Spring 2017

Sarbanes-Oxley Act Section 404 and Filing Status

Yanwen Wang
yw4@wildcats.unh.edu

Title:

Sarbanes-Oxley Act Section 404 and Filing Status

Author: Yanwen (Winnie) Wang

Faculty Sponsor: Le (Emily) Xu

Abstract

This thesis focuses on Sarbanes-Oxley Act, which is a United States federal law that sets new or expanded requirements for all U.S. public companies. Section 404 aims to ensure that all public companies have effective internal controls. Section 404 is not applied uniformly across different filers. This thesis focuses on the analyses of small companies as these companies, i.e. non-accelerated filers, got exemption from Section 404 (b), which requires a publicly-held company's auditor to attest to, and report on, management's assessment of its internal controls. Because this exemption allows non-accelerated filers to avoid significant compliance cost, the purpose of the thesis is to provide a trend analysis of changing proportion of non-accelerated filers from 2002-2016 to see if companies have taken advantage of the exemption only applicable to non-accelerated filers. I find that there was a larger proportion of non-accelerated filers right before the effective date of the exemption rule for Section 404 (b) in 2010. In addition, I find that the proportion of companies changing from accelerated to non-accelerated filers is the largest right before 2010. These results are consistent with the notion that non-accelerated filers have the incentive to avoid the huge cost to comply with Section 404 (b).

Table of Content

I. Introduction

On December 2nd 2001, Enron's bankruptcy exposed the scandal of hiding real numbers in financial statement. Their auditor, Arthur Anderson, and as such the public lost confidence of auditors' independence from their clients. Not only Enron, but other giants, such as WorldCom and Tyco, either collapsed or were embroiled in scandals at the same time and for much the same reason: fraudulent financial reporting for the sake of maintaining or increasing stock valuations (Wilbanks, 2016).

In order to rebuild the confidence of the public, the US Congress passed the Sarbanes-Oxley Act (SOX) in 2002. "SOX was enacted to help ensure accountability of corporations and their accounting firms by specifying detailed financial reporting requirements and imposing financial penalties and criminal sanctions on those who personally participate in fraud" (Wilbanks, 2016).

The Sarbanes-Oxley Act of 2002 was, no doubt, the most significant accounting and auditing legislation enacted in recent history. One of the major provisions of this legislation was the creation of the Public Company Accounting Oversight Board. The mission of PCAOB is to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports (Schroeder, 2016). Additionally, SOX aims to ensure auditor's independence, hold management liable for their published results, govern the reporting process, and also apply sufficient internal controls that will minimize the possibility of material misstatement, or fraud from occurring (Jaara & Oweis, 2016).

Section 404 is one of main provisions in Sarbanes-Oxley Act. Section 404 consists of two parts; Section 404 (a) is for companies, stating that each annual report required by Section 13(a) or 15(d) of the Securities Exchange Act of 1934 should contain an internal control report by management. It shall state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Section 404(b) requires a publicly-held company's auditor to attest to, and report on, management's assessment of its internal controls. Some experts insist that section 404 b could significantly improve the overall quality of internal control for public companies. While others believe that the expensive compliance fee is too costly for small companies, and filing with this rule might not worth to dong. According to a study conducted by Financial Executives International (FEI) in March 2005, on 217 publicly traded companies, it was concluded that an average of almost 26,758 extra internal labor hours were required to comply with SOX 404 requirements (Jaara & Oweis, 2016).

In this study, I investigate that the proportion change for non-accelerated filer and accelerated filer as well as the percentage change from one filing status to another from 2002 to 2016. I find evidence that companies tried to keep their non-accelerated filing status intentionally to avoid the huge cost to comply with section 404 (b). Section II is literature review and hypothesis development, following by section III which is the methodology and analysis. After that, I will conclude what I have found during the process of analysis.

