National Venture Capital Association

September 11, 2006

VIA Email

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
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Re: Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting -- Release No. 34-54122; File No. S7-11-06

The National Venture Capital Association (NVCA) represents the vast majority of American venture capital under management.[1] NVCA member firms and the funds they manage provide the start-up and development funding for innovative entrepreneurial businesses.

VC firms form and manage the funds that invest in start-up and early-stage businesses, which they commonly call "portfolio companies." Venture capital investing relies on the ability of venture capital funds ("VCFs") to exit those investments through a liquidity event, with the proceeds being distributed to their investors. Regardless of whether a given company's most likely liquidity event is an initial public offering ("IPO") or an acquisition by another company, its venture investors must maximize their return on successful companies in order to offset the inevitable losses from other entrepreneurial start-up companies.

All venture-backed companies operate with minimal staff and have a necessarily narrow focus on achieving business objectives – research and development, product development,

[1] The National Venture Capital Association (NVCA) represents more than 450 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members. For more information about the NVCA, please visit www.nvca.org.

manufacture, marketing and sales. For the types of small, high-growth technology companies that are the focus of many venture funds, investment dollars must be devoted to these key business goals. Money spent on unnecessary compliance can quickly undermine their competitive edge in this fiercely competitive sector of the economy. This is especially true in the growing number of technologies where the competition is truly global.

Though very few venture-backed companies are technically subject to the Sarbanes-Oxley Act ("SOX" or "the Act"), the Act has had a significant impact on venture capital in several ways. First, the prospect of an IPO causes venture-backed companies to begin to work toward SOX compliance long before they expect to actually become an "issuer" subject to the Act. Therefore, the costs involved in SOX compliance and the caution engendered by the Act's many requirements have lengthened the liquidity horizon for venture capital funds and their myriad investors.

While it is not the only factor, the effect of Sarbanes-Oxley is clearly a cause in the slowdown of the IPO market. IPO investors demand that companies have net income of a certain size before they are attracted to them. SOX compliance costs have reduced the net incomes of companies, which disguises their value to potential purchasers of an IPO. Moreover, we have not seen the much-touted reduction in the cost of capital, which is supposed to economically offset the high cost of Sarbanes-Oxley in general and Section 404 in particular. Therefore, the progress of companies toward an IPO is artificially delayed. Furthermore, it is not surprising that foreign stock markets have benefited from an upsurge in IPO activity that might otherwise have occurred in U.S. markets. Rebalancing the costs and benefits of Section 404 from an IPO perspective will demand a significant reduction in the cost side of the equation.

Second, successful or promising entrepreneurial companies are often acquired by publicly traded companies. Before such transactions are consummated, the acquiring company must assess the impact the acquired business will have on its Sarbanes-Oxley compliance. Therefore, as a practical matter, private companies need to be ready for integration into a SOXcompliant public company well before an acquisition is seriously contemplated. Section 404 internal controls compliance is a major part of that integration.

Naturally, the experience of public companies with Section 404 has been a significant concern for NVCA and the venture community at large. Therefore, we are pleased that the Commission has sought public comment on its next steps in addressing the imbalance between the cost of 404 implementation and its benefits. Our comments are based on the experience of venture capitalists as board members of entrepreneurial companies, private and public, and on our close observation of the experience of companies subject to 404. We have also followed the many views expressed over the controversy that Section 404 has engendered.

While we know that Section 404 has vexed companies of all sizes, our focus is limited to those companies we understand – private venture-backed companies and former portfolio companies that have become smaller growing publicly traded companies. We acknowledge that achieving a proper balance of 404 costs and benefits for all companies will improve the portfolio company acquisition market and the economy in general. We encourage the SEC in this effort. However, our comments will focus on the special circumstances of smaller companies.

NVCA closely observed and supported the work of the Advisory Committee on Smaller Public Companies (ACSPC). An NVCA board member, Ted Schlein, was a member of that Committee.

NVCA submitted a comment letter on the Draft Report of the Advisory Committee supporting its recommendation regarding Section 404 compliance for smaller companies. We are aware that the SEC does not intend to act on the specific recommendations regarding tiered implementation of Section 404 compliance obligations for smaller companies. However, we trust that this Concept Release is part of the Commission's approach to addressing the problems with 404 that the Advisory Committee identified.

We strongly endorse the basic principles behind the Advisory Committee's recommendations. Scaled regulation is an appropriate recognition of the great differences between the several hundred largest public companies in the U.S. and the thousands of smaller public companies. As the Committee's work demonstrated, the largest companies represent an overwhelming majority of the investor capital in public companies.[2] On the other hand, the smaller companies are the vast majority of SEC registrants and they drive job growth and innovation in our economy.[3] They also grow to be some of the most successful companies in the world.[4] Therefore, there are many reasons for the SEC to regulate companies differently based on size.

As to Section 404 specifically, we believe the Advisory Committee correctly concluded that it would be a serious mistake to require smaller public companies to comply with 404 until the cost of its implementation is <u>clearly</u> in line with its benefits for those companies. NVCA's April 3, 2006 comment letter, filed with the SEC under File No. 265-33, is Attachment A.

GENERAL COMMENTS AND SUMMARY

NVCA's comment letter on the ACSPC Draft Report set out the reasons we believe in the approach supported by the majority of the Committee over the "better implementation" approach advocated by the accounting firm representatives. We recognize that this Concept Release is a

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[2] FINAL REPORT OF ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES, April 23, 2006, Appendix E.

