Addressing the need for a private company clearinghouse

Market problem

Reliable financial and audit information is one of the foundations of capital markets. Emerging trends and market demands suggest the current process in the United States of exchanging private company sensitive information between CPA firms, clients, banks, investors and other entities is not working and needs to be dramatically improved.

Unlike the case with public companies, whose key data is accessible through the Securities and Exchange Commission's (SEC) Electronic Data Gathering, Analysis and Retrieval (EDGAR) system, there is no central repository for private company sensitive information in the United States. Many private businesses continue to rely on outdated and unsecured methods, such as traditional mail, hand delivery and email, to distribute financial statements, tax returns and other key documents. As a result, users of financial and related information cannot be certain if the documents they receive have been altered.

There are three trends causing lenders and investors to demand accurate, source-driven and verified financial information.

Key marketplace trends:

- Demand for authenticated information
- Digital transformation of financial services
- Compliance for private companies

Based on these trends, CPA.com, a subsidiary of the AICPA, developed an online clearinghouse that provides a secure, cloud- based platform to access private company information and, most importantly, validates the source of that data. This white paper examines the top marketplace forces that led to the creation of this document exchange **clearinghouse** for private companies.

Canopy Financial: A cautionary tale

Canopy Financial Inc., a health-care technology company[1], is an example of the type of fraud occurring today due to the current private company information exchange processes.

The company had raised $75 million in financing from venture capital and private equity firms that were impressed by the company's financial performance and market position. However, Canopy Financial's image of success was a fraud driven by two senior executives, who tricked investors into believing the company's financial results by providing fictitious audited financial statements under the letterhead of a Big Four accounting firm. Once the fraud was uncovered, the company filed for bankruptcy, leaving investors to incur millions of dollars in losses and causing great embarrassment for the private equity firm that managed the process.

The Canopy Financial case demonstrates a number of deficiencies in the current process for distributing private company financial information. Lenders and investors often rely on private companies to directly provide company financial data in formats that can be easily altered and are also unsecure. In this case, management provided a fictitious audit report and financial statements. Lenders and investors, in today's process, also have no way of verifying that the information has been provided by an appropriately licensed and peer-reviewed accounting firm.

The Canopy Financial executives were ultimately convicted and sentenced for perpetuating this fraud.

Trend I.
Demand for authenticated information

Users of private company financial and other sensitive information are beginning to require validated sources of information to support their lending and investing decisions. Many large firms and banks have experienced the use of fraudulent private company audit reports and financial statements. There are a number of ways these private company fraudulent audit reports and financial statements are being produced.

Banks are clearly increasing their focus on the sources of data they receive. One additional driver of this is the role fraudulent individual tax returns provided directly by individuals played in the consumer-mortgage crisis. Based on this, most banks prefer to use the IRS tax- transcript service to obtain business tax returns as part of their loan application process.

Fraud is driving an increasing reliance on IRS-source provided tax returns in the lending-decision process, despite more valuable information being available through CPA-prepared documents. It also clearly highlights the need for a source-validated means of obtaining private company information so the best available information is in the users' hands.

Trend II.
Digital transformation of financial services

Digital transformation in the financial services market is well underway, with cloud-based platforms giving rise to new ways of managing financial data. More than $35 billion has been invested in the Fintech market in 2023[2], with an emphasis on automation of data inputs, real-time access to information and increased reliance on source data.

An example of this trend is the emergence of alternative lending platforms that digitize the complete lending process, and today support close to 23 percent of the small-business loan market[3]. As the avenues to access capital for private business continue to evolve, so too must the vehicles of exchange and communication surrounding source data being relied on by lenders and investors.

Types of fraud:

1. Management produces a fictitious audit report and financial statement using an existing CPA firms' letterhead and report language.
2. Management alters the information in an actual CPA firm provided audited financial statement.
3. Management creates a fictitious accounting firm or uses a firm that is not properly licensed.

