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Office of the Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File No. S7-06-19: Amendments to the Accelerated Filer and Large Accelerated Filer Definitions; Release No. 34-85814

Dear Office of the Secretary:

Crowe LLP appreciates the opportunity to provide input on the Securities and Exchange Commission ("SEC" or "Commission") Proposed Rules, "*Amendments to the Accelerated Filer and Large Accelerated Filer Definitions*," ("Proposal"). We support the SEC's efforts to promote capital formation for smaller reporting issuers.

Overview

The Proposal as written would exempt issuers eligible to be a smaller reporting company¹ with less than \$100 million in revenue from the auditor attestation on internal control over financial reporting ("ICFR") required under Section 404(b) of the Sarbanes Oxley Act of 2002 ("Section 404(b)"). Accordingly, we use data from various studies focused on issuers that currently only provide management's assessment of the effectiveness of ICFR under Section 404(a) of Sarbanes Oxley ("Section 404(a)") as a proxy for entities that would be newly exempted from Section 404(b) in the Proposal. Further, our comments are grounded in the following views:

- Section 404(b) provides significant investor protection benefits;
- Multiple aspects of the current economic and regulatory environment, other than Section 404(b), significantly impact capital formation and influence an entity's decision to access public markets;
- Users (or "investors") are in the best position to determine whether the costs of 404(b) outweigh the benefits; and
- Issuers and their auditors need sufficient time to transition to any final rules.

Section 404(b) Provides Significant Investor Protection Benefits

Issuers Across the Spectrum of Revenues

¹ See Item 10(f)(1) of Regulation S-K.

Investors expect the financial statements on which they base investment decisions to be complete, accurate, and free from material misstatement, and effective ICFR is an important part of the foundation of high quality financial reporting. As Chair Clayton recently noted, “the bedrock of [the] capital market system is high quality, reliable financial statements.”² Issuer financial statements subject to Section 404(b) provide additional assurance to investors that the issuer has an effective system of internal controls on which to base the preparation of their financial statements when compared to issuers subject only to management’s assessment of the effectiveness of ICFR required under Section 404(a) of Sarbanes Oxley (“Section 404(a)”). Section 404(b) also results in earlier disclosure of ineffective ICFR when compared to issuers solely required to follow Section 404(a). For example, a 2009 study³ found after reporting effective ICFR, issuers required to only follow Section 404(a) were 46 percent more likely to report a restatement. Additionally, the study found, in the 90 days prior to filing ICFR disclosures (that is, the period during which auditors typically finalize their conclusions with respect to the effectiveness of the issuer’s ICFR), restatement rates were higher for issuers with an auditor attestation on ICFR, which often results in an ineffective ICFR conclusion. Therefore, issuers subject to Section 404(b) likely provide more timely disclosure to investors of ineffective ICFR and the potential for financial reporting issues.

When an issuer is not subject to Section 404(b), the Proposal asserts auditors still, in many cases, test the operating effectiveness of internal controls. Notwithstanding, such testing, if performed, does not provide the same level of assurance as Section 404(b) because the objectives are different. Under Section 404(b), the auditor’s objective is to express an opinion on ICFR, which, as noted in PCAOB Auditing Standard 2110, *Identifying and Assessing Risks of Material Misstatement (“AS 2110”)*, “encompasses a broader range of accounts and disclosures than what is normally in scope for a financial statement audit.”⁴ In fact, PCAOB Auditing Standard 2201 states:

To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.⁵

The differences in objectives decreases the level of assurance provided to investors on the issuer’s ICFR, which could be a significant detriment to investor protection for the reasons noted above.

Issuers with Less than \$100 Million in Revenue

The Proposal hypothesizes the benefits of Section 404(b) might be less for issuers with less than \$100 million in revenue (“low-revenue issuers”) because:

- Certain kinds of misstatements (for example, related to revenue recognition) are less likely;
- Financial systems and controls are less complex; and
- Financial statements are less meaningful to assessing valuation due to the perception of future prospects.

Stating that low-revenue issuers will likely incur higher restatement rates under the Proposal, the Commission points out that certain financial variables are less likely to impact valuation of low-revenue issuers because future prospects are more likely to impact investment decisions. Future prospects are important valuation datapoints for entities in a growth phase; however, as Chair Clayton pointed out low-revenue issuers are “often are seasoned companies with relatively straightforward business models,”⁶ and it is unclear how the Proposals

² <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other>.

³ Audit Analytics, *Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestations Filers and (2) Management-Only Report Filers* (November 2009).

⁴ <https://pcaobus.org/Standards/Auditing/Pages/AS2110.aspx> at paragraph 34.

⁵ <https://pcaobus.org/Standards/Auditing/Pages/AS2201.aspx> at paragraph B2.