[3] *See generally*, "*Venture Impact 2004: Venture Capital Benefits to the U.S. Economy*," a study commissioned by the NVCA and conducted by leading economic analysis and forecasting firm Global Insight (formerly known as DRI-WEFA), p. 2. The study found venture capital funded companies were directly responsible for 9.4% of total U.S. private sector employment and 9.6% of company sales. *Id.* at 3. Global Insight constructed a database of more than 20,000 U.S. companies that received venture capital investment at some point between 1970 and 2003. From this database, Global Insight was able to measure the number of jobs and revenues these companies contributed to the U.S. economy in the years 2000 and 2003. A copy of the study is available at http://www.nvca.org/pdf/VentureImpact2004.pdf

[4] Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen and Starbucks all received venture financing during their growth phases. More recent beneficiaries of venture funding include: e-Bay, JetBlue, Seagate, and Google.

significant part of the Commission's effort toward better implementation. Our ongoing concern with this approach is stated in the following excerpt from NVCA's April 3 comment letter.

> "[O]ur members believe that neither changes in guidance nor changes in the rules will fundamentally alter the 404 compliance requirements. The reason for this pessimistic assessment is that ultimately the accounting profession, and the Big Four accounting firms in particular, will determine what companies are required to do before the audit firm can attest to the quality of a company's internal controls. Unfortunately, all the incentives for an audit firm line up in favor of extensive and detailed documentation and testing of process level controls.
>
> Whether an auditor considers his or her professional reputation, risk of PCAOB sanctions, private civil liability risk or financial incentives, they all point to requiring more, not less documentation and verification. These are, of course, the types of activities that undermine the cost-effectiveness of internal controls oversight in smaller companies."

Attachment A, page 11.

In short, the principal challenge of the "better implementation" approach is that the principal implementers are few and their numbers are not growing. We do not suggest that the Commission is unaware of this fact. However, we wish to emphasize that this problem with the Big 4 accounting firms is central to the 404 predicament.[5]

We are hopeful that the Commission can solve this problem by changing the incentives for the big accounting firms. However, we believe that it will take more than a change in SEC guidance and incremental changes to the PCAOB's Audit Standard No. 2 ("AS-2") to do so. In a manner of speaking, the genie is out of the bottle. For the reasons cited above, the large accounting firms have become comfortable with the way they have implemented Section 404. When an entire industry has found a way of implementing regulations that addresses its key risks and promotes its profitability at the same time, organizational inertia is very strong.

Therefore, regardless of how the SEC changes its rules on management's role, righting the cost-benefit balance in 404 means dealing with the 404 audit. Some of the incentives that

[5] For an innovative approach to this particular problem, see *infra*, page 10, text accompanying footnote 8.

drive excessive testing and demands for documentation, e.g. class action litigation risk may be beyond the SEC or the PCAOB's control.[6] However, the SEC can certainly influence AS-2. This audit standard was clearly developed with insufficient regard for the proper balance between costs and benefits. Many well-founded recommendations that would have improved the balance were made and rejected.[7] Now after two years of experience, the SEC has the opportunity and must have the will to ensure that AS-2 is amended to eliminate the regulatory basis for the auditors' excessively cautious and costly implementation.

We believe that the SEC also needs to provide additional guidance as to what is needed to comply with its requirements for management's report on internal controls over financial reporting. We concur with the findings of the Government Accountability Office's Report on SOX and smaller companies that management's implementation efforts have been largely driven by AS-2. Absent abundant clarity as to the limits to which management must go in assessing and documenting internal controls, we believe that auditors, with AS-2 as their touchstone, will continue to drive excessive costs into the 404 process.

As we have suggested, we believe the audit firms are behaving rationally in their own best interests. Again, we do not suggest that either the Commission or the PCAOB fail to recognize the problem. However, the reason we strongly supported the Advisory Committee's recommendations for forestalling full 404 implementation for smaller companies indefinitely is that we have no assurance that the Commission and the PCAOB recognize the need for significant changes. As we've noted, significant inertia already exists in the current approach to

[6] The Advisory Committee made an important recommendation that could serve as a model for dealing with the very real risk of abusive litigation based on after-the-fact analysis of accounting judgments. The Committee's Recommendation V.P.1 says the SEC should develop a protocol for accounting that would protect the good faith preparer from regulatory action or legal liability, Advisory Committee Report, p. 102. NVCA supported this recommendation in our comment on the Draft Advisory Committee Report. We continue to see this as an opportunity for regulatory action where the rewards to investor and the economy could be enormous.

[7] *See, e.g.*, Attachment B, NVCA Comment letter, dated January 9, 2004, re: PCAOB Release No. 2003-017, PCAOB Rulemaking Docket Matter No. 008, Proposed Auditing Standard – An Audit of the Internal Controls over Financial Reporting Performed in Conjunction with an Audit of Financial Statements at page 4.

404 auditing. It will take strong medicine to remedy this. Therefore, in formulating specific changes, we do not think the Commission or the PCAOB should fear overshooting the mark. Caution and excessive conservatism have helped to create the problem. A willingness to be candid as to the defects of AS-2 and its implementation is a necessary prerequisite of the solution.

SPECIFIC COMMENT -- PCAOB ACCOUNTING STANDARD NO. 2 SHOULD BE AMENDED TO ELIMINATE PROVISIONS THAT ENCOURAGE COSTLY 404 AUDITS

One of the basic tenets of auditing is that auditors must exercise their professional judgment and expertise in determining the scope of the specific audit procedures to be performed. PCAOB's current rules acknowledge that the auditor should apply the concept of materiality at both the financial-statement and the individual account-balance level. However, AS-2 specifically limits the auditor's flexibility to exercise professional judgment. For example, AS-2 states:

- "The auditor should perform ***at least one*** walkthrough for ***each*** major class of transactions." *AS-2*, paragraph 79.
- "The auditor should identify ***each*** significant process over ***each*** major class of transactions affecting significant accounts or group of accounts…." *Id.,* paragraph 71.
- "The auditor should evaluate ***all*** controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. *Id*., paragraph 24.
- "Monitoring – The auditor's understanding of management's monitoring of controls extends to and includes it monitoring of ***all*** controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements." *Id.,* paragraph 49.

