

SEC PROPOSES EXPANSION OF EXEMPTION FROM INTERNAL CONTROL ATTESTATION

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More than 15 years ago, Sarbanes-Oxley (SOX) moved internal controls into the spotlight for SEC filers. With its enactment, SOX required:

- The CEO and CFO to provide certifications regarding the effectiveness of an organization’s internal controls (SOX 302);
- Organizations to establish and assess the effectiveness of internal controls over financial reporting (SOX 404a);
- The filer’s independent audit firm to assess and attest to the effectiveness of the client’s internal controls (SOX 404b);
- Organizations to have an audit committee of independent board members, including a designated financial expert with oversight responsibility for internal controls (SOX 407).

At the same time, SOX also introduced three categories of filers: large accelerated filers, accelerated filers and non-accelerated filers. The primary focus of the stratification is the due dates for an entity’s Forms 10-K and 10-Q.

Overlaying this three-tier filing stratification, however, is a distinct category of filers identified as smaller

reporting companies (SRC). SRC status eases some of the disclosure burden for smaller companies, which arguably have a more limited investor base. Each of these categories is delineated by the magnitude of a company’s public float. In the case of SRCs, this is coupled with an annual revenue limit. Table 1 gives the stratification.

Under certain circumstances, an SRC can be either an accelerated filer or a non-accelerated filer and benefit from the reduced disclosure requirements of the SRC reporting regime.

However, it is non-accelerated filers, rather than SRCs, that are exempted from the requirement to include the

independent auditor’s attestation to the effectiveness of the filer’s internal controls over financial reporting (SOX 404b). And herein lies the impetus for the SEC’s proposal to simplify and expand the category of companies that qualify for this exemption. The proposal justifies the expansion as an effort to reduce audit fees for smaller public companies, thereby freeing up cash for investment in the business.

The SEC’s proposal would conform the non-accelerated filer thresholds to the SRC thresholds. Under the new thresholds, an entity would be a non-accelerated filer and an SRC if its public float is less than \$75 million

TABLE 1. STRATIFICATION OF ENTITIES

CATEGORY OF FILER	DEFINITION	FILING DEADLINE	
		10-K	10-Q
Large Accelerated Filer	Public float of at least \$700 million	60 days	40 days
Accelerated Filer	Public float of at least \$75 million, but less than \$700 million	75 days	40 days
Non-accelerated Filer	Public float of less than \$75 million	90 days	45 days
Smaller Reporting Companies (SRC)	Public float of less than \$250 million <u>OR</u> Annual revenues of less than \$100 million and public float of less than \$700 million	Not applicable – either accelerated or non-accelerated filing status	

or its public float is less than \$700 million and annual revenues are less than \$100 million.

In reviewing historical data, the SEC estimates that the proposal could result in 539 additional issuers qualifying for non-accelerated filer status. Of these, 181 already qualify under the "emerging growth company" exemption from the internal control attestation, resulting in an additional 358 additional issuers qualifying for the exemption.

Inherent in this proposal is the assumption that the expanded exemption is justified under a cost (increased risk to investors) / benefit (reduced audit fees) analysis. On the risk side of the equation, 27.5% of non-accelerated filers had ineffective internal controls for two consecutive years in 2016-2017, based on management reporting. This compares to single digit ineffectiveness by accelerated filers. On the cost side, average audit fees

for non-accelerated filers averaged just over \$170,000 for the past four reporting cycles compared to about \$435,000 for accelerated filers with less than \$100 million of revenue. Based on surveys and trend analysis, the SEC estimates that roughly 30% of audit fees are related to the internal controls attestation during the years reviewed. With the new risk assessment auditing standards, the SEC rounded down the annual savings to \$100,000. The estimate attempts to adjust for the reality that costs on the substantive audit will increase as the independent auditor puts less reliance on internal controls.

In making this proposal, the SEC is relying on the fact that the company must continue to self-report on the effectiveness of its internal controls over financial reporting and the CEO and CFO must continue providing the required certifications. What is not evident from the SEC's proposal is the extent to which the

independent auditor's involvement in the assessment of internal controls has assisted non-accelerated filers in identifying the internal control ineffectiveness cited above. One must also question whether smaller companies will become less diligent if the oversight of the independent auditor is absent. Only time will tell.

If the proposal is adopted, some companies should consider retaining the independent auditor attestation if they anticipate an additional float or growth in revenues that will result in no longer qualifying for the exemption. Reestablishing the attestation could prove costly and time consuming.

It may be somewhat surprising that the SEC is diluting requirements surrounding internal controls. As comments are received, it will be interesting to see how investors react to this proposal.



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