CENTER FOR AUDIT QUALITY

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July 29, 2019

By email: rule-comments@sec.gov

US Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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

Dear Office of the Secretary:

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, DC, the CAQ is affiliated with the American Institute of CPAs. 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 opportunity to share our views and provide input on proposed amendments included in the Securities and Exchange Commission's (Commission or SEC) Proposed Rule, *Amendments to the Accelerated Filer and Large Accelerated Filer Definitions* (Proposal or Proposed Rule).

The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. We understand that this Proposal is intended to promote capital formation,[1] and while we are supportive of this goal overall, we believe the amendments in the Proposed Rule may not have the intended benefits to capital formation and may weaken the other two pillars of the mission. The CAQ supports preserving the current accelerated filer definition and our letter looks at the Proposal through the lens of the SEC's three-pronged mission. The letter is primarily focused on the requirement for an independent attestation of a public company's internal control over financial reporting (ICFR) which would no longer apply to an additional group of issuers under the proposed revisions to the accelerated and large accelerated filer definitions.

[1] See Proposed Rule, page 143.

Investor Protection

A Focus on Internal Control Over Financial Reporting Protects Investors

The CAQ agrees with SEC Chairman Clayton that the bedrock of our capital market system is high quality, reliable financial statements and without high quality and reliable financial information, capital markets do not function well.[2] It is critically important for investors to have trust and confidence in the capital markets and financial information publicly reported by issuers.

Management's ability to fulfill its financial reporting responsibilities depends in part on the design and operating effectiveness of the controls it has put in place over accounting and financial reporting. Without such controls, it would be difficult for most business organizations to prepare timely and reliable financial reports for investors, lenders, and other users. While no control system can absolutely assure that financial reports will not contain material misstatements, an effective system of ICFR can substantially reduce the risk of such misstatements in a company's financial statements.[3]

In the early 2000s there was limited visibility to investors and the markets related to the effectiveness of a public company's internal controls. To provide more transparency Congress passed the Sarbanes-Oxley Act of 2002 (SOX). Section 404 of SOX focuses on the assessment and related reporting of the effectiveness of a company's ICFR which is designed to prevent or detect material misstatements to a company's financial statements resulting from fraud or error. Data suggest[4] that the focus on ICFR has had a positive impact on both financial reporting and audit quality. This includes management's responsibility to annually assess and report on the effectiveness of internal control under Section 404(a) of SOX and the auditor's responsibility to perform an audit of management's assessment of the effectiveness of ICFR under Section 404(b) of SOX.

SOX is widely considered a bipartisan success that has led to positive changes in corporate culture. SOX generally and Section 404(b) specifically are "designed to screen out…the corner cutters, the people who want to cheat."[5] In addition, the auditor's annual assessment of the effectiveness of a company's ICFR also plays an important role in building investor confidence in public company financial reporting. The CAQ's *2018 Main Street Investor Survey* found that 81% of investors expressed confidence in public company auditors – the top response compared to other players that have roles in helping to advance investor protection, which we believe highlights the importance of the auditor attestation.

Effective ICFR Provides Smaller Companies a Strong Foundation of Quality Financial Reporting

The benefits of focusing on ICFR, including auditor attestation of ICFR, may be even more pronounced for smaller companies which, according to some studies, could be more susceptible to ICFR problems.[6] For example, we know research has shown that the risk of a material restatement is higher at smaller companies. Since 2003, non-accelerated US filers (companies with public float less than $75 million) have accounted for 62% of the total US financial statement restatements (6,993 unique filer restatements out of

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[2] Public Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to US-listed Companies with Significant Operations in China. Jay Clayton, SEC Chairman, Wes Bricker, SEC Chief Accountant, and William Duhnke, III, PCAOB Chairman.
[3] CAQ's *Guide to Internal Control Over Financial Reporting*.
[4] CAQ and Professor Susan Scholz, University of Kansas. "Financial Restatement Trends in the United States 2003-2012."
[5] Paul Sarbanes quoted in the Journal of Accountancy, "*Lawmakers reflect on Sarbanes-Oxley's effect on corporate culture*" (July 30, 2012).
[6] 2011 SEC 404b 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*.

CENTER FOR AUDIT QUALITY

a total of 11,306).[7] Establishing effective processes and controls is a prerequisite and provides a strong foundation for consistent high-quality financial reporting. The annual independent audit of ICFR helps illuminate problems before they lead to material weaknesses and financial statement restatements, and companies that are not subject to 404(b) experience financial reporting problems at a higher rate.[8]

The Proposal suggests that it is possible that low-revenue issuers may have less complex financial systems and controls and, therefore, be less likely than other issuers to fail to detect and disclose material weaknesses in the absence of an ICFR auditor attestation.[9] While this may be true in the case of some companies, there are other factors to consider when determining whether issuers are well-positioned to foster a control-conscious organization. Based on a fourteen-year review of SOX Section 404 disclosures, adverse auditor attestations and adverse management assessments of ICFR frequently cite a lack of accounting personnel resources, competency, and training[10] as the underlying cause for concluding that ICFR is ineffective. While this category of issuers may have less complex financial reporting, low-revenue issuers may have fewer resources to devote to accounting and controls and could be more likely to have unidentified material weaknesses in ICFR in the absence of an auditor's attestation. This could present an increased risk to investors.