[emphasis supplied in each bullet]

We believe that limiting the auditor's ability to exercise professional judgment in each of the above situations has resulted in auditors unnecessarily increasing the amount of work to be performed. This has and will create higher costs with little added benefits to financial reporting. There are several other aspects of the current AS-2 guidance which we believe create unnecessary costs. These are set out below in our responses to Question No. 10 of the Concept Release.

RESPONSES TO SPECIFIC QUESTIONS IN THE RELEASE

Question #1 -- Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies subject to the Section 404 requirements?

We believe that the SEC should issue additional guidance. Absent clearer SEC guidance, auditor interpretations of audit standards will continue to dominate the Section 404 process for both management and auditors.

Internal controls over financial reporting should reflect the nature and size of the company. The guidance issued by the SEC should provide management with flexibility as to how they design their internal controls over financial reporting, as well as how they perform their assessment of those controls. However, as noted in the Release, smaller companies have very different control environments compared to larger corporations for which Section 404 was written.

We believe that specific guidance tailored to smaller companies relating to the implementation of Section 404(a) would be beneficial. The COSO Guidance for Smaller Companies acknowledged that there are aspects of smaller companies, which create advantages in effectuating internal controls. SEC guidance should give additional weight to these aspects of smaller companies. Such guidance should direct management to use a top-down, risk-based approach to the process. It should explicitly point out the inefficiency of a bottom-up, mechanical type of assessment. Equally important, the guidance should acknowledge that management's assessment of its internal controls over financial reporting provide <u>reasonable</u>, as opposed to absolute, assurance of the effectiveness of such internal controls.

The authoritative nature of the SEC's additional guidance for management of smaller companies is critical. Absent a clear standard established by the SEC that sets the limits of 404 testing and documentation, there is a strong likelihood that the extent of 404 compliance activities will still be driven by audit firms using a very conservative interpretation of AS-2 as the standard.

Question #3 – Should additional guidance be limited to articulation of broad principles or should it be more detailed?

We believe that the additional guidance should be detailed enough so that smaller public companies can ascertain when they have performed an appropriate assessment of internal controls over financial reporting and that their monitoring controls are appropriate without reference to AS-2 and implementation approaches developed by audit firms.

Question #5 – *Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?*

The Commission's new guidance should be based on an authority higher than the PCAOB's AS-2. A rule would probably send a clearer signal to audit firms that testing and documentation in excess of that which is required of management by the SEC rule is not appropriate.

Question #10 – We also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b). Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?

As noted, NVCA supported the recommendations of the Advisory Committee on Smaller Public Companies regarding Section 404 implementation for smaller public companies. In so doing, we endorsed the Committee's conclusion that investors in smaller public companies will be better served by a Section 404 process that consists of the management assessment alone. This is based on the conclusion that investors are ill-served by a process where the costs of the auditor attestation are so clearly in excess of the benefits to investors. The Advisory Committee Report sets out the basis for this conclusion.

The General Comment section of this letter noted the problems we see with auditors' implementation of Section 404(b) and the influence the Audit Standard No. 2 has had on management's implementation of 404(a).

One of the most significant and intractable problems with controlling 404 costs is that a company's audit firm is required to perform the 404(b) attestation. Paired with the fact that only a few audit firms are viewed by investors as capable of performing a first-rate audit of either an IPO company or of large, complex public companies, this regulatory link between audit and internal controls attest creates an oligopoly market in 404 attest services with negligible price competition.

The Advisory Committee on Smaller Public Companies clearly noted this circumstance. Its Report suggests that the Commission explore whether it should permit "a qualified person other than a company's financial statement auditor to attest to and report on management's assessment of internal controls over financial reporting."[8] As the Report notes, "this could introduce an element of competition into the provision of Section 404 outside attestation and consequently reduce cost." *Id.*

The Commission has the authority to exempt companies from myriad Section 404 requirements. De-linking the financial statement audit from the internal controls attestation could be the most significant change the SEC might make in reducing Section 404 costs. While

[8] Advisory Committee Report, page 57, note 118.

significant thought and effort might be required to determine the qualifications of internal controls auditors, the market for such services is clearly evident. Permitting new firms to compete for 404 attestation work with the large financial statement audit firms could well provide competition in this area where it is sorely missing.

Besides creating more competition among 404 attestation service providers, we believe that the SEC and PCAOB need to enact rules that will require auditors to exercise appropriate judgment in performing an audit of internal controls over financial reporting. We believe that the PCAOB's AS-2 has resulted in an audit approach based on detailed, fully-documented process controls which has created unnecessary cost while failing to add substantially to the effectiveness of internal controls in smaller companies. The SEC and PCAOB should issue guidance that will ensure that auditors exercise judgment on testing and documentation of internal controls based on financial statement materiality and appropriate risk analysis.

There are several other aspects of the current AS-2 guidance which we believe create unnecessary costs. Specific changes to AS-2 which we believe are appropriate include:

1. AS-2 defines a material weakness as "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual ***or interim*** financial statements will not be prevented or detected."[emphasis supplied]. However, under SOX, management is only required to perform an assessment of internal control over financial reporting effectiveness as of year end. A definition of material weakness in AS-2 that includes interim financial statements requires auditors to plan their audits of internal control over financial control at a materiality level low enough to examine quarterly, as opposed to annual, impact. This low materiality threshold results in unnecessary costs.