⁶ <https://www.sec.gov/news/public-statement/statement-clayton-050919>.

considers the investor protection aspects of Section 404(b) for such seasoned low-revenue issuers. As noted in the Proposal, the financial variables (for example, earnings, book value of assets, book value of liabilities, etc.) cited are more likely to be considered in the valuation of seasoned companies; therefore, the SEC should more fully consider whether the Proposal is sufficient to protect investors in seasoned low-revenue issuers. The Commission might also consider whether there are additional financial variables (for example, rate of revenue growth) investors consider, even for low-revenue issuers, which should be evaluated in determining if exemption from Section 404(b) is in the interest of investor protection. If such variables are identified, we encourage additional outreach to investors to understand how such variables are used.

The Proposal does not appear to identify the types of data that impact users' perceptions of future prospects. For issuers with little to no revenue, liquidity metrics often are relevant to a user's evaluation of future prospects. A recent study of fiscal 2017 material weakness disclosures of issuers subject only to Section 404(a) revealed the accounting topic with the greatest frequency of material weaknesses was "Accounts/Loans Receivable, Investments, and Cash Issues,"⁷ which directly impacts an issuer's liquidity and future prospects. The same accounting topic appeared in similar studies in fiscal 2016⁸ and fiscal 2015⁹, ranked at number four and number one, respectively. Users' ability to assess future prospects of low-revenue issuers might be negatively impacted under the Proposal because the potential for misstatement in liquidity or similar metrics would increase.

Financial systems and controls are often less complex at low-revenue issuers, but the most frequent reason cited in fiscal 2017, 2016, and 2015 for non-accounting topic material weakness disclosures at issuers subject only to Section 404(a) was "Accounting Personnel/Resources, Competency/Training."¹⁰ Absent sufficient accounting personnel, there might be a heightened risk unidentified material weaknesses, which might negatively impact an investor's ability to assess future prospects, particularly if the unidentified material weaknesses impact the disclosures on which investors focus.

Frequency of Auditor Attestation

The Proposal requests comments on whether the Commission should consider changes to the frequency of auditor attestation on ICFR in addition to or in lieu of the proposed rule changes. For example, the Proposal suggests auditor attestation could occur once every three years rather than every year with coverage for either the most recent year or for the entire three year period. Changing the frequency of auditor attestation would impact auditor efficiency in planning and performing the audit. Auditors consider prior year audit results when planning and performing the current year audit, and performing an audit of ICFR on a rotational basis would significantly impact the year over year efficiencies gained from performing audits in consecutive years. To the extent the Commission were to adopt rules that would require an audit of ICFR in any single year on a rotational basis, the Commission might consider additional outreach to issuers to determine whether it is feasible for an issuer to 1) scale its staff; 2) conduct sufficient training; and 3) produce appropriate documentation to comply with Section 404(b) on a rotational basis.

Economic and Regulatory Environment

Chair Clayton remarked the Proposal "[is] intended to reduce costs without harming investors for certain smaller public companies and, importantly, encourage more companies to enter our public markets."¹¹ However, Section 404(b) is only one of a number of issues companies consider when determining whether to access public markets, and in our experience, it is unlikely to be the tipping point. Companies consider a wide range of information before accessing public markets including increased costs related to executive and director compensation, administrative costs (for example, engagement of competent outside legal counsel), reputational risk from increased scrutiny of officers and directors, litigation risk, required changes to governance processes, and stock exchange requirements, among other aspects of the economic and regulatory

⁷ Audit Analytics, *SOX 404 Disclosures: A Fourteen Year Review* (September 2018).

⁸ Audit Analytics, *SOX 404 Disclosures: A Thirteen Year Review* (August 2017).

⁹ Audit Analytics, *SOX 404 Disclosures: A Twelve Year Review* (August 2016).

¹⁰ See Notes 7, 8, and 9.

¹¹ See Note 3.

environment. For example, one study¹² found that increased executive compensation accounted for approximately 60 percent of the ongoing cost of accessing public markets.

The broadening of registration exemptions as well as increases in the availability of capital in the private equity markets are more likely than Section 404(b) to impact an entity's decision to access public markets. A December 2018 study of the decline of the IPO market in the United States¹³ observed:

The deregulation of securities laws in the 1990s and in particular the National Securities Markets Improvement Act of 1996 has facilitated the process of raising capital privately and been a key driver of the decline in U.S. IPOs. Privately-held startups are now able to grow to a size historically available only to their public peers. The IPO decline is not a market failure in the process of going public. Rather, it is the result of founders taking advantage of their increased bargaining power and lower cost of being private to realize their preference for control by choosing to remain private.

The study also cites two other scholarly articles that "agree that the Sarbanes-Oxley Act and other early-2000s changes in public firms' regulatory environment did not drive the fall in IPOs."¹⁴ The upward trend in the availability of capital outside of public markets, due to supply and demand dynamics, allows entities to access private capital more easily and cheaply. Notably, available private equity capital "has been on the rise since 2012 and hit a record high of \$2 trillion at year-end 2018 across all fund types."¹⁵ The evidence supports our experience that Section 404(b) is not a conclusive factor in a decision to access public markets.

