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Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

29 July 2019

Re: Request for Comment on Amendments to the Accelerated and Large Accelerated Filer Definitions (Release No. 34-85814; File No. S7-06-19)

Dear Ms. Countryman:

Ernst & Young LLP is pleased to provide comments to the Securities and Exchange Commission (SEC or Commission) on its proposal to amend the accelerated filer and large accelerated filer definitions to exclude certain smaller reporting companies, meaning that these companies would no longer have to obtain an independent audit of their internal control over financial reporting (ICFR), among other things.

We believe that audits of ICFR, which are required by Section 404(b) of the Sarbanes-Oxley Act of 2002, have a positive effect on investor confidence and market stability, and that companies that obtain audits of ICFR are more transparent and less susceptible to financial reporting risk than those that don't. While the benefit to any single company for a single period may be difficult to observe, the benefits to the quality of financial reporting across the market are more pronounced. The SEC staff has noted in the past that investors generally view the auditor's attestation on ICFR as beneficial, and that financial reporting is more reliable when the auditor is involved with ICFR assessments.¹

Accordingly, we encourage the SEC to carefully consider feedback from investors and preparers about the value of ICFR audits and whether smaller reporting companies with annual revenue of less than \$100 million should be excluded from the scope of the Section 404(b) requirement. In addition, we share our observations and comments on the proposing release for the Commission's consideration below.

Affected issuers

We recognize that the proposed amendments target a relatively small number of issuers that are primarily life sciences companies that have yet to generate meaningful revenues but are not emerging growth companies (EGCs). We also understand that the Commission believes the resources those companies currently expend on compliance costs supporting the auditor's opinion under the 404(b) requirements may be better directed into growing their businesses.

¹ 2011 [SEC 404\(b\) Float Study](#), Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between \$75 and \$250 million, page 7.

The proposal states that “the benefits of the ICFR auditor attestation requirement may be smaller for issuers with low revenues because they may be less susceptible to the risk of certain kinds of misstatements, such as those related to revenue recognition.” Notwithstanding the lack of significant revenues, we have observed that these issuers often enter into material complex financing and collaborative arrangements that require careful technical analysis to determine the appropriate accounting and financial statement presentation and disclosure. Without effective ICFR, low-revenue issuers may have a greater risk of failing to timely detect and correct material errors related to arrangements such as these.

While we agree with the SEC’s view that low-revenue issuers may have less complex accounting systems and processes, these issuers may also have fewer (and sometimes less experienced) employees performing and monitoring internal control functions given their business life-cycle stage and focus on product development. As a result, we believe such issuers may have a higher likelihood of having unidentified material weaknesses in the absence of an ICFR audit, which should be considered when weighing the costs and benefits of the proposal.

Role of the audit committee

Today, EGCs and non-accelerated filers may choose to voluntarily obtain an ICFR audit, and may file the related audit report or limit the report to internal use only. This proposal would increase the number of issuers that must make that decision, including companies with public float of up to \$700 million.

The audit committee has oversight and authority over the external auditors and the services that they provide, including audits of ICFR. It has been observed that companies that comply with Section 404(b) have historically had fewer restatements than those that do not.^{2,3} The audit committee of each issuer is therefore best positioned to evaluate the risks of forgoing an independent audit of ICFR based on these considerations and company-specific factors.

We therefore recommend that if the SEC moves forward with this rulemaking, it should emphasize in its adopting release that it remains within the decision-making authority and responsibility of the audit committee of each issuer that is exempt from Section 404(b) to determine whether voluntarily obtaining an independent audit of ICFR is appropriate after considering each issuer’s particular facts and circumstances.

Consideration of ICFR in audits

The proposal states that “[t]he proposed amendments would not relieve an independent auditor of its obligation to consider ICFR in the performance of its financial statement audit of an issuer...” and that “[a] similar evaluation is required in an ICFR attestation.” We agree that an independent auditor must consider ICFR as part of its risk assessment in both a substantive financial statement audit and a combined audit of financial statements and ICFR (commonly referred to as an integrated audit). However, we believe that investors should be aware of the differences between an audit of ICFR in the context of an integrated audit and an auditor’s consideration of ICFR in a substantive audit.