2. A significant deficiency is defined in AS-2 as "a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, or report external financial data reliably in accordance with generally accepted

accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected." We believe that this "more than a remote likelihood" language in the definition of a significant deficiency is too expansive and causes auditors to perform unnecessary work. A more appropriate standard would be "such that *it is at least reasonably possible* that a misstatement … will not be prevented or detected."

3. AS-2 requires auditors to apply the concept of materiality in their audits of internal control over financial reporting at both the financial-statement level and at the individual-balance level. Requiring auditors to plan and conduct their audits at the individual-balance level causes them to focus efforts on balances that are financially insignificant for the company as a whole. We believe that auditors should conduct their audits based upon materiality at the financial-statement level.

4. The PCAOB standard also currently requires auditors to perform walkthroughs of major classes of transactions on an annual basis. The guidance in AS-2 acknowledges that the auditor's judgment plays an important role in determining the major classes of transactions for which walkthroughs are necessary. Also the guidance provides auditors with flexibility to adjust the nature, timing and extent of testing based on risk. However, because walkthroughs are a required annual procedure, the guidance does not allow auditors to use their judgment and knowledge obtained from prior year audits of internal control over financial reporting to limit the extent of walkthroughs. The audit standard requires walkthroughs even if the auditor is satisfied that there have been no changes to controls tested in the previous audit. We believe that auditors should be able to use their prior knowledge in assessing risks and in designing their audits.

5. The final area where we believe AS-2 can be improved relates to the auditor's use of the work of others. We believe this is an area where companies could obtain cost efficiencies if the current guidance were modified. Under AS-2, three categories of internal control are described and the extent to which auditors can use the work of others is specified for

each category. We believe that these categories are too restrictive. The auditor should be able to use his or her judgment to determine the areas in which and the extent to which the auditor can rely on the work of others.

Question No. 14 – In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify controls that address the risks? Are there areas that have not yet been addressed or need further emphasis?

We have reviewed and evaluated the new COSO publication, Internal Controls over Financial Reporting – Guidance for Smaller Public Companies. It is a significant improvement over the 1992 COSO Framework and over the draft guidance for smaller companies COSO released late last year. It will be a useful tool in helping smaller public companies design, implement and evaluate their systems for internal control over financial reporting. The new guidance will not address the problem of excessive cost, however. While the new COSO guidance provides an extensive description of how the COSO Framework can be applied, we believe that regulatory changes are needed to address excessive costs of first-year compliance for smaller companies.

Question #15- What guidance is needed about the role of entity-level controls in evaluating and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g., GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?

As noted, we believe that smaller companies should be regulated differently for a number of purposes, including Section 404. In smaller public companies, active board and senior management oversight and the "tone at the top" are often key mitigating controls in less formal and less segregated internal control systems. Any guidance that is issued by the SEC should assign sufficient weight to the importance of these oversight controls. We recommend that any such guidance state explicitly that entity level controls, and, in particular, active oversight by management and the board of key financial and operational indicators are meaningful elements of internal controls over financial reporting in smaller public companies.

Question #19 – What types of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere.

Smaller public companies generally are less complex, have fewer levels of management, limited support staff and limited ability to fully segregate duties. As a result, active oversight by senior management and board members of smaller public companies is one of the key entity-level controls that management relies upon in order to develop cost-effective internal control over financial reporting. Such oversight can help to identify unusual activities that could impact financial reporting. We believe that the SEC guidance should acknowledge that management can rely upon such controls when it performs its 404 assessment. By acknowledging these types of controls, especially in smaller public companies, the SEC can give management a sound footing on which to establish 404 compliance in the absence of extensive individual account or transaction level testing.

Question #20 -- Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?

Specific guidance that acknowledges the usefulness of management's ongoing monitoring activities would be beneficial. Many daily operational tasks of senior management, such as review of key performance indicators, daily flash reports, budgets and cost trends can often identify financial reporting issues in a timely and cost effective manner. These activities contribute to the effectiveness of internal control over financial reporting. We believe that the SEC guidance should assign significant weight to such controls so that management can utilize these ongoing oversight activities as part of their assessment of the effectiveness of their internal controls over financial reporting.

CONCLUSION

NVCA urges the Commission to take aggressive action to modify the rules for Section 404 compliance. We affirm our belief that the entrepreneurial economy will suffer unless the cost-benefit ratio of Section 404 is brought into balance. We encourage the Commission to ensure that Audit Standard No. 2 is amended in significant ways in order to mitigate the excessive work and excessive costs that have resulted to date.

We stand ready to assist the Commission in this effort in any way we can.

Sincerely yours,

President

Attachments
A -- NVCA Comment letter, dated April 3, 2006, re: Draft Report of the Advisory Committee on Smaller Public Companies (File No. 265-33).
B -- NVCA Comment letter, dated January 9, 2004, re: PCAOB Release No. 2003-017, PCAOB Rulemaking Docket Matter No. 008, Proposed Auditing Standard – An Audit of the Internal Controls over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

ATTACHMENT A

National Venture Capital Association

April 3, 2006

VIA Email

Nancy M. Morris
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U.S. Securities and Exchange Commission
100 F Street, NE
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Re: File No. 265-23, Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies (Release No. 33-8666; 34-54385).

Dear Ms. Morris:

The National Venture Capital Association (NVCA) represents approximately 450 venture capital and private equity firms. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provide reliable industry data, sponsor professional development, and facilitate interaction among its members.[1]

NVCA supports the key recommendations in the Exposure Draft of the Final Report of the Advisory Committee ("Draft Report"). We also wish to commend the Committee for its considerable effort and significant contribution to the general understanding of the universe of thousands of smaller public companies that fall under the jurisdiction of the SEC.