Trend III.
Compliance for private companies

The regulatory and compliance environment has become far more complex for private businesses, their lenders and investors, and CPA firms servicing them. An example demonstrating the environment's growing complexity is a compliance requirement under the Dodd-Frank Custody Rule[4], which requires private equity firms with more than $150 million under management to ensure that their portfolio of private company auditors follow SEC independence rules or be subject to SEC inspections without notice. These SEC independence rules prohibit a CPA firm from assisting in the preparation of a client's financial statements which includes assembling of the financial statement.

The result is that the firm provides its audit report, in an unprotected format, to the client so that the client can attach the report to the company's financial statements. This creates a genuine control risk situation for the firm where the client may accidentally or intentionally attach the CPA firm's audit report to the wrong financial statements.

Need for a private company clearinghouse

As previously discussed, traditional means of private company information exchange no longer meet marketplace demands. All parties involved in the information exchange stand to benefit from a modern, sophisticated and centralized document repository.

A private company clearinghouse should streamline the flow of sensitive documents on a digital platform and have built-in protections to prevent fraud.

A clearinghouse needs to address the following:

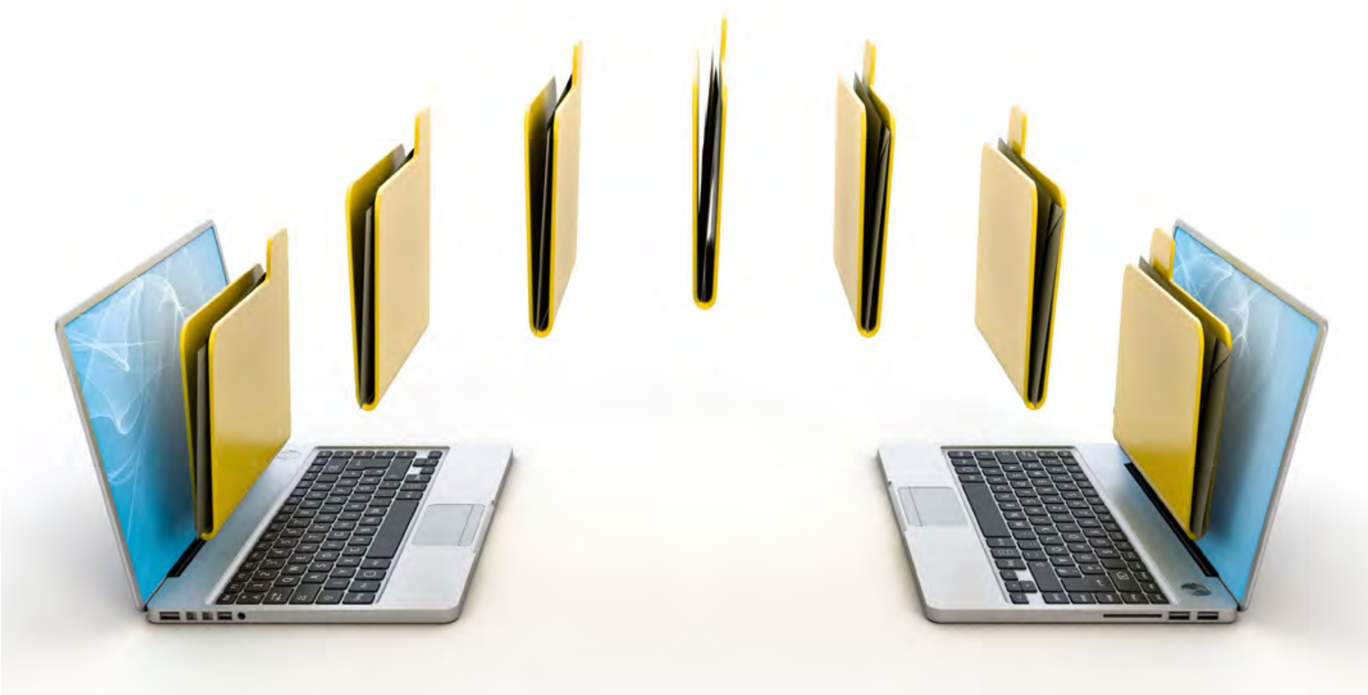
CPA firm validation
Validate CPA firm licensure and other professional requirements.

