CENTER FOR AUDIT QUALITY
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Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

File No. S7-11-13 Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to comment on SEC File No. S7-11-13, *Proposed Rule Amendments for Small and Additional Issues Exemptions Under Section 3(b) of the Securities Act* (the Proposed Rule). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ appreciates the Commission's continuing efforts to facilitate capital-raising by smaller, and particularly start-up, businesses and also provide appropriate levels of investor protection. In this letter, we provide our observations related to financial information and audit requirements included in the Proposed Rule.

Because complexity increases cost, both to issuers of securities and investors, we have focused our comments on three areas where we believe the Commission could reduce the potential complexity of its financial reporting and auditing requirements:

- **Clarity and Consistency of Financial Information Requirements.** The premise in the Proposed Rule is that the disclosure requirements for financial information under Regulation A should be less extensive than the requirements of Regulations S-K and S-X. We encourage the Commission to keep the financial information requirements as clear and scaled as possible and maintain an appropriate degree of consistency across registered and unregistered offerings to limit potential confusion.

- **Financial Reporting under U.S. GAAP.** Issuers of securities under Regulation A would meet the FASB's definition of a public business entity (PBE). Accordingly, Regulation A issuers that had previously reported in accordance with the FASB's alternative recognition, measurement, and disclosure standards for private companies would need to revise their historical financial statements in order to comply with U.S. GAAP for public companies. This could be confusing and costly for smaller companies, particularly those that have not previously been required to obtain an audit of their financial statements. We recommend that the Commission address using the U.S. GAAP definition of a PBE in its rules so as to assist Regulation A issuers in identifying the appropriate financial reporting framework. Further, in finalizing the financial statement requirements for Regulation A issuers, the Commission should consider the impact of requiring Regulation A issuers to reverse any private company reporting alternatives, including the related costs and consequential delays in capital formation.

- **Audit and Independence Standards.** We believe that the Proposed Rule could better leverage audits performed in accordance with AICPA audit and independence standards. We recommend that the Commission consider providing additional flexibility to balance the cost and benefits of requiring audited financial statements.

In the following paragraphs we discuss our observations in these areas in greater detail.

Clarity and Consistency of Financial Information Requirements

We encourage the Commission to improve the clarity and consistency of the financial reporting disclosure requirements. Specifically:

1. References to financial reporting measures or to amounts that are derived from financial statements should be consistent with terms used in U.S. GAAP and/or Regulation S-X. For example, we note that Form 1-A refers to terms such as "total revenues," "investment income," "income from operations," "revenues from operations," and "statement of other stockholders equity" that are not defined by U.S. GAAP or Regulation S-X.

2. Where the Commission determines that disclosure requirements for a Regulation A issuer should be consistent with those of a company that has registered its securities, we recommend that disclosure requirements and related instructions be conformed. For example, under the Proposed Rule, Tier 1 issuers would be required to provide financial statements of significant businesses acquired, or to be acquired, consistent with the requirements for a smaller reporting company under Rule 8-04 of Regulation S-X (except

that no audit is required in certain circumstances).[1] However, the corresponding disclosure requirement for pro forma financial information by a Tier 1 issuer makes no reference to Rule 8-05 of Regulation S-X. It is therefore unclear if the pro forma financial information presented by a Tier 1 issuer should differ from the information that would be reported by a smaller reporting company under Rule 8-05.

The Commission notes that Section 3(b)(2) of the Jumpstart Our Business Startups ("JOBS") Act requires it to issue rules so as to "increase the use of Regulation A, thereby helping to make capital available to small companies."[2] In that regard, it appears to us that some of the proposed disclosure requirements are more extensive than the comparable disclosure requirements for public companies, including those that qualify as smaller reporting companies.[3] For example, Form 1-A, as proposed, would require issuers to disclose selected financial information. There is no similar reporting requirement for smaller reporting companies. Form 1-A would require issuers to disclose the name of its auditor and fees paid in connection with the offering, even though not all issuers would be required to provide audited financial statements. There is no similar requirement for a registered offering, whether by a smaller reporting company or otherwise.

Financial Reporting under U.S. GAAP

Domestic Companies Offering Securities

According to the Proposed Rule, an offering under Regulation A would require a domestic company to submit Form 1-A on EDGAR for SEC staff review and include financial statements that are prepared in accordance with U.S. GAAP (and audited for Tier 2 offerings).