[1] For more information about the NVCA, please visit www.nvca.org.

BACKGROUND

Venture capital occupies a unique and valuable role in the U.S. economy. From 1970 – 2003 venture capital funds invested $338.5 billion dollars into more than 21,600 U.S. companies.[2] Every year, the most successful venture-backed private companies access the public equity markets through the IPO market. As the Committee has noted, smaller public companies can grow into some of the most prominent of U.S. companies. Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen and Starbucks all received venture financing during their growth phases. More recent beneficiaries of venture funding include: e-Bay, JetBlue, Seagate, and Google. A regulatory environment that promotes capital formation for small, growing companies is essential to the unique vibrancy of the American economy.

Venture capital's stake in maintaining and enhancing the strength and integrity of the public equity markets drives NVCA's support for the Advisory Committee and other efforts to improve regulation of smaller public companies. Venture investors – public pension funds, private institutions, financial companies and qualified individual investors – rely on venture capital investment returns to meet their financial obligations and to contribute to the virtuous economic cycle of liquidity and re-investment into new ventures. It is important to remember that venture capital is investors' capital. The ultimate liquidity of venture investments is essential to investor protection and capital formation.

Although many view SEC activity as applicable only to companies already in the public sphere, SEC rules and the securities laws upon which they are based directly impact venture capital. The new requirements of the Sarbanes-Oxley Act (SOX) have highlighted this fact. Venture backed companies seeking to access the public equity markets through the IPO process

[2] "*Venture Impact 2004: Venture Capital Benefits to the U.S. Economy*," a study commissioned by the NVCA and conducted by leading economic analysis and forecasting firm Global Insight (formerly known as DRI-WEFA), p. 2. The study found venture capital funded companies were directly responsible for 9.4% of total U.S. private sector employment and 9.6% of company sale. *Id.* at 3. Global Insight constructed a database of more than 20,000 U.S. companies that received venture capital investment at some point between 1970 and 2003. From this database, Global Insight was able to measure the number of jobs and revenues these companies contributed to the U.S. economy in the years 2000 and 2003. A copy of the study is available at http://www.nvca.org/pdf/VentureImpact2004.pdf.

have had to meet the new SOX regulatory requirements. That additional significant hurdle has increased the cost of an IPO and has slowed the process of venture-backed companies going public. NVCA does not view a longer pre-IPO period as a problem *per se*; however, unless regulatory requirements add investor value, their added cost should be a matter for concern to all policy makers.

Sarbanes-Oxley has had a more subtle impact as well. Perhaps the best illustration is in the comparative rate of venture-backed IPOs to venture-backed companies that are acquired. While the historic split between the IPO and acquisition routes has averaged about 50/50, in 2004 there were 333 merger-acquisition transactions of venture-backed companies and 83 venture-backed IPOs. While many factors affect the IPO market for the high-growth, innovative companies that venture funds typically back, the heightened cost, complexity and liability of SOX are certainly among the causes of this significant shift toward the acquisition route over the IPO.

The impact of SOX on acquisitions of private companies is not as well understood. SOX requirements have rippled through the world of private companies because of the importance for public companies of growth by acquisition. As noted, only a portion of successful venture-backed companies are candidates for an IPO. Many others achieve their maximum investor return by being acquired. Acquiring companies are quite often either public companies or are companies moving toward becoming public. Therefore, the certifiable SOX compliance of any potential acquisition is a key aspect – sometimes the crucial aspect – of such a transaction. Therefore, for many private companies with no immediate plan for offering stock to the public, SOX-compliance is still a necessity. New requirements, including the very costly requirements imposed by SOX Section 404, have added cost and delay to the private market for venture backed companies.

The overall landscape for capital formation through IPOs and acquisitions has been reshaped by Sarbanes-Oxley and the new rules, listing standards and practical norms that followed its enactment. As noted, SOX-related compliance concerns of public companies have added costly friction to the acquisition market -- and have actually prevented some transactions. In addition, the IPO market has changed at least in part because of new rules and a heightened sense of liability for IPO underwriters and restrictions on broker-sponsored analyst research. While many of these changes were necessary reforms to the IPO underwriting and distribution process, the cumulative effect of these many changes is certainly a factor in the overall liquidity of venture-backed companies.

NVCA's comments on the Draft Report are offered against this backdrop. These many new requirements on access to public capital -- however appropriate in isolation -- have had consequences of a magnitude beyond any anticipation and have affected important areas of the economy that were hardly considered. Therefore, we commend the Committee for its focus on capital formation as well as investor protection. We urge the Committee also to continue to focus critically on cost and benefits in formulating its final recommendations.

SCOPE OF NVCA COMMENTS

We support the Draft Report's key recommendations. In particular, we support the recommendation that the SEC scale its regulations in ways that differentiate among the three categories of companies in the Draft Report. We also support the Draft's recommendations that smallcap companies and microcap companies be relieved of some of the most costly requirements of SOX 404, provided they address their internal controls by other more cost effective means.

In addition, NVCA encourages the Committee to emphasize four other recommendations from the Draft Report in its final Report. One of these key recommendations is aimed at improving analyst coverage for smaller companies. We offer an additional item for the Committee's consideration in this area.

In addition, we support three particular recommendations that aim to mitigate some of the most counterproductive aspects of recent changes in accounting rules and the accounting profession.

Our comments are based on data, surveys and many discussions with venture capitalists whose daily focus is in helping the managers of growing companies add value for investors.

DETAILED COMMENTS REGARDING SECTION 404 AND SCALED REGULATION

The Draft Report's recommendations on SOX 404 compliance strike the appropriate balance regarding investor protection, shareholder value and national economic priorities.

