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PCAOB White Paper Calls Attention to the Risk of Material Weaknesses at Emerging Growth Companies

Last week, the Public Company Accounting Oversight Board (PCAOB) released its semi-annual white paper[1] providing general information about certain characteristics of emerging growth companies (EGCs). The PCAOB's white paper provides the following key observations:[2]

- There were 1,951 companies that identified themselves as EGCs in at least one SEC filing since 2012 and have filed audited financial statements with the SEC in the 18 months preceding the measurement date ("EGC filers").[3] The PCAOB staff observe that the number of EGC filers has grown since the enactment of the Jumpstart Our Business Startups (JOBS) Act, but has stabilized recently.[4]
- There were 742 EGC filers (or 38 percent) that have common equity securities listed on a U.S. national securities exchange ("exchange-listed"). These EGC filers represented 15 percent of the 4,797 exchange-listed companies and approximately 1 percent of total market capitalization of exchange-listed companies.
- The five most common industries for EGC filers as of November 16, 2016, are pharmaceutical preparations, blank check companies, real estate investment trusts, prepackaged software, and surgical/medical instruments and apparatus.[5]

[1] PCAOB staff updates this white paper semiannually, based on the most recent data available as of May 15 and November 15 in each year.

[2] *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016*, Kevin Murphy, Tosha Williams and Harsha Samaraweera, PCAOB: https://pcaobus.org/EconomicAndRiskAnalysis/ORA/Documents/White-Paper-Characteristics-Emerging-Growth-Companies-November-2016.pdf.

[3] In its white paper, the PCAOB notes that the 1,951 EGC filers do not include companies that were not reporting as EGCs as of the measurement date, as follows:
(i) 200 companies that ceased to qualify as EGCs because of their annual revenue or large accelerated filer status,
(ii) 465 companies that ceased to be SEC registrants, and
(iii) 414 companies that did not file audited financial statements with the SEC in the 18 months preceding the measurement date ("inactive EGCs").

[4] *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016*, p. 7.

[5] Ibid, p. 11.

- Many EGC filers that were not exchange-listed had limited operations. Approximately 50 percent of the non-listed EGC filers reported zero revenue in their most recent filing with audited financial statements and 23 percent of non-listed EGCs that filed periodic reports disclosed that they were shell companies.
- Approximately 51 percent of EGC filers, including 74 percent of those that were not exchange-listed, received an explanatory paragraph in their most recent auditor's report expressing substantial doubt about the company's ability to continue as a going concern.
- Among the 1,951 EGC filers, 1,262 provided a management report on internal control over financial reporting in their most recent annual filing. Of those 1,262 companies, approximately 47 percent reported material weaknesses.
- Approximately 96 percent of EGC filers were audited by accounting firms that also audited issuers that are not EGC filers, including 39 percent of EGC filers that were audited by firms that provided audit reports for more than 100 issuers and were required to be inspected on an annual basis by the PCAOB.

The observation on material weaknesses is noted as an issue for which further comment is warranted below.

Background

EGCs are a group defined by the JOBS Act, which was passed into law in 2012. The JOBS Act is designed to make it easier for small and growing businesses – specifically, those on track to conduct an IPO – to attract investors and access capital while complying with U.S. securities laws. For these businesses, the JOBS Act changes existing securities laws in a number of ways. Specifically, it:

- Encourages IPOs by organizations defined as EGCs.
- Facilitates the ability of companies to raise capital in private and small public offerings without registering with the SEC, thereby reducing the costs and red tape associated with raising capital.

EGC is a status of eligibility laid out in the JOBS Act; to achieve this status, companies must post annual gross revenue of less than $1 billion in their most recently completed fiscal year.[6]

As the PCAOB staff note in their just-released white paper, one focus of the JOBS Act is to reduce the regulatory burdens on EGCs in order to facilitate capital raising through public markets. The JOBS Act generally provides that new PCAOB standards will not apply to the audits of EGCs unless the SEC determines that applying such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency,

[6] For additional information, read Protiviti's *Guide to Public Company Transformation – Frequently Asked Questions* (Third Edition), available at www.protiviti.com/ipo.

competition and capital formation. To implement this provision, upon adoption of a rule subject to this determination, the PCAOB recommends to the SEC whether the rule should apply to audits of EGCs, and submits information and analysis in its adopting release to assist the SEC in making a determination. The purpose of the PCAOB's white paper is to provide general data about EGCs to inform the analysis contained in PCAOB rulemaking releases regarding the impact of applying new standards to the audits of EGCs.[7]

