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ACCOUNTING & AUDIT

Some Businesses Choosing Debt Over Selling Stock to Avoid Audit

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For some years now, growing corporate debt has evoked much headshaking among financial observers, who have described it in terms ranging from "big concern" to

"unexploded bomb," and who now see its hazards greatly increased by the potential economic effects of the COVID-19 pandemic.

While extremely low interest rates are generally assigned most of the responsibility for the debt explosion, regulatory factors have been implicated as well. Now research in a leading accounting journal newly identifies federal accounting regulations that have had the unintended effect of spurring indebtedness among one particular group of companies – small firms that have sought to navigate among those rules to their advantage.

The rules in question are Section 404 of the Sarbanes-Oxley act of 2002 (SOX 404) and an exemption that permits small firms to avoid an expensive requirement of this provision. According to the new study in ***The Accounting Review***, a peer-reviewed journal of the **American Accounting Association**, the exemption considerably increases the likelihood that the small firms qualifying for it will fund growth by incurring debt rather than by selling common stock.

A salient part of Congress' response to the notorious corporate accounting scandals of nearly two decades ago, SOX 404 mandates that corporate managements and their external auditors both attest to the effectiveness of company internal controls over financial reporting. But, as the study notes, SOX 404 "has been especially costly and controversial for smaller firms," which has led the SEC (and then Congress through the Dodd-Frank act) to exempt them from the provision's expensive auditor-attestation requirement. Firms qualify for this exemption principally on the basis of the smallness of their public float (the value of company shares held by the public at large), with the maximum initially set by the SEC at $75 million and raised in March of this year to $250 million. Avoiding the expensive auditor-attestation requirement gives companies a strong incentive to keep their public floats below the regulatory threshold.

As the study's authors, David P. Weber and Yanhua Sunny Yang of the University of Connecticut, explain, "The traditional trade-off theory of capital structure views financing choices as a balancing of various costs and benefits of debt versus equity... The SOX 404 exemption can affect that balance and the resulting financing choices of firms near the threshold by making additional common equity relatively more costly and additional debt relatively less costly."

And, indeed, the professors find that the exemption has done precisely that, a result "consistent with firms' altering their financing choices to maintain their exemptions and avoid costly regulation." This choice, Prof. Weber acknowledges, could prove to

come at a severe cost for some companies in the current pandemic. As he says, "Certainly one potential cost of taking on more debt than would otherwise be optimal is the increased risk of financial stress in the event of a negative economic shock, such as the current coronavirus situation."

In analysis involving 1,095 small public firms, the professors found strikingly different patterns in raising capital between those slightly above the SOX-mandated threshold (with a public float of $75 to $100 million) and those slightly below the threshold ($50-75 million). Before SOX, both groups were about equally likely to issue common stock as a means of external financing; after SOX the below-threshold firms were on average 19.4% less likely to issue common stocks than those above the threshold. As the researchers observe, this is a sizable effect considering that common-stock issuance accounted for only 47% of the external financing of the two groups combined.

Another analysis, while involving a much smaller number of firms, is also revealing. The professors focused on twenty-five companies that issued debt in a given year in the post-SOX era, some of whom rose above the $75-million threshold the following year and some of whom did not. Among the former group about half issued common stock in addition to taking on debt in their first year after rising above the threshold; in contrast only about 20% of the latter group issued stock, with almost 80% continuing to rely exclusively on debt. Though based on a relatively small sample, the difference between groups was statistically significant.

The research also finds the propensity to favor debt over equity to be strongest among the companies that have the highest market-to-book ratios – in the professors' words, firms "with highly valuable growth options." Through debt those companies seek to remain below the public-float threshold while pursuing opportunities too promising to pass up.

The study's findings are based on data regarding the external-financing activities of 1,095 unique firms during the six years prior to and the nine and a half years following the enactment of SOX. As indicated above, the research sample consisted of companies with a public float of between $50 million and $100 million, about 36% of whom were below the $75 million threshold and about 64% above it. Included in the analysis was any year in which a company raised, by sale of common stock or by incurring debt, a sum amounting to five percent or more of its total assets.

In view of the unintended effects of SOX 404 on corporate financing uncovered by the study, what inference should be drawn about the recent raising of the exemption

threshold to $250 million? Comments Prof. Weber: "While it is still too early to have definitive data on this, it is reasonable to conjecture that it may have a potential benefit in taking some pressure off smaller firms to favor debt over equity and shifting it to larger firms that may be better able to absorb the costs of threshold avoidance.

"It should be noted, however, that some leading accounting scholars have argued against expanded exemption, claiming that any cost savings larger companies realize through it will be dwarfed by hazards to investors. Our paper does not speak to this question. The study's value, we believe, is in alerting regulators to a heretofore unrecognized, though important, effect of SOX 404 and, more generally, of basing regulatory exemptions on equity values."

The study, "The Debt-Equity Choice When Regulatory Thresholds are Based on equiy Values: Evidence from SOX 404," is in the March/April issue of ***The Accounting Review***, a peer-reviewed journal published six times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Auditing: A Journal of Practice and Theory, Accounting Horizons, Issues in Accounting Education, Behavioral Research in Accounting, Journal of Management Accounting Research, Journal of Information Systems, Journal of Financial Reporting, The Journal of the American Taxation Association,* and *Journal of Forensic Accounting Research.*

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