finds that the cost savings associated with exempting these issuers (an estimated \$388 million in aggregate audit fee savings) have been less than the lost benefits (e.g., an aggregate \$719 million in lower earnings) in aggregate present value terms.”

Footnote 190 provides a discussion of “critical assumptions and estimates” related to our study. Our paper is referred to as the “Ge *et al.* 2017 Study” throughout the release (with the full citation provided below); we adopt that reference throughout our comment letter. The Ge *et al.* 2017 Study is subsequently mentioned in the release on pages 76 (footnote 205), 77 (footnote 206), 85 (footnote 223), 89-91 (footnote 244), 91 (footnote 251), 97 (footnote 260), 107-108 (footnotes 279 and 280), and 109 (footnote 283).

The Ge *et al.* 2017 Study is meant to quantify measurable costs and benefits of Section 404(b) exemption. As the rule being proposed in SEC Release No. 34-85814 would result in an increase the number of issuers exempt from 404(b) attestation, we believe that our research provides direct insight into the consequences and benefits of an outcome of this rule.

As cited in the release, the primary quantifiable benefit of 404(b) attestation exemption is audit fee savings. The Ge *et al.* (2017) Study estimates that exempting issuers from 404(b) attestation would have saved these issuers an aggregate of \$388 million in audit fees from 2007 through 2014.

Less clear in the proposal summary, the primary quantifiable cost of 404(b) attestation exemption arises from internal control misreporting. The Ge *et al.* (2017) Study estimates that 9.3 percent of issuers exempt from 404(b) attestation disclose effective internal controls, even though they maintain ineffective internal controls. The authors estimate that 404(b) compliance would reduce internal control misreporting by 38.1 percent (from 9.3 to 5.8 percent). The internal control misreporting imposes at least two measurable costs on misreporting issuers: lower operating performance due to non-remediation of ineffective internal controls, and market values that fail to reflect an issuer's underlying ineffective internal control status. These misreporting issuers experience an aggregate \$719 million of lower future three-year operating performance due to non-remediation and delay a \$935 million decline in market value due to failure to disclose ineffective internal controls. We disagree with the stance in footnote 244 that “companies may choose to improve their controls when they are otherwise expecting to enter a period of improved performance, which could lead to a similar association without such improved performance being caused by the changes in internal controls.” The Ge *et al.* 2017 Study builds on research that directly links the types of weaknesses with the source of the lower operating efficiency (e.g., inventory in Feng *et al.* 2015).

These costs of failing to identify and remediate ineffective internal controls are consistent with numerous studies documenting that the ineffective internal controls do not only reduce the quality of the issued financial statements, but also have a significantly negative impact on issuers’ operations. For example, ineffective internal controls have been shown to lower the operating efficiency of issuers because managers rely on lower quality internal reports when managing their firm (Feng *et al.* 2015; Cheng *et al.* 2018; Kravet *et al.* 2018). We agree that “marginal changes in the reliability of the financial statements of issuers whose valuation is driven primarily by their future prospects could have limited issuer- and market-level effects to the extent that the current financial statements of these issuers are less critical to assessing their valuation” (page 92 of the release). This does not support, however, the statement on page 42 that smaller reporting companies (SRCs) will be less hurt by failing to discover and disclose

ineffective internal controls. Instead, this cost is particularly relevant for SRCs because, as noted on page 42 of the proposal, their stock market valuation is particularly dependent on their future prospects. These prospects will be hurt by managers relying on faulty management reports (Feng et al. 2015; Cheng et al. 2018; Kravet et al. 2018), and investors will be misinformed about the internal control status of these issuers (Ge *et al.* 2017 Study). Moreover, although the proposal relies on SRCs having fewer complex reporting issues (see page 26 and elsewhere), the Ge *et al.* 2017 Study highlights that smaller issuers have different issues, such as a lack of staffing, that create different (not fewer) internal control challenges.

The Ge *et al.* 2017 Study notes that although each issuer directly benefits from audit fee savings, only issuers that misreport their internal control effectiveness directly bear the costs of misreporting. However, untruthful reporting by even a handful of issuers could hurt the trust between investors and issuers, which would hinder effective capital formation for all current and prospective issuers. As a result, all issuers are (indirectly) adversely affected by internal controls misreporting by only a few.

On a related point, we take issue with how the Ge *et al.* (2017) Study is characterized on page 85 of the release. We agree with the language that “researchers have been able to predict the identification by auditors of material weaknesses in ICFR beyond those identified by management, to some extent, by using otherwise available information about issuers” (p.85), but we do not believe that this predictive ability implies “limited incremental information provided by ICFR auditor attestation reports...” (p.85). The conclusion of our paper notes the following: “We assert that IC misreporting would fall from 9.3 to 5.8 percent if these exempt firms were subject to 404(b)” (p.378). Moreover, our returns analysis suggest investors are not able to fully discern this misreporting. Thus, our inference is precisely the opposite of how the release characterizes our findings. We believe that 404(b) attestation would materially reduce internal control misreporting.

In conclusion, we do not support a key outcome of the proposed rule – an increase in the number of issuers exempt from Section 404(b) attestation. Although the SEC has clearly given great thought to the costs and benefits of this proposal, we disagree with the SEC’s stance on page 16 and elsewhere in the proposal that the benefits of audit attestation may be more limited for SRCs. We disagree with the position on page 22 that the proposed change will be unlikely to affect investors’ ability to make informed decisions. We disagree with the position on page 26 that there is less of a need for an internal control audit given smaller issuers are less complex. And we disagree with the SEC’s assertion that improvements in operating efficiency following material weakness remediation might be unrelated to the remediation. We do not opine on any other aspect of the proposed rule.

Sincerely,

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Feng, M., C. Li, S. McVay, and H. Skaife. 2015. Does ineffective internal control over financial reporting affect a firm's operations? Evidence from firms' inventory management. *The Accounting Review* 90 (2): 529-557.

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Supplemental information:

For transparency and to aid in assessing the generalizability of our findings, we outline the sample selection criteria employed in the Ge *et al.* 2017 Study. The authors begin with the universe of issuers exempt from 404(b) attestation and focus on years 2007 through 2014. They select 2007 as the initial year because this is when managerial assessment of the issuer's internal control over financial reporting (hereinafter "404(a) attestation") was required for issuers exempt from 404(b) attestation. The sample ends in 2014 because the study was published in 2017 and some tests require operating performance information up to three years in the future. The authors impose three initial data screens using information from Compustat: non-missing CIK, non-missing fiscal year end, and market capitalization and total assets greater than \$5 million. The authors impose one initial data screen using information from Audit Analytics: non-missing 404(a) attestation opinions. This yields an initial sample of 11,274 issuer-years. After eliminating observations that voluntarily comply with 404(b) attestation, are not traded on an exchange, or having missing variable values, our final sample includes 5,305 issuer-years exempt from 404(b) attestation.