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Audit Committee Material Weaknesses in Smaller Reporting Companies: Still Struggling

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The audit committee is an essential component of corporate governance, playing an important role in protecting shareholders from reputational risks and decreased value that can arise from fraudulent financial reporting, corruption, and bribery activities (Deloitte, 2013). However, at many smaller reporting companies, the audit committee often has been a missing, or ineffective, link in the chain of corporate governance. Specifically, Gramling *et al.* (2009) found that 19.5% of smaller reporting companies with material weaknesses in internal control in 2008 disclosed that they had a weakness related to the audit committee.

This paper provides data on the extent to which smaller reporting companies disclosed audit committee material weaknesses during the period from 2008 through 2011. We also provide detailed information on the types of audit committee weaknesses disclosed by these companies in 2011. Our purpose is to examine whether smaller reporting companies collectively have improved their corporate governance (i.e., audit committees) since 2008, or whether audit committee weaknesses are still an issue for these types of companies as a group. The next section provides background information, followed by the results and conclusions.

BACKGROUND

The SEC's rules require public companies to issue an annual report on the company's internal control over financial reporting and to include an opinion by their auditor on the

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effectiveness of internal control over financial reporting. According to COSO's website (http://www.coso.org/ic.htm), "the most widely used internal control framework in the U.S." is COSO's (1992) *Internal Control – Integrated Framework*. Companies use COSO as the benchmark for assessing the effectiveness of their internal controls (including the audit committee).

Smaller reporting companies began complying with SOX Section 404 for fiscal years ending on or after December 15, 2007. However, while SOX Section 404 does require an external auditor's opinion on the effectiveness of internal control over financial reporting, the Dodd-Frank Act permanently exempted smaller public companies from having a separate auditor's report on internal control. Therefore, only management is required to issue a report on internal controls for smaller public companies.

RESULTS

Trends in Audit Committee Material Weaknesses from 2008 to 2011

We used the *Audit Analytics* database to identify smaller reporting companies (to focus only on smaller reporting companies, we searched U.S.-based public companies with market capitalization greater than $0 and less than $75 million and screened out two companies in 2008 and one company in 2010 with auditor reports on internal control[1]) with management reports on internal control indicating material weaknesses related to audit committees for fiscal years 2008 through 2011 (as of March 2013). Table 1 provides an annual comparison of the number of total and initial smaller reporting companies with material weaknesses related to audit committees.

[Insert Table 1 about here]

[1] These companies are screened out, as the presence of an auditor report on internal controls indicates that the companies are not smaller reporting companies. Rather, they appear to be larger companies that have suffered market value declines, falling below $75 million.

The number of total and initial material weaknesses related to audit committees for smaller reporting companies remained relatively consistent for the years 2008 through 2011. Table 1 indicates that almost half (average of about 47%) of smaller reporting companies with a material weakness related to audit committees each year from 2008 through 2011 are new additions to the list, which we refer to as "initial companies" (17 companies appeared in Table 1 for all years from 2008 through 2011). The fact that over half of the companies failed to remediate their audit committee material weaknesses in the next year is troubling. Academic research (Hammersley *et al.*, 2012) notes that a failure to remediate material weaknesses is associated with greater audit fees, greater likelihood of auditor resignation, and greater likelihood of receiving a modified or going concern audit opinion. Thus, un-remediated internal control weaknesses are costly to companies in terms of both reputational and direct monetary costs. Table 1 also reveals that a little over half (average of about 53%) of smaller reporting companies with material weakness related to audit committees each year from 2008 through 2011 do not report such a weakness in the following year. This could be because the companies corrected the problem, or the companies may have disappeared from the database.

Table 2 indicates that the percentage of smaller companies reporting a material weakness related to audit committees remained relatively stable from 2008 to 2010, but increased in 2011, indicating no improvement over time for the overall group of smaller reporting companies.[2] Table 2 also discloses that the total number of smaller reporting companies declined steadily in each year from 2,041 in the 2008 fiscal year to 1,452 in the 2011 fiscal year, a total decrease of

[2] We recognize that individual companies may have remediated their audit committee material weaknesses, but the overall group's collective performance has not improved over time.