II. Legislative History and Literature Review

Legislative History

All public companies are required to submit an annual assessment of the effectiveness of their internal financial auditing controls to the Securities and Exchange Commission, but the effective dates differed depending on what category the company fell in. (SEC). All Exchange Act reporting companies were divided into three categories of filers: large accelerated filers, accelerated filers and non-accelerated filers[1] to determine the deadline of filing annual reports Form 10-K, quarterly reports Form 10-Q, and current reports on Form 8-K for a number of specified events according to a variety of other disclosure requirements. Originally, a company can be classified into accelerated filer if it meets the following conditions as of the end of it fiscal year: common equity public float was $75 million or more as of the last business day of its most recently completed second fiscal quarter; has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least 12 calendar months; has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act or the company is not eligible to use Forms 10-KSB and 10-QSB (Release No. 22-8128). In addition, when complying section 404, companies that have public float of $700 million or more are large accelerated filers, and those with public float of less than $75 million fall into the non-accelerated filer category.

[1] Non-accelerated filer that I mentioned include non-accelerated filer and smaller reporting companies.

Category of Filer	Revised Deadlines For Filing Periodic Reports	
	Form 10-K Deadline	Form 10-Q Deadline
Large Accelerated Filer ($700MM or more)	60 days	40 days
Accelerated Filer ($75MM or more and less than $700MM)	75 days	40 days
Non-accelerated Filer (less than $75MM)	90 days	45 days

(https://www.sec.gov/fast-answers/answers-form10khtm.html)

Section 404 of SOX use these criteria to distinguish companies. On June 5, 2003, the commission adopted several amendments to its rules and forms implementing Section 404 of the Sarbanes-Oxley Act of 2002. Under the compliance dates originally established, companies meeting the definition of an "accelerated filer" in Exchange Act Rule 12b-2 would have become subject to the internal control reporting requirements with respect to the first annual report that they filed for a fiscal year ending on or after June 15, 2003. Later, in February 2004, SEC extended the compliance dates for accelerated filers to fiscal years ending on or after November 15, 2004.

In general, non-accelerated filers' compliance date was extended longer than accelerated filers. Non-accelerated filers would not have become subject to the requirements until they file an annual report for a fiscal year ending on or after April, 2005 (Release No. 33-8238). In February 2004, SEC also extended the compliance dates for non-accelerated filers and for foreign private issuers to fiscal years ending on or after July 15, 2005 (Release No. 33-8392). In September 2005, SEC again extended the compliance dates for the internal control over financial reporting requirements applicable to companies that are non-accelerated filers. Based on the September 2005 extension, domestic and foreign non-accelerated filers were scheduled to comply with the internal control over financial reporting requirements beginning with annual reports filed for their first fiscal year ending on or after July 15, 2007 (Release No. 33-8618). In 2006, SEC published another documents that shows a chart that summarized the revised compliance date and final rules that will be in place after effective date.

When SOX was implemented, non-accelerated filers were permitted to defer compliance with Section 404 (a)'s requirement to provide management's report on the effectiveness of internal control over financial reporting until their annual report filed for a fiscal year ending on or after December 15, 2007 (Release No. 33-8618). Deferrals of the auditor attestation requirement under section 404 (b) have extended even longer. In October 2009, the SEC issued what it described as the last such deferral. Non-accelerated filers would be required to include an auditor's attestation report in their annual report filed for a fiscal year ending on or after June 15, 2010 (Release No. 33-8238).

Finally, on July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Securities and Exchange Commission is adopting amendments to its rules and forms to conform them to Section 404(c) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"), as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 404(c) provides that Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934 (the "Exchange Act"), which is effective on September 21, 2010 (Release No. 33-9142).

Despite the fact that SOX 404 has been investigated in depth by different scholars, there are very small number of papers that have examined the effect of exempting non-accelerated filers form SOX 404 (b). According to a study by Feng and Li (2011), intentionally keep smaller filing status will have a direct negative effect on the U. S. economy since non-accelerated filers form the vast majority of listed companies in the U. S. financial market. Furthermore, it has been found that these requirements prevent emerging companies from going public (Feng and Li, 2011). Moreover, “some small sized companies have even disregarded future, or present growth opportunities, so they would avoid the compliance burden of SOX 404 (B)” (Feng and Li, 2009). A 2009 study by the Government Accountability Office (hereafter referred to as GAO) shows that complying with SOX 404 requirements have affected manager’s behavior. Managers would prefer to take conservative actions in their investment decisions in order to keep their companies in the non-accelerated filers’ category because these managers believe that complying with SOX 404 (b) requirements would result in increasing the non-value adding spending in terms of money and time (GAO, 2009).

