SEC Raises Risks for Small Cap Investors

Check out this week's Danger Zone interview with Chuck Jaffe of Money Life.

The Securities and Exchange Commission just made investing more dangerous for the little guy.

Under a new proposal, nearly 1,000 more companies can omit disclosures about their internal accounting controls that warn investors of potential red flags. This rule change puts investors in micro-cap stocks in the Danger Zone.

Background on This Reduction in Protection

Under existing rules, companies with under $75 million in public float are defined as "smaller reporting companies" (SRC's) and exempted from some disclosures that are mandatory under Section 404(b) of the Sarbanes-Oxley Act. Most notably, these firms don't have to disclose the auditor's opinion on their internal controls for financial reporting. These opinions warn investors when there are issues with the personnel, processes, or technology that make a company's accounting potentially unreliable.

The new SEC proposal would raise this cap from $75 million to $250 million, allowing an estimated 966 additional companies to avoid this disclosure. According to the SEC, this change will reduce the administrative burden on smaller companies and make public markets more accessible. In practice, it won't have any impact on access to capital markets, but it will significantly increase the risk for investors.

The SEC's Stated Reasons for the Reduction Don't Hold Water

The SEC has framed this change as sticking up for the little guy. In the press release announcing the rule change, Chairmen Jay Clayton said:

"*Both smaller companies — where the option to join our public markets will be more attractive — and Main Street investors — who will have more investment options — should benefit*."

The justification for this change rests on the assumption that raising the cap to $250 million will encourage smaller companies to go public, thereby giving them access to capital while increasing the range of investment opportunities available to public market investors.

Unfortunately, the SEC's own research contradicts this assumption. A 2011 analysis by the Chief Accountant of the SEC stated:

"There is no conclusive evidence from the study linking the requirements of Section 404(b) to IPO activity."

IPO activity has dropped since the 404(b) requirements were put in place in 2002, but that decline is most likely driven by the huge increase in capital available from private markets, not public disclosure requirements. Unicorns like Uber and Airbnb have delayed IPOs because they can raise all the money they need from VC's, not because going public would involve too much red tape. Besides, most IPO's are already exempted from 404(b) requirements for their first five years anyway.

Furthermore, there's evidence that exempting smaller companies from audits will actually drive individual investors away, which would completely contradict the SEC's reasoning. A study in the Washington University Law Review found that reduced disclosures led to decreased trading in recent IPO's. If the SEC wants Main Street investors to have access to more micro-cap stocks (a questionable goal in the first place), decreased disclosure requirements are not the way to go.

How This Rule Change Can Hurt You: Acacia Research Corporation (ACTG)

Acacia Research (ACTG) fell 40% after disclosing that auditors saw material weakness in its internal controls in 2017.

We warned our clients of the risks related to this weakness during last year's 10-K filing season and suspended our rating on the stock, as we do for all stocks where the companies' auditors have identified such weaknesses. If the auditors do not have confidence in the firm's accounting, we don't have confidence in the integrity of its financials either.

How This Rule Change Can Hurt You: According to the Journal of Accounting, Auditing and Finance

While, we can't say that the weakness in internal control is the only reason for ACTG's decline, we know that such weaknesses mean materially higher risk. Don't just take our word on that front.

A study in the Journal of Accounting, Auditing, and Finance found that material weaknesses lead to an increased risk of stock crashes. We wonder if this study factors into the SEC's decision making here?

Acacia's market cap in early 2017 hovered right around $250 million, so it would have been right on the cusp of being a company that could avoid disclosing its material weakness. Investors deserve to have all the information needed to understand the potential risks of an investment. Clearly, the internal control audit makes the short list of needed information.

Investing in micro-cap stocks is already a risky endeavor, so the SEC should be looking to reduce that risk, not amplify it. Getting rid of internal control audits creates additional risk for investors by hiding red flags that they could otherwise use to make more informed decisions about their investments.

Audit Opinions Serve a Crucial Purpose for Executives, Boards and Investors

Even if eliminating the mandate for smaller companies to audit their internal controls did lead to more IPO's, that would be a questionable tradeoff. After all, these audits ensure the accuracy of financial reporting and the integrity of the processes that support them, which are just as important for internal decision making as they are for public investors. A company with material weakness in its internal controls might miss serious problems with its business until they are too late to fix.

You'd think managers and executives would want this information. Who would choose to ignore internal accounting controls? And, if managers and board members are doing their diligence on internal controls, then is there any good reason not to disclose that diligence to investors?

Lastly, don't investors deserve to know that the executives are or are not doing that diligence?

Third-party studies have shown the value of internal control audits. Companies that choose not to audit the internal controls of new acquisitions – another exemption allowed by the SEC – earn lower returns on assets and have higher levels of goodwill impairment and financial restatements.

Internal control audits should be basic operating procedure for companies of any size.

One Risky Company to Avoid Today

Sparton Corp (SPA) is another company in the $75-$250 million market cap range that recently disclosed a material weakness in internal controls. The design and manufacturing company reported in its 2018 10-K that its new enterprise resource planning system had improperly accounted for inventory and cost of goods sold on its contracts with the U.S. military.

The company has restated its recent quarterly financials to account for this mistake and claims it has put in place new processes to avoid future problems. However, the existence of this accounting issue should have investors concerned about future problems. Until the company has demonstrated, over a sustained period of time, that it has adequate controls in place to maintain accurate financial reporting, investors should view SPA's financial statements with skepticism.

On top of the accounting concerns, SPA poses risks to investors through its poor fundamentals and expensive valuation. The company's return on invested capital (ROIC) declined from 13% in 2012 to 4% in 2018, and it has burned a cumulative -$86 million (60% of market cap) in free cash flow over the past six years.

Despite its ongoing struggles, SPA's valuation implies significant future cash flow growth. In order to justify its stock price of ~$14/share, SPA must grow after-tax operating profit (NOPAT) by 7% compounded annually for the next 10 years. See the math behind this dynamic DCF scenario.

The combination of declining fundamentals, an expensive valuation, and auditor's concerns about internal accounting controls make SPA a stock investors should avoid.

The SEC Needs Technology to Protect Investors

One has to wonder if the proposed rule change has less to do with the best interests of investors and more to do with the SEC's own limited resources. The chronically underfunded agency faces an especially daunting challenge this year as it will be forced to retry over 100 cases after a Supreme Court ruling invalidated cases heard by its in-house judges.

Perhaps, this new proposal signals that the SEC decided that it couldn't afford to verify disclosures for nearly 1,000 micro-cap companies. After all, fewer disclosure means less work.

Regardless of the reasoning behind the decision, the SEC could benefit from adopting new technologies to aid in its enforcement of proper disclosures. Our research finds all kinds of material disclosure transgressions, many of which were brought to the attention to the SEC many years ago.

Rather than scale back protections for investors, we believe the SEC could benefit from leveraging more technology. There are many tasks that machines can perform better and in place of humans so that the agency's human resources can focus on higher level problems.

For example, machine learning and natural language processing tools can flag unusual assumptions or other red flags hidden in the footnotes that might be signs of potential fraud. These tools could help the agency better target its human resources to crack down on misleading accounting and fulfill its stated purpose of protecting individual investors.

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Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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