NVCA supports the Draft Report's recommendations for significant relief from the requirements of SOX 404 for both categories of smaller public companies. The experience of venture capitalists is consistent with the Committee's observations and conclusions, set out in its excellent Draft Report. The majority of venture-backed companies will be affected by changes in the requirements on the category of companies designated "smallcap" companies. Therefore, our comments are focused on the Draft Report's recommendations regarding smallcap companies rather than "microcap" companies.

We nonetheless view the recommendation for exemption of microcap companies from both major aspects of SOX 404 as appropriate. The Committee's careful consideration of the special circumstances of microcap companies supports the draft recommendation for a conditional exemption from SOX 404. Moreover, the new requirements the Draft recommends regarding audit committees, certifications and codes of conduct are the types of internal controls that can be most effective in microcap companies.

We agree with the Draft Report's conclusions regarding the benefits and costs of Section 404 compliance for smallcap companies. The Draft correctly describes the very different control environment in smaller companies compared to the large corporations for which Section 404 was written. Internal controls in smaller companies differ from those in larger companies as much as their cultures.

The approach to internal controls compliance that companies have experienced to date has been excessively costly and wasteful. The Draft properly notes that the PCAOB's AS-2 has caused an audit approach based on detailed, fully-documented process controls which has created unnecessary cost while failing to add substantially to the effectiveness of internal controls in smaller companies.

We fully support the Draft's conclusion that smaller companies, of necessity, operate differently than large ones. They must adapt more readily, change more rapidly and compete more relentlessly in order to succeed. For these reasons, as noted in the Draft, smaller companies do not reach a "steady state" where repetition and familiarity mitigate costs. Moreover, while the costs of SOX 404 have been well-documented, its purported benefits have been mostly assumed rather than proven.

As noted earlier in this letter, Sarbanes-Oxley requirements have rippled through the economy in unanticipated ways. Private companies are spending inordinate amounts of time and money on compliance and controls that are not appropriate to the nature of these enterprises. From the venture capitalist perspective, there is another more insidious cost – management and board distraction.

Our culture of entrepreneurship is a national treasure. It creates jobs, builds communities and promotes growth of many kinds. The success of entrepreneurial companies depends on dedicated managers and board members who are focused on adding value to their companies. Venture capitalists have seen how this focus is blurred and this zeal blunted by time-consuming unproductive compliance exercises. For this reason alone, the Draft Report's recommendations are of critical importance. Absent relief from at least some of these unproductive compliance exercises, the pre-eminence of American entrepreneurship could fade.

The Draft Report's assessment of excessive overall costs in relation to benefits is accurate. The hard costs are well documented and the soft costs from management distraction are easily understood. Benefits from this massive effort to document and verify internal control procedures have not been demonstrated. The Committee's final Report should clearly state that the benefits of 404 compliance (and any new regulation, for that matter) should face the same scrutiny as have claims of excessive cost. Mere assertions of improved "investor confidence" should not suffice when so much is at stake.

For these reasons, NVCA supports the conclusion that exemption of smallcap companies from the auditor attestation part of SOX 404 strikes the appropriate balance between a company's obligation to create value for its shareholders and its duty to prevent mistakes and/or fraud in financial reporting. Knowing that the downside economic risk from requiring 404 compliance is greater and the cost disproportionately higher for the thousands of smaller companies, it is bad regulatory policy to require them to go through the expense and management distraction of the 404 attestation process. Similarly we support the conclusion that microcap companies should be exempt from Section 404 provided they have adopted appropriate governance and control-enhancing practices such as those outlined in the Draft Report.

<u>The SEC should designate separate smallcap and microcap categories of public companies that should be treated separately for SOX 404.</u>

The Draft Report recommendation on scaled regulation reflects some of the Committee's most important work. Through its focus on smaller public companies, the Committee has brought new rigor to the questions of numbers, size and characteristics of the thousands of public companies that make up the smallcap and microcap segments of SEC registrants. The Draft Report's recommendations are fully supported by its analysis. Moreover, as noted above, important economic – and investor -- goals will be promoted by adopting a tailored regulatory approach that reflects the actual benefits and actual costs of new SEC requirements.

We are aware that the Committee was very thoughtful in its consideration of the right measures and right metrics for categorizing smallcap and microcap companies. The Draft Report reflects this careful analysis. We also recognize the value of the "market capitalization" metric in the SEC regulatory context. However, from a venture capital perspective, revenue is the single most tangible indicator of a company's size and operational complexity. Therefore, we support the additional use of revenue criteria in the Draft Report for differentiating companies by size for Section 404 purposes. Indeed, should the Committee decide that the final Report should recommend a metric other than market capitalization for scaled regulation generally, we recommend revenue as that metric.

<u>Many of the assumptions underlying arguments against the Draft Report's recommendations are incorrect.</u>

The Draft Report includes separate statements from three committee members. NVCA appreciates the contributions of all committee members but respectfully disagrees with both the conclusions and assumptions that underlay the opposition of Messrs. Jensen, Schacht and Veihmeyer to the Draft Report's recommendations for smallcap and midcap exemptions from some of the requirements of Section 404.

These separate statements do not reflect idiosyncratic views. Many others have made similar arguments in their public opposition to these key Committee recommendations since they were initially considered. Therefore, we will focus on the erroneous premises which are most often cited as reasons why the Committee should back away from the recommendations in the Draft Report.