Why the cost matters?

Section 404(a) of the Act requires management to assess and report on the effectiveness of internal control over financial reporting (“ICFR”) and Section 404(b) requires that an independent auditor attest to management’s assessment of the effectiveness of those internal controls. According to the SEC, because the cost of complying with the requirements of Section 404 of the Act (“Section 404”) has been generally viewed as being unexpectedly high, effort to reduce the costs while retaining the effectiveness of compliance resulted in a series of reforms in 2007 (SEC, 2009). Also, this SEC report presents an analysis of data from publicly traded companies collected from an SEC-sponsored Web survey of financial executives of companies with Section 404 experience conducted during December 2008 and January 2009. The analysis of the survey data is designed to inform the Commission and other interested parties as to whether delaying of deadlines occurring since 2007 had the intended effect of facilitating more cost-effective internal controls evaluations and audits, especially as they may apply to smaller reporting companies. The findings of the analysis relating to efficiency include evidence on the total and component compliance costs, the changes in costs over time, and the factors that help to explain why costs are lower or higher for some companies than for others. These findings include evidence of direct and indirect effects that management ascribes to Section 404 compliance, including evidence on intended benefits. As a result, the general conclusion from the analysis of survey data is that compliance costs vary with company size (increasing with size) and compliance history (decreasing with increased compliance experience). Larger companies tend to incur higher compliance costs in dollar terms ("absolute cost"), while smaller companies report higher costs as a fraction of asset value ("scaled cost"). The evidence suggests that companies bear some fixed start-up costs of compliance that are not scalable. Some of these costs are recurring fixed costs, while others are one-time start-up costs borne in the first years of compliance that tend to dissipate over time. For companies complying with both parts of Section 404, the cost of complying with Section 404(b) is reportedly similar to the incremental cost of complying with Section 404(a) alone. The resource requirements of Section 404(a) and Section 404(b) compliance are quite different, however. The Section 404(a) cost is borne through increased internal labor and outside vendor expenses, while the Section 404(b) cost is experienced primarily through increased independent-auditor fees, according to the survey evidence.

According to Holder, Karim, and Robin (2013), the concerns of small firms such as those belonging to the non-accelerated category are perceived as important by market participants. They represent a significant component of the U.S. economy. They form by far the largest category of public firms. For instance, in 2009, there were more than 5,000 non-accelerated filers representing about six percent of the market capitalization of listed firms (SEC 2010). "They are perceived as bearing a relatively higher burden in terms of compliance costs. Moreover, there are concerns that SOX provisions such as Section 404b were a bit of overkill for small firms (Cutler, 2006) notes that the structure of small firms is far less complex and the financial condition much more transparent, implying that the regulation is unnecessary".

Additionally, some small businesses argue that they could act better to remain nimble and competitive in the market, so that they don't need to comply with Section 404 (b) for well-defined internal control process (Gao, Wu & Zimmerman, 2009). Small accelerated filers may be similar given the significant cost of implementing Section 404(b), it is conceivable that some companies close to meeting the definition of non-accelerated filers would have incentive to move to the category of non-accelerated filers.

The SEC's Division of Corporation Finance has published its latest batch of guidance for small filers. The guidance is the result of a year of participating in public forums alongside the Public Company Accounting Oversight Board, and it is available on the SEC website. Smaller reporting companies, and particularly micro-cap companies, often lack in-house public company expertise, and even their outside counsel may not be used to working with public companies, says Paul Chestovich, a partner with the Minneapolis- based law firm of Maslon Edelman Borman & Brand. Moreover, many small company executives struggle to find the time to learn the nuances of SEC filing. One example of life at small public company: Many such filers don't have spare cash to pay executives or outside consultants, and instead use stock-based compensation. There's nothing inherently wrong in that, Chestovich notes, but it does make SEC filing more complex.

How it works?