Implications and Recommendations for EGCs

There are a number of benefits to a registrant to being classified as an EGC under the JOBS Act. Among these benefits, as detailed in Protiviti's *Guide to Public Company Transformation* (www.protiviti.com/ipo), the JOBS Act:

- Allows adoption of any new or revised accounting standards using the same time frame as private companies if the standard applies to private companies. Usually, new accounting standards provide for a less-demanding timeline for private companies (compared to public companies) in transitioning to, and implementing, the new standard.
- Permits general solicitation in direct public offerings, thereby broadening the investor base.
- Allows engagement with qualified institutional buyers and institutional accredited investors in oral or written communications to gauge their interest in a proposed IPO either prior to or following the first filing of the IPO registration statement.
- Exempts from registration under the 1933 Securities Act transactions involving the offer or sale of securities by an issuer over a 12-month period of either (a) $1 million or less, or (b) if the issuer provides potential investors with audited financial statements, $2 million or less, with both amounts adjusted by the SEC for inflation.
- Permits submission of a draft registration statement on a confidential basis to the SEC staff for confidential nonpublic review prior to public filing, so long as the initial confidential submission, and any required amendments, are made public at least 15 days before the issuer's commencement of a roadshow.
- Permits an equity IPO registration statement with two years of audited financial statements (as opposed to the prior requirement calling for three years of audited financial statements).[8]
- Allows omission of selected financial data (which is currently required for up to five years of data) for any periods preceding the earliest audited financial statements included in the initial registration statement, including within its selected financial data or in its management discussion and analysis (MD&A) disclosure for those periods. This provision would apply to

[7] *White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016*, p. 4.

[8] However, this provision applies only to an equity IPO registration statement. It would not apply to other registration statements or to periodic reports, such as the Annual Report on Form 10-K under the 1934 Exchange Act.

future registration statements and periodic reports, such as the Annual Report on Form 10-K under the 1934 Exchange Act.

- Provides compliance with the SEC's executive compensation disclosure requirements on the same basis as a smaller reporting company.
- Exempts from certain provisions of the Dodd-Frank Act, including current and future executive compensation-related disclosures (e.g., the "say-on-pay" vote requirement), the advisory vote on golden parachute payments requirement ("say-on-golden-parachutes"), the requirement to disclose the relationship between executive compensation and the financial performance of the company ("pay-for-performance"), and the CEO pay-ratio disclosure requirement.
- Exempts from compliance with the internal control attestation requirements of Sarbanes-Oxley Section 404(b), as well as any future PCAOB rules that might be adopted relating to mandatory audit firm rotation or supplemental auditor discussion and analysis reporting.

While these exemptions and benefits may be attractive, they do not mean that EGCs should accept or minimize issues surrounding potential findings of material weaknesses. These deficiencies in internal control over financial reporting may undermine a company's reputation in that market. As noted in the PCAOB's white paper, 47 percent of EGC filers reported material weaknesses in their most recent annual filings.

This risk is real and should be addressed proactively. Therefore, EGCs should consider developing a **financial reporting risk profile** (FRRP), a proactive approach developed by Protiviti to identify financial reporting issues and manage them in order to head off financial restatements before they occur, thereby better enabling management to focus efforts on more important matters and reduce the risk of reputation damage.

An effective FRRP focuses on six areas:

- Accounting principle selection and application
- Estimation processes
- Related-party transactions
- Business transaction and data variability
- Sensitivity analysis
- Measurement and monitoring

The underlying objective of an FRRP is to identify the most likely areas of potential misstatements so that the appropriate oversight and control can be established to reduce the financial reporting risk to an acceptable level. For these reasons – along with the fact that the focus areas listed above correspond to several of the most common reasons why newly public companies have material weaknesses and are forced to issue financial restatements – the FRRP process represents a valuable exercise for the leadership of EGCs and their boards.

Furthermore, EGCs should take the necessary steps to document all key business processes that feed the financial reporting process so that these processes are repeatable and better defined, reducing reliance on ad hoc activity by key employees. These processes may include a fair amount of financial reporting-related policies and activities, such as those that aid in the preparation of financial schedules for external auditors in the support of audits, filings, executive compensation policies, all employee benefit plans and related disclosure requirements.