The first erroneous premise is that Section 404 is the "cornerstone" of the Sarbanes-Oxley Act. While it has long been recognized that internal controls reporting and attestation would represent an enormous proportion of the issuers' cost of SOX, the Act had profound and far-reaching consequences even before Section 404 became effective. To suggest that an exemption from any of the requirements of 404 eviscerates Sarbanes-Oxley is to ignore the vast proportion of this multi-faceted law. To name a few provisions that affect issuing companies only, CEO and CFO certification, Audit Committee independence rules, new listings standards and new criminal liability provisions made Sarbanes-Oxley a boon to the legal profession in advising managers and boards on compliance. Moreover, SOX created the PCAOB (federalizing regulation of the accounting profession), restricted links between investment banking and research (changing the securities underwriting business), changed the reporting obligations of lawyers who advise corporations, nearly doubled the size of the SEC and greatly expanded the Commission's authority (Fair Funds authority, for example). Therefore, it is a gross exaggeration to suggest that the 404 exemptions in the Draft Report would undermine the impact of Sarbanes-Oxley on public companies.

The second faulty premise in most criticism of the Draft Report is that a disproportionate number of fraud cases arise in the very companies that would receive 404 relief. One of the separate statements cites (with alarm) the fact that 75% of accounting fraud cases brought during the period 1998 – 2003 were in “small firms.” This type of assertion has been made in support of regulation of smaller issuers for many years. However, thanks to the work of the Advisory Committee, we now know that smaller public companies (comprising only 6% of the total market capitalization) make up 80% of public companies. Thus the number of accounting frauds cited and the number of companies are roughly proportional. While definitions no doubt differ and numbers may vary, it is hard to see how these statistics support an assertion that smaller companies present special fraud risks.

In the internal controls context, it is useful to examine the COSO report of 1987-97[3], which is often cited as supporting the need for SOX 404 mandates in smaller companies. This study noted that the vast majority of small company frauds involved senior managers. As the Draft Report notes, the types of process level controls required by SOX 404 and AS-2 can be over-ridden by CEOs and CFOs in the small company environment. Therefore, even if smaller public companies presented a special – albeit unproven -- fraud risk, application of SOX 404 would not address it.

The third faulty – or at least unproven – premise of arguments against the Committee’s 404 recommendations is relates to investor confidence. It is argued that Sarbanes-Oxley restored investor confidence to the benefit of all issuers; therefore, it is argued, this issuer benefit would be jeopardized by the relatively narrow relief proposed in the Draft Report. As noted already, the benefits of SOX and 404 in particular are more presumed than proven. Clearly those who criticized early claims of extraordinary 404 costs as “anecdotal” should be required to provide more than opinions and narrow examples of its benefits.

From the perspective of venture capital, we certainly cannot find any indication that SOX has lowered the cost of capital or returned investors to the IPO market. As noted already, the

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[3] Committee of Sponsoring Organizations, “Fraudulent Financial Reporting: 1987-1997 - An Analysis of U.S. Public Companies.” Available at www.coso.org.

IPO market did not recover dramatically with the implementation of various SOX provisions. To the contrary, the new regulatory friction and risk that resulted from SOX has increased the compliance cost of going public without any demonstrable increase in investor appetite. Similarly, the merger and acquisition market for venture-backed private companies has suffered because of cost and compliance risk. On the other hand, investor reaction shows little affect of any increased confidence arising from SOX.

On the larger question of the Act's total impact on investor confidence, at least one respected observer believes it was negative. Peter Wallison, Resident Fellow at the American Enterprise Institute, documented the case in a 2004 Paper[4] that the passage of the sweeping Sarbanes-Oxley legislation actually had a negative effect on the stock markets while the scandals that prompted legislative action were readily absorbed by the markets. Therefore, while such contrarian views may still be unconventional, there is, on the other hand, no real evidence that a smallcap exemption from the Section 404 auditor attestation risks the loss of an amorphous SOX-based investor confidence. Nor will the Draft's recommendation for a conditional full exemption for companies that comprise only 1% of total market capitalization.

The fourth faulty premise -- which is really a hopeful argument – is that "better implementation" will correct the gross imbalance of cost to benefit in 404 implementation. NVCA has been hopeful that experience and the passage of time would help correct the imbalance. However, at this stage, we must view such assertions as the triumph of hope over experience.

To date, additional SEC and PCAOB guidance seem to have brought little improvement. The COSO's attempt to adjust its guidance for smaller companies was a failure. As noted already, the structure of Section 404 and the PCAOB's AS-2 are simply not appropriate for smallcap and microcap companies.

[4] Peter J. Wallison, *Sarbanes-Oxley as an Inside-the- Beltway Phenomenon*, (AEI, June 2004). Available at http://www.aei.org/publications/filter.all,pubID.20582/pub_detail.asp. *See generally*, Materials related to AEI program, "Sarbanes-Oxley: What Have We Learned?" (March 13, 2006). Available at http://www.aei.org/events/eventID.1273,filter.all/event_detail.asp.

Moreover, our members believe that neither changes in guidance nor changes in the rules will fundamentally alter the 404 compliance requirements. The reason for this pessimistic assessment is that ultimately the accounting profession, and the Big Four accounting firms in particular, will determine what companies are required to do before the audit firm can attest to the quality of a company's internal controls. Unfortunately, all the incentives for an audit firm line up in favor of extensive and detailed documentation and testing of process level controls.

Whether an auditor considers his or her professional reputation, risk of PCAOB sanctions, private civil liability risk or financial incentives, they all point to requiring more, not less documentation and verification. These are, of course, the types of activities that undermine the cost-effectiveness of internal controls oversight in smaller companies. Therefore, we strongly urge the Committee to decline the tempting appeal of "better implementation" in favor of its forthright and well-supported recommendation for new internal controls rules that will be cost-beneficial for smaller public companies and entrepreneurial private companies.