Auditor Requirements for Evaluating Internal Control Are Different for Financial Statement and ICFR Audits

The Proposal states, "in many cases auditors are testing operating effectiveness of certain internal controls even if they are not performing an integrated audit."[11] It is true that under Public Company Accounting Oversight Board (PCAOB) *Auditing Standard 2110: Identifying and Assessing Risks of Material Misstatement* (AS 2110) an auditor obtains a sufficient understanding of each component of ICFR ("understanding of internal control") to (a) identify the types of potential misstatements, (b) assess the factors that affect the risks of material misstatement, and (c) design further audit procedures.[12] The auditor also obtains a broader understanding of control activities for relevant assertions for which the auditor plans to rely on controls. However, in the audit of ICFR, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally in scope for a financial statement audit.[13] The auditor also is required to test the effectiveness of those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to *each* relevant assertion of *each* significant account and disclosure.[14] These differences in scope reflect the fact that the objectives of the ICFR and financial statement audits are not identical.[15] In a financial-statement only audit, the auditor obtains an understanding of internal control that is sufficient to assess the factors that affect the risks of material misstatement and to design further audit procedures.[16] However, in an audit of ICFR, the auditor's objective is to express an opinion on the effectiveness of the company's ICFR. Therefore, the Proposed Rule would eliminate the level of assurance that investors obtain about the effectiveness of ICFR of the companies impacted by the Proposal. Accordingly, it is important for the Commission to clearly understand the level of internal controls testing performed by the auditor under

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[7] 2017 Financial Restatements: A Seventeen Year Comparison; Audit Analytics (May 2018).
[8] 2011 SEC 404b 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,* pages 39 and 42.
[9] See Proposed Rule, page 27.
[10] See, e.g., Audit Analytics, *SOX 404 Disclosures: A Fourteen Year Review (September 2018).*
[11] See Proposed Rule, page 23.
[12] AS 2110, paragraph 18.
[13] AS 2110, paragraph 34.
[14] AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 2201), paragraph 39.
[15] AS 2201, paragraph 06.
[16] AS 2110, paragraph 34.

each scenario (financial statement-only audit vs. integrated audit, inclusive of a separate auditor attestation of ICFR) as the Commission considers whether to move forward with the Proposal.

Providing Trust and Confidence in Other Information Important to Investors

The Proposed Rule states that, “the financial statements of low-revenue issuers may, in many cases, be less critical to assessing their valuation given, for example, the relative importance of their future prospects.”[17] If investors are using information other than what is in the financial statements to make investment decisions, the Commission may wish to consider whether investors would benefit from auditor involvement with that information to address potential risks related to its completeness and accuracy (not only for the issuers affected by the Proposal, but all issuers). For example, investors in companies that would qualify as non-accelerated filers under the Proposal may rely heavily on non-GAAP financial measures, key performance indicators (KPIs), or other disclosures for decision making. Non-GAAP financial measures, KPIs, and Management’s Discussion and Analysis are considered “other information” to the extent they are included in a document that contains the audited financial statements and an auditor’s responsibility for this other information is limited to reading it and considering whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[18] We recommend the Commission consider whether there is a need for further efforts related to this information to determine if there is an expectations gap regarding the auditor’s involvement.[19]

<u>Fair, Orderly, and Efficient Markets</u>

SOX Section 404(b) Fosters Fair and Orderly Markets

We know that, historically, companies required to comply with SOX Section 404(b) have fewer financial statement restatements, which helps foster orderly markets.[20] From 2007 to 2017, restatements have generally declined.[21] This time period includes the financial crisis and an extremely volatile market; however, there was not a spike in restatements. In periods of economic uncertainty, SOX Section 404(b) provides stability by providing additional assurance on a company’s ability to deliver high-quality financial information. 74% of investors expressed confidence in the US capital market system in 2018.[22] This confidence likely stems from the important safeguards that currently exist, including the annual ICFR auditor attestation. At the CAQ, we advocate for investors in companies of all sizes to be entitled to the same levels of protection.

Complexity Impacts Efficiency

Today, users of annual company filings cannot easily determine whether a company is subject to auditor ICFR attestation as the definitions of smaller reporting companies and non-accelerated filers still overlap for some issuers.