² 2011 [SEC 404\(b\) Float Study](#), Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between \$75 and \$250 million, page 40.

³ 2013 [GAO Study](#), SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation.

As explained further below, we are concerned that investors may inappropriately infer conclusions regarding the quality or effectiveness of a company's ICFR based only on a financial statement audit. Such inferences would be just as inappropriate today as they were before implementation of the Sarbanes-Oxley Act of 2002. Without an audit of ICFR, investors have no independent assurance regarding the effectiveness of an issuer's internal control. Under the proposed rules and absent voluntary compliance, investors would not receive such assurance until an issuer no longer qualifies as a non-accelerated filer, either due to increases in its revenue above \$100 million or its public float above \$700 million.

The auditor has a different objective when it considers ICFR in the context of a substantive audit than it does in an integrated audit, and the outputs and the extent of evidence obtained differ significantly. Furthermore, while the auditor has an obligation to communicate to the audit committee any material weaknesses and significant deficiencies identified in a financial statement audit, the financial statement audit is not designed to identify such internal control deficiencies.

The objective of the tests of controls the auditor performs during a primarily substantive audit is to assess control risk, or the risk that the financial statements are materially misstated due to failures in internal control.⁴ This assessment typically involves evaluating the design of internal controls to obtain an understanding of the company's ICFR for the purposes of identifying and evaluating the risks of material misstatement and to design the substantive testing approach. Therefore, the work an auditor performs related to ICFR in a financial statement audit is more limited in scope and detail than the work the auditor performs in an audit of ICFR.

In a substantive audit, the auditor is not required to rely on controls and may choose not to do so. When the auditor does not plan to rely on controls (either for the financial statements as a whole or for specified financial statement accounts), the auditor frequently puts less emphasis on testing the design of the controls during the assessment of control risk. It is also inherently more difficult for an auditor to challenge the design of internal controls when the auditor doesn't test the effectiveness of those controls.

The objective of the tests of controls in an audit of ICFR is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's ICFR. The auditor's opinion relates to the effectiveness of the company's ICFR at a particular point in time and taken as a whole.⁵ In an integrated audit, an auditor builds on the control risk assessment and tests of design in a substantive audit by testing the operating effectiveness of controls over all relevant financial statement accounts and assertions. Therefore, in an integrated audit the scope and extent of effort is much more significant, as is the assurance regarding the effectiveness of ICFR.

Auditors decide whether to test the operating effectiveness of controls in a substantive audit based on what they believe is the most effective and efficient testing approach, given the nature of the account and the company's processes. When the auditor is not relying on controls, the auditor must obtain more evidence from substantive testing procedures. The auditor must therefore evaluate whether sufficient evidence can be obtained more efficiently by performing more extensive substantive testing or by testing the operating effectiveness of controls. Certain processes, such as those that are highly automated and where it is impractical to obtain sufficient audit evidence without testing controls, may require a controls

⁴ Public Company Accounting Oversight Board (PCAOB), [Auditing Standard \(AS\) 2201, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, Appendix B - Special Topics](#).

⁵ PCAOB, AS 2201, [An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, Appendix B - Special Topics](#).

reliance approach. Therefore, the auditor may perform certain internal control testing procedures when a company is not subject to the requirements of Section 404(b), but control testing typically won't be as extensive as it would be in an integrated audit. Hence, investors should not assume that a company's ICFR is effective just because a company receives an unqualified audit report on its financial statements.