Public float is the portion of a company's outstanding shares that is in the hands of public investors, as opposed to company officers, directors, or stockholders that hold controlling interests. These are the shares that are available for trading. The float is calculated by using the market capitalization minus the holding by affiliates. According to GAO (2009), SEC defines an affiliate as "an affiliate of, or person affiliated with, a specified person, is a person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the person specified"? (SEC rule 405). Although executive officers and directors are always considered affiliates, firms differ in how they treat block holders because the SEC has not established a bright-line cutoff. For example, according to GAO (2006), California Micro Devices Corp. considers shares held by a 5 percent owner as affiliated and excludes them from public float, whereas Vical Corp. counts 10 percent owners as affiliates, along with executive officers and directors. By expanding the cutoff line, companies could result more affiliated when they set the threshold as 5%, while other company use 10% threshold.

As I mentioned in previous paragraph that public float is calculated by using market capacity minus the amount of holding by affiliates. Because the SEC does not prescribe a bright-line cutoff for affiliates, non-accelerated filers might have incentives to manipulate with the amount held by affiliates to keep their filing status and accelerated filers may have the same incentive to change to the non-accelerated filer status. In addition, because the exemption of Section 404(b) took effect in 2010, it is reasonable that some companies might predict how the rules evolved and take some measures in advance.

I state the two hypotheses in an alternative form as follows:

H1a: There are more accelerated filer changes to the non-accelerated filer status in the post-2009 period.

H2a: There is a larger proportion of non-accelerated filers among all filers in the post-2009 period.

III. Methodology and Results

All data are collected from the Audit Analytics from year 2002 to 2016. Below is Table 1 regarding the descriptive statistics.

Table 1: Descriptive Statistics

Accelerated- Filers					
2002-2016	Market Capacity	Audit fee	Total fee	Revenue	Asset
Mean	1,124,033,970	1,031,210	1,346,415	1,032,710,313	3,201,146,254
Median	323,778,152	600,363	732,557	224,324,375	467,047,281
Non-accelerated Filers					
2002-2016	Market Capacity	Audit fee	Total fee	Revenue	Asset
Mean	448,954,894	471,520	644,997	920,094,255	5,072,143,126
Median	19,057,011	102,176	127,113	35,306,079	75,979,785

As shown above, the mean of both audit fee and total fee for non-accelerated filers are less than that for accelerated filer. This is to be expected because accelerated filers should comply with section 404(b), while non-accelerated filers were exempted. Later on, I create a database that only contains public companies which changed their filing status during that period of time. As the companies grow in market capitalization, the public float should increase so that their filing status is more likely to change from non-accelerated filer to accelerated filer.

Table 2: Numbers of companies changing from non-accelerated filer to accelerated filer

	NA to AF	SRC to AF	Total NA(SRC) to AF
2002-2003	747	0	747
2003-2004	393	0	393
2004-2005	460	0	460
2005-2006	369	0	369
2006-2007	325	0	325
2007-2008	243	15	258
2008-2009	81	32	113
2009-2010	117	78	195
2010-2011	164	115	279
2011-2012	113	73	186
2012-2013	103	78	181
2013-2014	155	116	271
2014-2015	186	95	281
2015-2016	105	51	156 [2]

Figure 2: Numbers of company changing from non-accelerated filer to accelerated filer

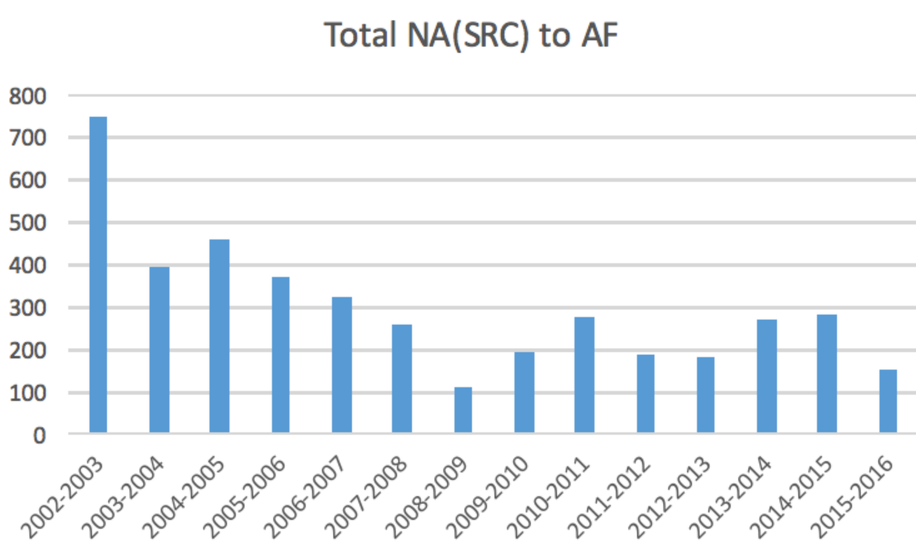


Figure 2 visual presentation of Table 2.