U.S. GAAP has historically distinguished between public and private companies with respect to disclosure requirements and transition requirements for the adoption of new accounting standards. Recently, as a result of requests made by the newly formed Private Company Council, the FASB has expanded the differences in financial reporting to include recognition and measurement differences. For example, within the past few months, the FASB has approved new standards that would permit private companies to adopt alternative accounting principles for goodwill, certain hedging transactions, and the consolidation of certain variable interest entities.[4] The objectives of private company alternatives in U.S. GAAP are to reduce the complexity of, and costs to comply with, certain accounting and reporting requirements for private entities. It is likely that the number and extent of differences between "private" and "public" company financial reporting will continue to increase.

The FASB recently clarified which entities are eligible to apply these alternative accounting principles and which are not. An entity that meets the definition of a PBE is not eligible to report its financial

[1] This is addressed in the proposal in Form 1-A, Part F/S, (b)(5) *Financial Statements for Tier 1 Offerings – Financial Statements of Businesses Acquired or to be Acquired*.
[2] See Section I.A. of the Proposal, pages 7-8.
[3] See the definition of a smaller reporting company in Item 10(f)(1) of Regulation S-K.
[4] See Accounting Standards Update No. 2014-02, *Intangibles—Goodwill and Other (Topic 350): Accounting for Goodwill (a consensus of the Private Company Council)* and Accounting Standards Update No. 2014-03, *Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps—Simplified Hedge Accounting Approach (a consensus of the Private Company Council).* The Accounting Standards Update related to the consolidation of certain variable interest entities has been approved but not issued as of this writing.

information using the "private company" alternatives. Specifically, under U.S. GAAP, an entity is a PBE if:

- It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

- It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of, or for purposes of issuing, securities that are not subject to contractual restrictions on transfer.[5]

We believe that domestic companies offering securities under Regulation A would meet the definition of a PBE and therefore would not be permitted to file financial statements using the alternatives under U.S. GAAP that are available to private companies.

Similar to a company contemplating an initial public offering on Form S-1, Regulation A issuers may be required to revise their historical financial statements in advance of an offering in order to comply with the requirements of Form 1-A. We believe that a potential Regulation A issuer may be confused about whether it may apply private company alternatives in any financial statements filed with the Commission. Accordingly, we encourage the Commission to clarify application of the U.S. GAAP definition of a PBE in its final rule so as to assist Regulation A issuers in identifying the appropriate financial reporting framework.

The FASB has not provided specific guidance to address how private companies would transition away from using private company alternatives. In the absence of specific transition guidance, we understand that companies that become PBEs after using private company alternative accounting principles may need to retrospectively apply the PBE accounting and reporting requirements to all periods presented. Therefore, to the extent that a Regulation A issuer prepared its financial statements using one or more private company alternatives prior to a Regulation A offering, those financial statements would need to be revised to retrospectively remove the effects of applying those private company alternatives in connection with a Regulation A offering. If the financial statements reflecting the private company alternatives had previously been audited, the company may need to have its revised financial statements audited. In finalizing the financial statement requirements for Regulation A issuers, we recommend that the Commission consider the impact of requiring Regulation A issuers to reverse any private company reporting alternatives, including the related costs and consequential delays in capital formation.

In addition, we note that under the JOBS Act, emerging growth companies (EGCs) may defer adopting new or revised accounting standards effective for public companies if private companies have a delayed effective date. We believe that Regulation A issuers that meet the definition of an EGC should have the same flexibility available to them.

[5] Accounting Standards Update No. 2013-12, *Definition of a Public Business Entity – An Addition to the Master Glossary.*

Foreign Private Issuers

The Proposed Rule seeks comment about whether foreign private issuers (FPIs) should be permitted to use Regulation A. If the Commission extends the ability to offer securities under Regulation A to FPIs, we believe the Commission should permit financial statements for FPIs to be prepared in accordance with (1) U.S. GAAP, (2) IFRS as issued by the IASB, or (3) Item 18 of Form 20-F.