29%. This decrease appears consistent with reports of a continuing decline in the number of U.S. public companies (Weild and Kim, 2009; Krantz, 2013).[3]

[Insert Table 2 about here]

Sample Companies in 2011

Table 3 provides descriptive information about the 86 sample companies that had material weaknesses related to audit committees in fiscal year 2011. The companies are quite small, with median market capitalization of $5.7 million, median revenues of $0, and median assets of $277,000. Median revenues of $0 likely indicate the presence of development stage companies, which are in the early stage of their life and focus on business activities such as R&D or marketing (Investopedia, 2013). The limited financial resources of these smaller companies may be an important reason for the existence of material weaknesses related to audit committees.

The companies cover a broad range of industries, with the greatest concentration in agriculture, mining, and construction; wholesale and retail; and transportation and communication. Among industries with more than 20 total companies, the industry group of agriculture, mining, and construction had the highest rate (12%) of smaller companies with material weaknesses related to audit committees. The financial, insurance and real estate industry reported the lowest rate (2.7%) of smaller companies with weaknesses related to audit committees. Manufacturing is the largest industry, and it experienced a 5.5% rate of smaller companies with weaknesses related to audit committees.

[Insert Table 3 about here]

[3] Weild and Kim (2009) cite regulatory changes to promote lower trading costs as the main reason that the number of U.S. public companies is declining. They assert that these regulatory changes have produced numerous unintended consequences.

Finally, the companies typically have other material weaknesses in addition to their audit committee weaknesses. The median number of material weaknesses disclosed is three, with a range of 1-7.

Audit Committee Material Weaknesses

We analyzed the management's report on internal control over financial reporting for each of the 86 companies to determine the nature of the audit committee-related material weaknesses (based on management's description of the problem). The most common weaknesses reported for fiscal year 2011 are presented in Table 4. For purposes of comparison, the three most commonly reported weakness reported for fiscal year 2008 (Gramling *et al.*, 2009) included the lack of an audit committee, or the lack of a functioning audit committee (65% of companies with an audit committee material weakness), lack of independent (or outside) board members or audit committee members (52%), and lack of board members with financial expertise (29%).

[Insert Table 4 about here]

The total number of weaknesses reported in Table 4 exceeds 86, as many companies cited more than one material weakness related to the audit committee. The results reported in Table 4 for fiscal 2011 identify the same top three audit committee material weaknesses as in Gramling *et al.* (2009): the lack of an audit committee, or the lack of a functioning audit committee (72% of companies with an audit committee material weakness), lack of independent (or outside) board members or audit committee members (47%), and lack of board members with financial expertise (28%). Thus, the audit committee situation is largely unchanged from 2008 to 2011 – the same issues are found in smaller reporting companies in 2011 as in 2008.

In addition, 11 disclosures (13%) related to weaknesses in entity-level controls, six described weakness in board oversight (not specifically mentioning the audit committee) (7%), and two described the lack of an independent audit committee chair (2%).

The weaknesses summarized in Table 4 primarily relate to audit committee existence or composition – establishing an audit committee and getting independent financial experts on the committee. Thus, the vast majority of disclosed weaknesses continue to be foundational issues of audit committee existence or composition, as opposed to more specific issues present in functioning audit committees. Solving this problem of audit committee existence and composition by adding new directors can be quite lengthy, as discussed by PwC (2013).

CONCLUSION

This study suggests that the nature and extent of audit committee material weaknesses have not improved over the last several years for the group of smaller reporting companies collectively. However, we believe that companies of all sizes, and most importantly, smaller reporting companies, are going to find themselves focusing more efforts on improving their audit committees. This increased focus will likely result from at least four sources. First, the Committee of Sponsoring Organizations (COSO, 2013) issued its new internal control framework in May 2013. COSO's new framework focuses more strongly on the role of a corporation's board and board audit committee than the prior COSO guidance did (Hoffelder, 2013). Second, the PCAOB (2012) issued new guidance on external auditor communication with the audit committee. This guidance further highlights the important role of the audit committee in the financial reporting process. Third, Beasley *et al.* (2010) find that fraudulent financial reporting cases overwhelmingly involve the CEO and/or CFO. Such a finding puts additional pressure on the audit committee to take a lead role in mitigating the risk of accounting fraud.

