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SEC's Effort to Exempt More Companies From Audits of Financial Controls Likely to Face Investor Resistance

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The SEC staff in the past several months has been drafting a proposal that would exempt more public companies from audits of financial controls. The plan is part of the commission's broader effort initiated by SEC Chairman Jay Clayton to cut red tape and encourage more companies to go and stay public, but moving forward with its agenda will not be easy.

Investor protection advocates believe that effective controls over financial reporting instill greater investor confidence in a company's results. And they do not believe more classes of companies should be exempted from the auditor attestation of management's internal control over financial reporting (ICFR) under [Section 404\(b\)](#) of the [Sarbanes-Oxley Act of 2002](#).

Even if the agency moves forward with the plan, it will likely be without the backing of all its commissioners. Democratic Commissioner Robert Jackson believes that [Section 404\(b\)](#) has been beneficial for the capital markets, and any effort to exempt more companies must be backed up with evidence that shows the requirement is unnecessary.

"I look forward to [the staff's] recommendations. I hope it comes with some real analysis with some real proof," Jackson told *Thomson Reuters* in late 2018. "But if all it is, is giving something away to people who have been asking for awhile, I am not likely to support it."

"People forget that Sarbanes-Oxley 404 was created to deal with the lack of internal controls at Enron, WorldCom, and this is about basic stuff: 'Do I understand what's happening in the accounting of subsidiaries below me,'" he added.

However, business groups like the U.S. Chamber of Commerce and Biotechnology Innovation Organization (BIO) in the past several years have been lobbying for broader exemptions because they believe the auditor attestation rule is costly and does not offer much benefit to investors. They often say that the decline in the number of initial public offerings (IPOs) compared to the 1990s is partly a result of unnecessary regulation. And Clayton seems to be siding with businesses.

"Costs associated with [Section 404\(b\)](#) have not been scalable for small and midsize public companies due in large part to a 'one-size-fits-all' implementation that has failed to account for

unique business models,” eight business organizations, including the Chamber and Securities Industry and Financial Markets Association (SIFMA), said in a Spring 2018 report. Currently, public companies that are classified as “nonaccelerated filers” are exempt from Section 404(b). Nonaccelerated filers that have less than \$75 million in worldwide common equity are exempt from the audits of financial controls under [Rule 12b-2](#) of the [Securities Exchange Act of 1934](#) as mandated by Section 989G of the Dodd-Frank Act. [Sec. 989 of PL111-203](#)

If a majority of the commissioners decide to issue a proposal, the SEC will seek comments on amending the definition of accelerated filer to grant exemptions to more public companies. Accelerated filers are companies with more than \$75 million but less than \$700 million in common equity. Large accelerated filers have more than \$700 million in equity.

The SEC staff is looking into adding a revenue test for the [Section 404\(b\)](#) exemption, William Hinman, director of the SEC’s Division of Corporation Finance, said last year. For example, for a biotech company that has more than \$75 million in public float with routine financial statements but has no revenue, the money that goes to pay for the auditor attestation report can instead be used to make life-saving drugs, he said.

“While Section 404(b) is an important component of our public company regulatory regime, we have heard from market participants and our former Advisory Committee for Small and Emerging Companies that, particularly for smaller companies, the costs associated with this requirement can divert significant capital from the core business needs of companies without meaningful benefit,” Clayton said in a [speech](#) in August 2018. He emphasized that companies that are exempt from auditor attestation of reporting controls are still required to establish and assess the effectiveness of their controls.

But those who prefer to leave the threshold intact pointed to research that shows [Section 404\(b\)](#) has been beneficial.

“Peeling SOX 404(b) has been on the Chamber’s wish list for years, but there is no evidence for it except the Chamber wants it,” SEC Commissioner Jackson said.

For example, 2013 research by the U.S. Government Accountability Office (GAO) found that companies that obtained auditor attestation generally had fewer financial restatements than those that did not.

A 2017 report by Audit Analytics found that companies have been getting better at presenting reliable financial statements. Its study found that the total number of restatements dropped in 2016, to the lowest number in 15 years. Researchers at Audit Analytics said the positive trend is in part due to improved internal controls.