Figure 2 and Table 2 show how many companies change their filing status from non-accelerated filer into accelerated filer from 2002 to 2016. I expected that there would be less non-accelerated filers changed into accelerated because in post-2010 because the exemption

[2] NA stands for non-accelerated filer. AF stands for accelerated filer. SRC stands for smaller reporting company.

of Section 404(b) is finalized for the non- accelerated filer at that time. As a result, my hypothesis is not consistent with what I have got in the table, there are definitely more non-accelerated filers change into accelerated filer form 2009-2011. However, there was a decrease in the number of non-accelerated filers changing status to accelerated filers from 2002 to 2009. The number tanked in 2009. This might be due to smaller companies anticipating the exemption to be taken place soon. The number of companies changing from NAF to AF started to increase in 2010 again. It is unclear why this is the case.

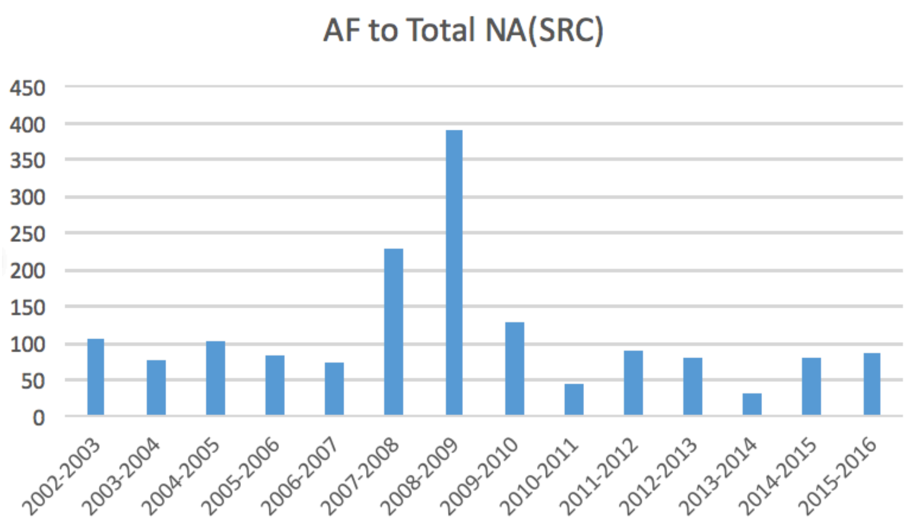
In contrast, some business might shrink or for any other reason, their public float was below the threshold for accelerated filer and become non-accelerated or smaller reporting company. SEC have set up a stricter exit rules- companies needs to report a public float below 50 million in order to fell into the category of non-accelerated filer (SEC 2005).

In Figure 3 below, I trace how many companies change their filing status from accelerated filer to non-accelerated filer over time.

Table 3: Numbers of companies changing from accelerated filer to non-accelerated filer

	AF to NF	AF to SRC	AF to Total NA(SRC)
2002-2003	107	0	107
2003-2004	77	0	77
2004-2005	102	0	102
2005-2006	85	0	85
2006-2007	31	43	74
2007-2008	73	158	231
2008-2009	175	218	393
2009-2010	58	70	128
2010-2011	17	29	46
2011-2012	39	51	90
2012-2013	34	46	80
2013-2014	14	17	31
2014-2015	27	54	81
2015-2016	32	56	88

Figure 3: Numbers of company changing from accelerated filer to non-accelerated filer



Based on Table 3 and Figure 3, on average, there are about 89 companies that change their filing status from accelerated filers into non-accelerated filer from 2002-2007.[3] Although the numbers fluctuate during those years, the variation is not dramatic. In year 2007, the number increased sharply, and that was the year when the deferral was announced by SEC. Moreover, there were more companies change their status into non-accelerated in year 2009. This trend supports our hypothesis that companies have incentives to become a non-accelerated filer. The relationship is reversed in year 2010, which is the year that non-accelerated filer officially exemption from Section 404 (b).