Given the complexity of various filer definitions, which this Proposal further compounds, investors may not be aware of which companies are exempt from SOX Section 404(b) requirements. While we acknowledge

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[17] See Proposed Rule, page 27.
[18] PCAOB Auditing Standard (AS) 2710, *Other Information in Documents Containing Audited Financial Statements*, paragraph 04.
[19] Such efforts could include SEC coordination with the PCAOB’s research project on the auditor’s role in relation to other information and company performance measures, including non-GAAP measures.
[20] 2013 GAO study, *SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation.*
[21] 2017 Financial Restatements: A Seventeen Year Comparison; Audit Analytics (May 2018).
[22] 2018 Main Street Investor Survey.

that the information is currently disclosed in the auditor's report as well as management's annual report on ICFR, it also may be helpful to disclose it more prominently elsewhere in the 10-K for the ease of access and understanding by investors. We encourage the SEC to consider requiring issuers to disclose on the cover page of their annual Form 10-K whether an ICFR audit has been performed. This disclosure could be in the form of a checked box similar to the current disclosure identifying filer status. Such disclosure would increase transparency and alert investors to when there might be increased risk among companies competing for their investment.

Capital Formation

Estimating Costs and Benefits Is Challenging

The economic analysis in the Proposal focuses heavily on the anticipated cost savings of an individual company, and the assumption that these cost savings will result in more companies being willing to enter the public market. While we acknowledge the importance of understanding the costs and benefits to an issuer, we believe it is equally worthwhile to consider the expected impact of the Proposed Rule on the financial reporting ecosystem and the public interest generally. Effective ICFR – which we believe the auditor attestation supports – benefits the marketplace at large. With fewer restatements, overall investor confidence may increase.

Furthermore, it is unclear how the estimated savings per issuer identified in the Proposal has taken into account the testing strategies that the auditor may employ in the absence of a SOX Section 404(b) attestation. While the transactional (substantive) testing performed by the external auditor may be reduced when the auditor can rely on effective internal controls, the extent of internal control testing procedures is impacted by the risk and complexity in auditing the company and the testing strategies of the auditor. Accordingly, the SEC's anticipated level of cost savings may not be achieved.

Annual auditor attestation of ICFR may be even more critical as companies implement new GAAP requirements, such as revenue recognition, leases, and credit losses. These new accounting standards are complex and strong internal controls are critical to successful implementation. For investors, knowing that the new controls being put in place to comply with new accounting requirements have been evaluated independently could promote confidence in post-adoption financial reporting.

Given the challenge of quantifying the costs and benefits of SOX Section 404(b) for a particular issuer or group of issuers, should the Commission move forward with approving the Proposed Rule, we encourage performing a robust post-implementation review which includes a more holistic cost-benefit analysis (i.e., one that also considers changes in the quality of financial reporting as measured, for example, by the number of restatements and unreported material weaknesses) related to the companies who will become exempt from the SOX Section 404(b) requirements.

Other Opportunities to Reduce Unnecessary Compliance Burdens

As we believe the current accelerated filer definition is appropriate, we encourage the Commission to consider other opportunities to reduce unnecessary compliance burdens for issuers which may serve to foster capital formation. We commend the SEC for periodically evaluating regulatory requirements and considering whether they continue to be fit for purpose and urge the Commission to continue doing so. Chairman Clayton's recent remarks[23] that disclosure requirements must be rooted in the principles of

[23] SEC Chairman Jay Clayton's Remarks for Telephone Call with SEC Investor Advisory Committee Members on February 6, 2019.

materiality, comparability, flexibility, efficiency, and responsibility provide helpful guideposts for these efforts. We encourage the Commission to continue its important work to improve disclosure effectiveness, which we believe will have a positive benefit for all issuers and investors.[24]

Effective Date

Given the complexity of the proposed transition rules, as well as the impact on the issuers identified in the Proposal and their audits, the SEC should be clear about the timing of the rule adoption and related effective date. We encourage the Commission to provide sufficient notice to allow issuers and their auditors time to adjust to the changes.

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We appreciate the opportunity to comment on the Proposal. As the Staff and Commission gather feedback from investors, preparers, and other interested parties, we would be pleased to discuss our comments or answer any questions regarding the views expressed in this letter.

Sincerely,

Julie Bell Lindsay

Julie Bell Lindsay
Executive Director
Center for Audit Quality

cc:

SEC
Jay Clayton, Chairman
Robert J. Jackson, Jr., Commissioner
Allison H. Lee, Commissioner
Hester M. Peirce, Commissioner
Elad L. Roisman, Commissioner
William H. Hinman, Director, Division of Corporation Finance
Kyle Moffatt, Chief Accountant, Division of Corporation Finance
Sagar Teotia, Chief Accountant
Marc Panucci, Deputy Chief Accountant

PCAOB
Megan Zietsman, Chief Auditor and Director of Professional Standards

[24] See CAQ's comment letters related to the Commission's proposed rules on our website at www.thecaq.org including our response to proposals such as *Financial Disclosures About Guarantors and Issuers of Guaranteed Securities and Affiliates Whose Securities Collateralize a Registrant's Securities* and *FAST Act Modernization and Simplification of Regulation S-K*.