Additionally, pre-public companies should design and implement a process for documenting conclusions on reporting and accounting matters. This process should:

- Provide background on current transactions, issues or circumstances that warrant an explanation (e.g., transactions involving significant estimates or judgments).
- Identify key accounting and reporting questions.
- Reference all pertinent accounting standards and guidelines.
- Outline facts, historical trends, available data and details of the transaction or issue.
- Identify acceptable approaches and alternatives for applying the applicable standards and guidance.
- Document management's analysis and rationale for the selected alternative, applying the appropriate principle or standard.

In our view, the above steps are critical because they minimize the risk of an occurrence of one or more material weaknesses in the organization's financial reporting. Consider the possible effects of just one material weakness on an EGC:

- Erosion of shareholder confidence
- Potential share price reduction
- Distraction throughout the organization
- Reduced brand equity
- Significant remediation costs, including organizational time and effort along with outside legal and other fees

The tables below list the most common issues that result in a material weakness, according to data from Audit Analytics (www.auditanalytics.com):

Internal control issues undermining the effectiveness of internal control over financial reporting (fiscal year 2015):

Material and/or numerous auditor/year-end adjustments
Accounting personnel resources, competency/training
Information technology, software, security and access issues
Segregation of duties/design of controls (personnel)
Non-routine transaction control issues
Inadequate disclosure controls (timely, accuracy, complete)
Restatement of nonreliance of company filings
Journal entry control issues
Ethical or compliance issues with personnel
Senior management competency, tone, reliability issues
Restatement of previous 404 issues
Treasury control issues
Insufficient or nonexistent internal audit function

Accounting issues undermining the effectiveness of internal control over financial reporting (fiscal year 2015):

Revenue recognition issues
Tax expense/benefit/deferral/other (FAS 109) issues
Accounts/loans receivable, investments and cash issues
PPE, intangible or fixed asset (value/diminution)
Foreign, related party, affiliated and/or subsidiary issues
Acquisition, merger, disposal or reorganization issues
Expense recording (payroll, SG&A) issues
Debt, quasi-debt, warrants & equity (BCF) security
Cash flow statement (FAS 95) classification errors
Lease, FAS 5, legal, contingency & commit issues
Capitalization of expenditures issues
Deferred, stock-based or executive compensation issues
Lease, leasehold and FAS 12 (98) (subcategory) issues

The varied nature of these issues points to the need for a FRRP and better-documented processes to enable management to get their arms around the potential sources of serious internal control issues.

In Closing

Potential EGCs looking to file publicly should consider undergoing a comprehensive evaluation of their readiness to become a publicly held organization. Those already public may need to fast-track their readiness and compliance initiatives. Key steps should include the following:

- Assemble a team or PMO with experience in the public company readiness process, including but not limited to legal, finance, operations and IT.
- Implement strong corporate governance protocols, including an independent board of directors and audit committee and appropriate board committee structure with experienced directors.
- Ensure strong fraud controls are in place.
- Establish strong entity-level controls and an appropriate tone at the top, with the requisite governance policies and procedures and a strong code of conduct that is communicated and reinforced.
- Plan and build an IT infrastructure and processes that are scalable and sustainable.
- Design and execute a capable forecasting process.
- Assign or bring in professionals possessing the necessary knowledge and technical expertise in the relevant accounting and reporting requirements (e.g., to ensure reliable SEC filings).
- Build strong internal control over financial reporting processes and controls to reduce financial reporting risk to an acceptable level.

We cannot stress strongly enough that it is important not to wait until the first auditor attestation to address the above areas. Many of them should be in place prior to the company's first public filing (e.g., 10Q, 302/906), and others should be in place prior to the initial management assertion on the effectiveness of internal control over financial reporting, as required by Sarbanes-Oxley Section 404(a). If these areas have not been addressed and the first public filing is upcoming, the organization should prepare itself by putting in place a robust remediation program.

About Protiviti

Protiviti is a global consulting firm that delivers deep expertise, objective insights, a tailored approach and unparalleled collaboration to help leaders confidently face the future. Protiviti and our independently owned Member Firms provide consulting solutions in finance, technology, operations, data, analytics, governance, risk and internal audit to our clients through our network of more than 70 offices in over 20 countries.

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