Source confirmation and document authentication
Confirm the original source of uploaded documents and ensure that documents being exchanged are authentic and unaltered.

Reduced risk and liability exposure
Reduce risk through utilization of clearinghouse workflows to maintain privity defense.

Control over distribution and user notification
Control the distribution of financial information and notify users of any change or recall of information they have received.

Document requests and tracking
Facilitate requests for documents by lenders and investors and track the status of document requests and exchanges.



CPA firm validation

CPA firms authorized to issue audit and review reports must adhere to a number of stringent professional requirements. These requirements include, though are not limited to, maintaining firm licensure with their State Board of Accountancy and where required, participating in a peer review program.

To ensure that CPAs who are uploading **sensitive** information are adhering to professional standards, a clearinghouse should be able to validate CPA firms' licensure and, where required, verify that they are current in their relevant peer-review commitments.

Source confirmation and document authentication

To address fraud associated with private companies or other third parties falsifying a CPA firm's report, a clearinghouse should validate the CPA firm as the originator of uploaded audit and review reports. It should also verify that those reports relate to the proper set of unaltered sensitive information. By doing so, the clearinghouse mitigates the need for third-party users to confirm the source of the documents directly with the CPA firm.

A clearinghouse should also ensure that uploaded CPA firm-generated documents are unaltered before clients share them with intended third parties. This capability reduces the risk of fraud in loan, investment and other financial and management decisions. By ensuring the authenticity of the exchanged information, a clearinghouse brings increased levels of confidence to third-party users in the information they are receiving.

Reduced risk and liability exposure

A major risk to private businesses and CPA firms is that they may unintentionally find themselves in a privity relationship with lenders or investors, such as private equity firms who reach out to the firm to verify the authenticity of an audit report or financial document. In many cases, this type of contact can create greater potential exposure for the business.

A clearinghouse should keep third-party users anonymous and prevent the creation of a privity relationship, and the legal issues that can follow. In addition, a clearinghouse should eliminate the need for lenders and investors to contact a firm since the information source and the report have already been authenticated by the platform.

> "The privity defense is based on privity of contract, and that is a connection between the accounting firm and the person who is relying upon the report. The question always becomes: Are you in privity with a third party that may be looking at your reports?"
>
> – Rich Miller
> *Former AICPA General Counsel*

Additionally, by ensuring the delivery of unaltered information, the clearinghouse serves as a barrier to lawsuits, which can arise when a fraudster alters or forges an audit report or referenced financial statements. Without the clearinghouse, firms will continue to be required to defend the firm's brand and reputation in cases involving fictitious users of the firm's letterhead.

Control over distribution and user notification

The clearinghouse should eliminate communication problems that can arise when a business withdraws or changes its audit report by automatically tracking recipients. The communication required by professional standards related to the withdrawal of, or change, to an issued audit report occurs, first, directly between CPA firms and their clients. Under traditional means of private company information exchange, the client is then asked to forward notification of this change to parties who are relying, or may have relied, on the original report – an obvious communication weakness if client management is not acting in good faith and wants to conceal this information. The clearinghouse should eliminate this communication inefficiency and risk by notifying anyone who has received the report through the platform that the CPA firm has withdrawn or changed its audit report.

Additionally, restricted-use reports, such as internal control, agreed-upon procedures and management-use only reports, are often distributed by management to recipients who are not intended users of the reports.

By limiting report access to a class of users solely specified by the CPA, a clearinghouse maintains control over these reports.

Document requests and tracking

Historically, for lenders and investors, the available means for requesting sensitive information from private companies and their CPA firms has been largely a manual, lengthy process with little to no transparency regarding the status or timeliness of these requests.