Potential cost savings

There are many entity-specific factors that affect audit fees, including fees for audits of ICFR. The fees associated with complying with Section 404(b) can vary significantly from company to company, and drawing broad conclusions is challenging. While it is challenging to estimate the fee difference between an integrated audit and a nonintegrated audit across a broad range of issuers with any reliability, we believe the 25% decrease in audit fees cited by the SEC (and certainly the 25% to 60% range) may be overstated due to other factors affecting the population of companies included in the table on page 75 of the proposing release. We note that some non-accelerated filers and EGCs are shell companies or special-purpose acquisition companies for which the financial statement audit would be much less complex and for which the total fees would be disproportionately lower than for a more complex operating company. The variation in the average annual audit fees for EGCs over the four years included in the table on page 75 also calls into question whether a reliable conclusion can be drawn about cost savings from the data.

Technical issues and transition

Revenue test

Many issuers that would be affected by the proposal recognize significant revenues under collaborative arrangements. Under these arrangements, the counterparty may not be a customer of the issuer, but is instead a collaborator that shares in the risks and benefits of developing a product to be marketed. Such revenue is often recognized unevenly based on the terms of the contract and fulfillment of milestone obligations. Because the recognition of this revenue is generally uneven, it may result in period-to-period fluctuations that could cause such an issuer to transition in and out of non-accelerated filer status and Section 404(b) requirements.

We note that the cost and effort required to undergo an ICFR audit are frequently higher during the first year. The likelihood of identifying ineffective ICFR is also higher during the first year auditing ICFR. We suggest that the Commission consider the higher costs and risks to which an issuer would be subject if it moved in and out of accelerated status multiple times.

Transition to Section 404(b) compliance

Currently, entities do not transition out of smaller reporting company (SRC) status and filer status in the same way or at the same time. If a registrant that has previously reported as an SRC no longer meets the SRC criteria, Item 10(f)(2)(i) of Regulation S-K doesn't require compliance with the larger reporting company disclosure provisions until the subsequent fiscal year's first Form 10-Q.⁶ Conversely, a company that becomes an accelerated filer or a large accelerated filer at the end of the year must comply with the accelerated due dates beginning with that year's Form 10-K.

⁶ When an issuer becomes an SRC under the transition provisions, it may begin using SRC disclosure accommodations beginning with its next Exchange Act report due after its public float determination date (i.e., the Form 10-Q for its second fiscal quarter).

In defining accelerated filers and large accelerated filers to exclude low-revenue SRCs, proposed Exchange Act Rules 12b-2(1)(iv) and 12b-2(2)(iv) state, “The issuer is not eligible to use the requirements for smaller reporting companies under the revenue test in paragraph (2) or (3)(iii)(B) of the ‘smaller reporting company’ definition in this section, as applicable” (emphasis added). Given that Item 10(f)(2)(i) of Regulation S-K would permit a registrant to continue to use SRC accommodations in the annual report on Form 10-K for the year in which it fails the determination test, it is unclear whether the Commission also intends for such a company to continue as a non-accelerated filer for that same Form 10-K.

We recommend that the SEC clarify the transition criteria in any final rule. For example, the SEC could clarify that, although a registrant may continue to use SRC disclosure accommodations for the Form 10-K in the year it no longer qualifies for SRC status, the company becomes an accelerated filer or large accelerated filer for purposes of that Form 10-K.

Effective date

We recommend that the adopting release for any final rule consider and provide guidance on the timing of adoption and transition to allow issuers and their auditors sufficient time to plan for compliance. For example, the SEC could provide that the revised definitions of accelerated filer and large accelerated filer should be applied beginning with public float determination dates that fall after the effective date of any final rule.

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We would be pleased to discuss our comments with the Commission or its staff at your convenience.

Yours sincerely,



Copy to:

Mr. William Hinman, Director, Division of Corporation Finance
Mr. Kyle Moffatt, Chief Accountant, Division of Corporation Finance
Mr. Sagar Teotia, Chief Accountant, Office of the Chief Accountant
Mr. Marc Panucci, Deputy Chief Accountant, Office of the Chief Accountant