Moreover, a study in the January 2019 edition of *[The Accounting Review](#)* published by the [American Accounting Association](#) finds financial value in [Section 404\(b\)](#) requirements. The researchers looked at the stock prices of companies that bought other companies. A rule allows companies to exclude for one year internal control audits of the acquired company. The paper found that there is a significant drop in the acquirer’s stock on the day it discloses that it skipped the Section 404(b) requirement in its annual report. There can be as much as a 44 basis-point difference in one-day abnormal returns.

Jeffrey Mahoney, General Counsel of the Council of Institutional Investors (CII), pointed out that the SEC's 2011 staff [Study and Recommendations on Section 404\(b\) of the Sarbanes-Oxley Act of 2002 for Issuers With Public Float Between \\$75 and \\$250 Million](#) concluded that a further exemption was not warranted.

“Consistent with the SEC staff study, the 2013 GAO study found that companies and investors benefit from 404(b), including through improved reliability of financial reporting,” Mahoney said. “It is my understanding that the evidence of the benefits of 404(b) has only grown in recent years. I would be surprised if an SEC staff analysis today would result in a conclusion different than the conclusion reached in 2011.”

SEC Investor Advocate Rick Fleming is also opposed to widening the exemptions from [Section 404\(b\)](#) because effective controls reduce the risks of material errors or fraud and contribute to better internal accountability. In a December 2018 report to Congress, Fleming said that the role of independent auditor attestation of internal controls also helps to lower a company's cost of capital because it increases confidence in the capital markets. “We continue to believe that a reduction of auditor attestation requirements, though advanced in the name of capital formation, could have the opposite effect, and we will continue to monitor any further developments in this area.”

Former SEC Chief Accountant Lynn Turner was blunt in his criticism about adding a revenue test to qualify for the exemptions.

“Investors make hundreds of millions of investments in startups and growing companies long before they achieve significant revenues,” Turner said. “And they want to know management has good controls in place to ensure proper reporting of what is happening with that cash. The SEC idea to put in place a revenue test for these companies is just plain dumb and will cost, not benefit, Main Street investors.”

In the meantime, some believe that the SEC's plan to add the revenue test only complicates already complex matters.

Currently, the commission provides several disclosure exemptions from [Regulation S-K](#) and [Regulation S-X](#), which set out the form and content of financial reports, if companies qualify as a “smaller reporting company” (SRC).

“This makes it more confusing. Too many tests as well,” said Sara Hanks, co-founder and CEO of CrowdCheck, who served as cochair of the SEC's Advisory Committee on Small and Emerging Companies. “Let's reduce all of these bands to maybe three: Major reporting companies, reporting companies, smaller reporting companies. And I would apply SOX 404 to only the major ones.”

But Chris Ivey, an attorney with Stradling Yocca Carlson & Rauth, P.C., says that if the SEC moves ahead with amending the definition of accelerated filer, the agency in a way is trying to make its rules more consistent.

“It gets confusing because there are different definitions that apply to different areas of regulation,” Ivey said.

In June 2018, the SEC published [Release No. 33-10513](#), *Amendments to Smaller Reporting Company Definition*, to lift the threshold of the public float for a smaller reporting company to \$250 million from \$75 million. A company with no public float or with a public float of less than \$700 million also qualifies as a smaller reporting company if it had annual revenues of less than \$100 million during its most recently completed fiscal year. Previously, companies could provide scaled disclosure if they had no public float and less than \$50 million in annual revenues.

Ivey said even if there are different definitions for a different set of SEC rules, many companies see them along the same lines as if there were one definition.

“A company would say ‘I qualify as a smaller reporting company.’ Therefore, at least the way they used to think about before they changed these rules, ‘I am a smaller reporting company, I don’t have to get auditor attestations under 404(b),’” Ivey said. “Now because smaller reporting company rules were aligned with the accelerated rules, the thresholds are the same. So, the way I view this is it’s making the accelerated filer rules consistent with the amendments that were made to the smaller reporting company rule.”

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