Another test that I run is to calculate the proportion of each filing status using numbers in each category divided by numbers of all publicly traded companies in that period for each year from 2002 to 2016. Based on Audit Analytics, some companies didn't disclose their filing status. When I calculate the number of all publicly traded companies, I use two

[3] I compute the mean of …. over 2002-2007: (107+77+102+85+74)/5=89

alternative measures. One is including those companies that didn't disclose their filing status in the denominator, while the other is only counting the companies who disclose their filing status in the denominator. The dilute proportion rates, which only count companies who disclose their filing status in the denominator, would be more accurate than the other analyses because we don't know the reason why those companies didn't disclose the status.

Table 4 and Figure 4 below present the proportion changing for accelerated filers to non-accelerated filer from 2002 to 2016, including the dilute proportion rate and nominal proportion rate.

Table 4: Proportion change for different filing status

	Total number ((Include blanks and Not disclosure)	Total number (Net)	Non-accelerated Filer	Accelerated filer
2002	17328	7306	4822	2483
2003	17901	9092	5590	3501
2004	17168	10060	6252	3802
2005	17191	9035	4796	2857
2006	16992	7709	3286	2372
2007	17139	7828	3403	2317
2008	17063	10099	5468	2370
2009	17135	10217	6225	2079
2010	17578	9923	6095	1903
2011	16708	9388	5484	1817
2012	16646	9116	5224	1791
2013	19437	9594	5697	1647
2014	21169	9450	5374	1648
2015	20933	8798	4643	1689
2016	16551	5688	2157	1466

Figure 4: Proportion change for different filing

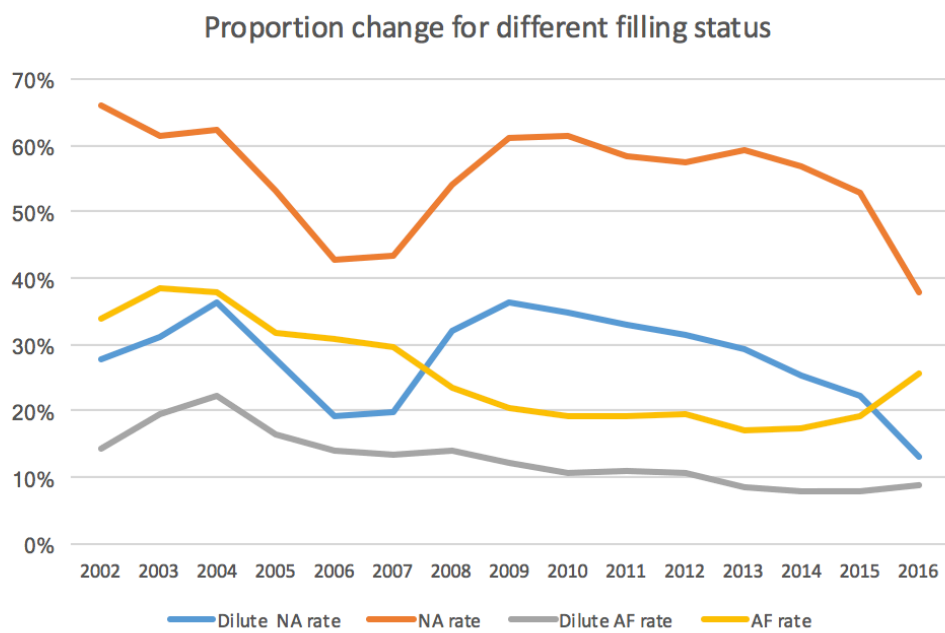


Table 4 and Figure 4 give us a general idea of how the proportion change over time and we can see the trend evolved over time. Generally, the dilute proportion and nominal proportion rate change in the same direction. In 2006, the proportion of non-accelerated filers reached the bottom, but it's unclear why that might have happened. In 2009, there was a sharp increase in the proportion of companies changing from the accelerated to non-accelerated filing status. This means that before the exemption of Section 404 (b)took effect in 2010, more companies tried to change into the non-accelerated status in anticipation of the exemption rule taking effect.