The JOBS Act of 2012 provides many companies seeking to access the public markets a five-year exemption from the provisions of Section 404(b), which we believe has increased capital formation, though, similar to the above, the five year exemption is typically not the conclusive factor in deciding to execute in IPO. Entities do, however, view the exemption favorably in their overall capital raising analysis. Nonetheless, certain research contrasts with this favorable view. A study of 312 EGC IPOs from 2012 through 2015 found "savings [from the 404(b) exemption] is not large enough to offset the average increase in the dollar amount of money left on the table [from IPO underpricing]."¹⁶ Another more recent study found that "EGCs paid higher audit fees than non-EGCs after IPOs...[which] reveal[s] an unintended consequence of the JOBS Act: it failed to reduce audit fees, a major component of the compliance costs of EGCs."¹⁷

User Input

Users are the intended beneficiaries of Section 404(b), and their input on the relative cost and benefits of Section 404(b) should be carefully considered. The Proposal notes "low-revenue issuers are more likely than other accelerated filers to believe that the costs of complying with SOX Section 404 substantially outweigh the benefits." Note though this statement is taken from a survey of issuers rather than a survey of investors. The SEC should consider whether they have received a sufficient number of comments from users to make an informed conclusion on the relative costs and benefits of the Proposal prior to issuing any final rules. If users do not provide a sufficient number of comments on the Proposal, we encourage the SEC to conduct additional outreach directly with investors to understand their views on the benefits of Section 404(b).

As auditors, we can provide perspective on the Proposal's assertions with respect to the cost of Section 404(b). The Proposal estimates savings of approximately 25 percent of audit fees for newly exempt companies;

¹² <https://www.cfo.com/credit-capital/2011/11/the-true-costs-of-being-public-more-than-you-think/>

¹³ Ewens, Michael and Farre-Mensa, Joan, *The Deregulation of the Private Equity Markets and the Decline in IPOs* (December 26, 2018). Available at SSRN: <https://ssrn.com/abstract=3017610> or <http://dx.doi.org/10.2139/ssrn.3017610>.

¹⁴ *Ibid.*

¹⁵ https://www.bain.com/contentassets/875a49e26e9c4775942ec5b86084df0a/bain_report_private_equity_report_2019.pdf

¹⁶ Chaplinsky, Susan J. and Hanley, Kathleen Weiss and Moon, Katie, *The JOBS Act and the Costs of Going Public* (February 19, 2017). *Journal of Accounting Research*, Forthcoming. Available at SSRN: <https://ssrn.com/abstract=2492241> or <http://dx.doi.org/10.2139/ssrn.2492241>

¹⁷ Inder K. Khurana and Lei Zhao, *Does the JOBS Act Reduce Compliance Costs of Emerging Growth Companies? Theory and Evidence*. (2019) *AUDITING: A Journal of Practice & Theory* In-Press. Available at <https://doi.org/10.2308/ajpt-52403>.

however, as noted in the Proposal, the estimate is subject to “significant uncertainty” because it can be difficult to adjust the estimate for differences in asset size, issuers’ transition to the 2013 COSO framework, and for other reasons. Estimating the cost savings of the Proposal should not be limited to an uncertain estimate of the direct quantitative impact to audit fees.

The Proposal cites a study (“Jia et. al.”) finding “smaller reporting issuers that switched regimes over time found that being subject to the ICFR auditor attestation requirement was associated with an increase in stock market valuation ...”¹⁸ Notwithstanding the valuation premium cited in the Proposal, Jia et. al. also finds a “clear benefit” from Section 404(b) in the form of reduced cost of debt with only a small increase of approximately five percent in audit costs.¹⁹ The Proposal acknowledges the five percent finding adjusts for more variables than other studies that found the net reduction in audit fees was close to the 25 percent estimated by the Proposal, and we recommend the staff to consider the implications of the “significant uncertainty” involved in the cost estimate as part of their consideration of comments received on the Proposal, particularly when weighing costs versus benefits.

Transition

Any changes to the scope of 404(b) would have a significant impact to issuers and auditors alike. We encourage the SEC to provide sufficient time for issuers and auditors to consider any changes prior to the effective date of any final rule.

Closing

We thank the SEC for providing the opportunity to express our views on questions raised in the Request. Please contact Jim Dolinar at [REDACTED], Sydney Garmong at [REDACTED], or Mark Shannon at [REDACTED] to answer any questions that the staff may have regarding the views expressed in this letter.

Sincerely,



Crowe LLP

¹⁸ Hongmei Jia, Hong Xie, & David Ziebart, *An Analysis of the Costs and Benefits of Auditor Attestation of Internal Control over Financial Reporting*, Working Paper (2014) at <https://www.lsu.edu/business/accounting/files/researchseries/20141027JXZ.PDF>.

¹⁹ *Ibid*.