Finally, there has been an increased focus by the SEC on the Foreign Corrupt Practices Act (FCPA), and hence companies have strengthened efforts to bolster their anti-corruption/bribery programs. Audit committees are increasingly being asked to consider how their companies mitigate corruption/bribery risks (Deloitte, 2013).

To address continuing issues with audit committee fundamentals in smaller reporting companies, we recommend that boards and/or management of such entities discuss the reasons for their audit committee weaknesses and look for assistance in the improvement process. Specifically, in addition to available published resources (Gramling *et al.*, 2009), we encourage companies to consult with their external auditors, attorneys, the National Association of Corporate Directors, and stock exchange representatives for additional insights into building an effective audit committee in a smaller public company. A recent report published by the Center for Audit Quality (CAQ, 2013) emphasizes that to be effective, an audit committee needs to have a diverse membership and an audit committee chair who is a strong leader. While our analysis shows no progress on the audit committee front from 2008 to 2011, it is clear that pressures continue to mount for effective audit committees in all U.S. public companies, regardless of size.

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TABLE 1
Annual Comparison of the Number of Total and Initial Smaller Reporting Companies with Material Weaknesses Related to Audit Committees

	2011 Fiscal Year	**2010 Fiscal Year**	**2009 Fiscal Year**	**2008 Fiscal Year**
Total Companies	86	78	84	90
Initial Companies	39	37	41	N/A
% Initial Companies	45%	47%	49%	N/A

Total Companies represent distinct registrants with material weaknesses related to audit committees. These companies are U.S.-based, have a market value greater than $0 and less than $75 million, and do not have an auditor report on internal controls.
Initial Companies represent distinct registrants included in "total companies" that did not report a material weakness related to audit committees in the *prior* fiscal year.

TABLE 2
Smaller Reporting Companies with Material Weaknesses Related to Audit Committees
(Number and Percentage of All Smaller Reporting Companies)

	2011 Fiscal Year	**2010 Fiscal Year**	**2009 Fiscal Year**	**2008 Fiscal Year**
Smaller Companies with MW Related to Audit Committees	86	78	84	90
All Smaller Companies	1,452	1,609	1,896	2,041
Smaller Companies with MW Related to Audit Committees % of All Smaller Companies	5.9%	4.9%	4.4%	4.4%

Note: Smaller reporting companies included above are distinct registrants, U.S.-based companies with a market value of greater than $0 and less than $75 million, and do not have an auditor report on internal controls.

TABLE 3
86 Smaller Reporting Companies with
Material Weaknesses Related to Audit Committees
for 2011 Fiscal Year

Company Size

	Median
Market Value	$5,699,645
Revenues (50 companies had $0 revenues per Audit Analytics)	$0
Assets (n = 83)	$277,386

Total Number of Material Weaknesses

Median number of material weaknesses per company	3
Range of material weaknesses per company	1-7

Standard Industrial Classification Codes

	86 Smaller Reporting Companies with Material Weakness Related to Audit Committees	1,452 Total Smaller Reporting Companies for Industry	Percentage of Companies with MW Related to AC for Industry
0000-1999 Agriculture, Mining, and Construction	14	117	12.0%
2000-3999 Manufacturing	29	529	5.5%
4000-4999 Transportation and Communication	6	69	8.7%
5000-5999 Wholesale and Retail	7	80	8.8%
6000-6999 Financial, Insurance, and Real Estate	10	365	2.7%
7000-8999 Services	18	279	6.5%
9995 Non-Operating Establishments / No SIC	2	13	15.4%
Total	86	1,452	6.0%

Note: Smaller reporting companies included above (both with MW related to AC and for industry totals) are distinct registrants, U.S.-based companies with a market value of greater than $0 and less than $75 million, and do not have an auditor report on internal controls.

TABLE 4
Summary of Weaknesses Related to Audit Committees
for 2011 Fiscal Year

Companies		
Number	% of 86	**Material Weaknesses**
62	72%	No audit committee; no functioning audit committee
40	47%	Lack of independent board or audit committee members
24	28%	Lack of financial experts to serve on the audit committee
11	13%	Weaknesses in entity-level controls
6	7%	Weaknesses in board of directors' oversight
2	2%	Lack of independent audit committee chair

Note: Number of material weaknesses exceeds the 86 companies surveyed because some companies reported more than one audit committee-related weakness.