IV. Conclusion

The implementation of Sarbanes-Oxley Act was enacted to restore investor confidence in the financial markets and to enhance the quality of financial of public trade companies. Section 404 (b) requires a publicly-held company's auditor to attest to, and report on, management's assessment of its internal controls. However, for smaller companies, the huge cost to comply with section 404(b) in SOX is argued to offset the benefit. This cost therefore incentivizes companies to remain at or switch to the NAF status. In this study, I investigate the trend of public companies transferring from accelerated filers into non-accelerated filers, and see if there are any significant changes over time.

My findings are that there was a larger proportion of non-accelerated filers right before the effective date of the exemption rule for section 404 (b) in 2010. In addition, I find that the proportion of companies changing from accelerated to non-accelerated filers is the largest right before 2010. I therefore infer that non-accelerate filers tried to maintain the filing status to avoid the huge compliance cost for Section 404 (b). . These findings are important because Section 404 of the Sarbanes-Oxley Act was enacted to ensure that public companies have a great internal control environment. Intentionally manipulating shares held by affiliates or other means to keep or move to a filing status is, perhaps, an unintended consequence of the Act.

Reference

Bova, F., Minutti-Meza, M., Richardson, G., & Vyas, D. (2014). The sarbanes-oxley act and exit strategies of private firms. *Contemporary Accounting Research, 31*(3), 818-850. doi:10.1111/1911-3846.12049

Cutler, M. G. 2006. Sarbanes-Oxley: Section 404 and the Death of the Small Public Company. Working paper, University of Florida.

Franklin, M. (2016). Sarbanes-oxley section 404: A historical analysis. *Journal of Accounting & Finance (2158-3625), 16*(4), 56-69. Retrieved from http://search.ebscohost.com.libproxy.unh.edu/login.aspx?direct=true&db=bth&AN=118733558&site=ehost-live

Gao, F. (2016). To comply or not to comply: Understanding the discretion in reporting public float and SEC regulations. *Contemporary Accounting Research, 33*(3), 1075-1100. doi:10.1111/1911-3846.12170

Gao, F., J. Wu,& Zimmerman, J. (2009). Unintended consequences of granting small firms exemptions from securities regulation: Evidence from the sarbanes-oxley act. *Journal of Accounting Research, 47*(2), 459-506. doi:10.1111/j.1475-679X.2009.00319.x

Holder, A. D., Karim, K. E., & Robin, A. (2013). Was dodd-frank justified in exempting small firms from section 404b compliance? *Accounting Horizons, 27*(1), 1-22. doi:10.2308/acch-50288

Jaara, O. O., & Oweis, M. R. (2016). The impact of sarbanes oxley 404 exemption on; non-accelerated filers, investor's confidence, and external audit fees. *International Journal of Accounting & Financial Reporting (IJAFR), 6*(1), 20-37. doi:10.5296/ijafr.v6i1.8911

Kroll, K. (2012). Fresh SEC guidance for non-accelerated filers. *Compliance Week, 9*(99), 24-64. Retrieved from http://search.ebscohost.com.libproxy.unh.edu/login.aspx?direct=true&db=bth&AN=79359677&site=ehost-live

Securities and Exchange Commission (SEC) 2002. Final rule: Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports. Release No.33-8128. Available at: https://www.sec.gov/rules/final/33-8128.htm

Securities and Exchange Commission (SEC). 2005. Final rule: Revisions to accelerated filer definition and accelerated deadlines for filing periodic reports. Release No. 33-8644. Available at: https://www.sec.gov/rules/final/33-8644.pdf

Securities and Exchange Commission (SEC). 2009. Study of the Sarbanes-Oxley act of 2002 section 404 internal control over financial reporting requirements. Available at: https://www.sec.gov/news/studies/2009/sox-404_study.pdf

Wilbanks, D. (2016). The sarbanes-oxley act. *Professional Safety, 61*(2), 23-25. Retrieved from http://libproxy.unh.edu/login?url=https://search-ebscohost-com.libproxy.unh.edu/login.aspx?direct=true&db=bch&AN=112903797&site=eds-live