To address this issue, a clearinghouse needs to provide a real-time means for requesting multiple documents simultaneously and from different parties if necessary, while offering complete transparency into the status of those requests and notifications of when the information has become available. Efficiency in the exchange process meets the continued marketplace demand for immediate access to information to support lender, investor and borrower decision making.

Financial technology momentum in the lending process

A clearinghouse for private company information introduces new levels of efficiency as well as client and customer satisfaction to organizations across industries. One industry where these improvements resonate strongly is banking, which is increasingly turning to technology to stay competitive.

A clearinghouse introduces heightened efficiency to the small business loan application process by providing a digital-information source that allows banks to electronically obtain required small business financial statements and other CPA-provided documents from their original source. It also supports the bank's goal to provide capital to approved customers more quickly, and meets small businesses' expectations to receive capital as soon as possible after submitting their loan application.

Other key benefits for the bank include:

- More efficiency in the bank's due-diligence process
- Improved communication pertaining to ongoing loan covenant requirements
- Stronger technology-based competitive position

Better alignment with banks' needs

A clearinghouse's alignment with banks' technology-first approach to small-business lending gives banks renewed confidence in CPA-prepared documents and reaffirms CPAs and their services' integral role in the capital-raising process. A clearinghouse will also meet the increasing demands by banks to have authenticated source provided documents, which today has been creating over-reliance on IRS tax transcript source documents, despite more valuable information being available in other CPA-prepared documents. Looking ahead, a clearinghouse's contribution to the financing process is only expected to grow as technology's influence in financial markets intensifies.

Road to transformational change

Today's capital markets demand accurate and timely financial information, yet widespread uncertainty, inefficiency and risk plague the antiquated access and exchange processes for the financial information of private companies. In addition to capital-market concerns, a concerted focus on information authentication, sophisticated digital platforms and more complex compliance requirements have combined to create a perfect storm that surrounds the need for a centralized clearinghouse for private company information.

For CPAs, private businesses, and lenders and investors, a clearinghouse presents first-of-their-kind opportunities for the streamlined exchange of authenticated data, advances liability and fraud prevention, and manages information across a secure cloud-based platform. It also affirms the pivotal role that CPAs and their services play in market-building lending and investment decisions today and for years to come.

> "Not only will this change the way accountants will deliver information, I see a future where investors and lenders will routinely request that information be delivered through RIVIO. This marks the dawn of a new era of relevance for [CPA] practitioners."
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> – Gail Perry, CPA
> *Editor-in-Chief, CPA Practice Advisor*

Footnotes

1. https://archives.fbi.gov/archives/chicago/press-releases

2. https://www.spglobal.com/marketintelligence/en/news-insights/research/

3. https://www.forbes.com/advisor/business-loans/small-business-loan-statistics/

4. https://www.mccarter.com/insights/private-equity-sec-custody-rule-one-size-does-not-fit-all/

About this white paper

This position paper examines the top marketplace forces that led to the creation of the private company RIVIO Clearinghouse by CPA.com. In particular the paper reviews the key needs that an online clearinghouse should address.

The development of the RIVIO Clearinghouse has been supported by feedback from firms, investors and lenders, and private businesses. In addition a number of AICPA Technical Committees provided feedback along the way. We would welcome your comments and feedback as you read through this paper. Please share them at Inquire@RIVIO.com.

About RIVIO Clearinghouse

The RIVIO Clearinghouse, a service of CPA.com, an AICPA Company,is an online financial document clearinghouse that enables private businesses

to exchange key financial information with their investors and lenders as well as retrieve information from their CPA firm, ensuring data is submitted from an authenticated source. It provides a validation process to verify that CPA firms leveraging the clearinghouse are appropriately following the stringent professional requirements to upload attested financial information.

The RIVIO Clearinghouse was commercially launched into the marketplace in May 2016. RIVIO is an acronym for: Repository of Intelligent Validated Inputs and Outputs Additional resources are available on: RIVIO.com.

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