Audit and Independence Standards

According to the Proposed Rule:

- Financial statements for Tier 1 issuers would not be required to be audited. Tier 1 issuers would be required to provide audited financial statements to the extent an audit was obtained for other purposes and the audits were performed in accordance with either U.S. generally accepted auditing standards or PCAOB *auditing* standards[6] and the auditor complied with SEC independence standards.

- Financial statements for Tier 2 issuers would be required to have their financial statements audited. Auditors of Tier 2 issuer financial statements would be required to comply with PCAOB standards (including PCAOB auditing standards, requirements on auditor ethics, independence and quality control) as well as SEC independence standards. Tier 2 issuers would not be permitted to provide financial statements audited in accordance with U.S. generally accepted auditing standards.

Auditors of Tier 1 or Tier 2 issuers would not need to be registered with the PCAOB, even if the auditor were to state that the audit complied with PCAOB standards.

We have several recommendations regarding the proposal that we believe would reduce complexity and improve investor understanding of the financial statement audit.

Unaudited Financial Statements

To the extent that the final rule provides that the financial statements of a Tier 1 issuer may be unaudited, we recommend that the Commission require that (a) the financial statements and related notes be labeled "unaudited" and (b) Form 1-A specifically disclose that the financial statements have not been subject to an audit or review by an independent accountant. The absence of specific disclosures could create an expectation gap about the extent of involvement of an independent accountant.

Audited Financial Statements

The intent of the JOBS Act is to expand the use of Regulation A by smaller companies to raise capital. For potential Regulation A issuers that already have financial statements prepared and audited in accordance with U.S. generally accepted auditing standards (or are having financial statements audited

[6] The text in the Proposed Rule (via the form requirements) specifies that the audit would need to be performed in accordance with the "Standards of the PCAOB." This differs from the language on page 101 in Section II.C.3.b(2) of the Proposed Rule. We recommend that the Commission address this inconsistency in the final rule.

for the first time), a requirement for audits to comply with PCAOB standards and SEC independence standards will introduce an additional burden. We do not believe that the financial statement audit for a Regulation A issuer (which is, by definition, not a public company) should be required to comply with public company audit and independence standards.

If the financial statements of a Tier 1 issuer are available because they were already prepared and audited in accordance with either U.S. generally accepted auditing standards or PCAOB auditing standards for other purposes, we believe that an investor would benefit from obtaining those audited financial statements, even if the auditor did not comply with SEC independence rules at the time the financial statements were issued. Under the Proposed Rule, however, a Regulation A issuer might withhold an audit report that complied with U.S. generally accepted auditing standards (including independence) standards from its filing rather than incur the additional costs of ensuring that the audit was conducted in accordance with the SEC independence requirements.

We note that U.S. generally accepted auditing standards govern the audits of private companies. Accordingly, audits of financial statements of Regulation A issuers are required to refer to AICPA standards, which includes AICPA independence standards. It is unlikely that an accounting firm previously engaged by a Tier 2 issuer to audit its historical financial statements would have complied with all PCAOB standards. Requiring compliance with SEC independence rules in Regulation A offerings, as proposed, could increase costs for Regulation A issuers by requiring them to obtain an audit that was performed in accordance with SEC independence rules. Further, requiring compliance with SEC independence rules in Regulation A offerings would limit the number of auditors that would be able to audit Regulation A issuers' financial statements, as some firms not registered with the PCAOB may currently lack the controls and processes necessary to comply with and monitor certain aspects of SEC independence rules.

Lastly, we also note that audits of Regulation A issuers' financial statements would not be subject to inspection by the PCAOB, which could lead to investor confusion.

After consideration of our recommendations, if the Commission adopts final rules consistent with its proposal, we believe the Commission should clarify whether a Tier 1 issuer may *voluntarily* provide an audit opinion on its financial statements obtained for other purposes if the auditor complied with U.S. generally accepted auditing standards, including AICPA independence standards, but had not complied with SEC independence rules.

Conclusion

We appreciate the Commission's efforts to facilitate capital-raising by smaller companies and encourage the Commission's ongoing consideration of the benefits of clarity and consistency for all issuers of securities, particularly as the SEC Staff focuses on making specific recommendations for updating the rules and regulations that govern public company disclosure.

The CAQ appreciates the opportunity to provide our views on the Proposed Rule. We welcome the opportunity to respond to any questions regarding the views expressed in this letter.

Sincerely,

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Cc:

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