DETAILED COMMENTS ON OTHER IMPORTANT COMMITTEE RECOMMENDATIONS

The Draft Report contains many sound recommendations that deal with areas of great importance to smaller publicly-traded companies. NVCA comments will focus on four of these recommendations that we see as most crucial for entrepreneurial companies and venture capital in particular. We see these recommendations dealing with analyst coverage and accounting as among the most critical for the SEC to address in the current market and regulatory environment.

<u>NVCA especially supports Recommendation IV. P.4. The SEC and other regulatory agencies should undertake a special review of the importance of analyst coverage for companies and investors.</u>

The steady decline in analyst research for smaller public companies has been a matter of concern for many years. Changes in the economics of the equities markets as well as changes in the rules on broker-sponsored analyst research have steadily eroded the amount of third-party analytical information about smaller public companies available to investors. This is of serious concern for venture capital because of the importance of analyst coverage to newly public companies. We therefore, strongly urge the Committee to emphasize this recommendation in the final Report.

We support the two specific recommendations in the Draft Report. There is a clear need for credible third-party research coverage for smaller companies that cannot attract the attention of "buy-side" analysts. The SEC should continue to permit fully-disclosed company-sponsored analyst reporting. Furthermore, we support the recommendation for continuation of brokers' use of "soft dollars" to support true research by their clients.

We also believe the Committee could do more in the analyst research area. We recommend that the Committee review and consider supporting the recent recommendation by the NASD to eliminate the quiet periods before and after expiration, termination or waiver of a lock-up agreement. The recent imposition of these quiet periods has affected the coverage available to newly-public companies. The NASD believes that SEC Regulation AC certification addresses the "booster shot" problem (underwriter providing overly-rosy analysis to investment banking clients). Aside from "booster shots" these quiet periods are unnecessary as far as we can see. Moreover, allowing continued research coverage during this critical time in the life of new public companies would help protect all IPO investors who hold beyond the initial period but need liquidity for a portion of their holdings in the first year. Finally, more continuous research coverage would almost certainly promote the capital formation role of the IPO market for smaller growth-oriented companies.

The overall lack of analyst coverage for smaller companies is shown clearly in the excellent data provided in the Draft Report by the SEC's Office of Economic Analysis. See Draft Report, Table 14. The absence of meaningful coverage for so many companies should prompt the SEC to take the lead in encouraging other knowledgeable organizations to consider ways to broaden it. This initiative should also involve a careful look at other ways to remove regulatory disincentives to analyst coverage of newly public companies. The Committee should recommend that this effort be evaluated to see whether it can work synergistically with SEC Chairman Cox's broad initiative on use of interactive data.

<u>NVCA especially supports Recommendation V.P.1. The SEC should develop a protocol for accounting that would protect the good faith preparer from regulatory action or legal liability.</u>

Like many others in business, venture capitalists and entrepreneurs have witnessed the steady erosion in the use of judgment and common sense in accounting and auditing decisions over the past few years. Many regulatory changes and other events have affected the accounting profession over this time period. Nearly all of them have promoted the tendency of accounting firms to respond hesitantly and conservatively to any ambiguous accounting situation. The fact that this tendency has added cost and complexity for issuers is no surprise. Moreover, this added cost and complexity has been accompanied by confusion as to the proper treatment of various transactions. This situation makes a mockery of well-publicized effort to move to more principle-based accounting standards and more understandable financial reports.

The Draft Report makes the appropriate points as to the nature of the problem. Its proposal for a safe harbor for thoughtful, good faith accounting judgments could provide part of the solution to the often dysfunctional situation that exists between issuers and their accounting firms. The safe harbor for forward looking statements in the securities laws is a good model as the Draft Report suggests.

We hope that the safe harbor approach can help cut through the various layers of liability concern that have eroded the use of judgment and common sense in accounting. Some of our members believe that, aside from genuine liability concerns – both real and perceived - some accountants have used liability risk as a catch-all rationale for costly, complex and overly conservative approaches to ambiguous accounting situations. Whether accountants' liability concerns are real, perceived or wholly unreasonable, the impact on the issuer-client is the same.

Were a true safe harbor in effect for the types of well-documented judgments described in the Draft Report, the result should be a more reasonable approach to accounting interpretations. Such a result would be a substantial help to smaller companies, both public and private. Therefore, we urge the Committee to emphasize this recommendation in its final Report.

<u>NVCA especially supports Recommendation V.P.4. The PCAOB should establish a *de minimus* exception to the SEC's auditor independence rules.</u>

A materiality standard is appropriate to ensure that the consequences <u>to the client</u> of an independence violation are proportional to the nature of the violation. The shortage of audit firms with scope, reputation and capabilities heightens the potential impact of independence rules on smaller private companies and venture-backed companies in particular.

The consequences of a finding of non-independence by an auditor of a company are profound. This is especially true for a company in the pre-IPO process. Venture-backed companies have a very real exposure to over-broad interpretations of auditor independence rules. Since a single venture fund invests in many companies, there is a risk that "affiliate" relationships could be found which would undermine the independence of an auditor based on the most highly attenuated connection. This is just one example where a common sense approach to independence rule violations would help. In general, an approach that distinguishes violations that are material to an issuer's financial statements from those that are merely technical would be a significant benefit for capital formation without compromising investor protection. Therefore, we urge the committee to highlight this recommendation in its final Report.

<u>NVCA urges the Committee to include Secondary Recommendation V.S.1 regarding increasing competition in the accounting field in the Committee's primary recommendations in the final Report.</u>

Any discussion of the practical consequences of the Sarbanes-Oxley Act and the events of the past years inevitably comes to the need for more competition in the accounting profession. Cost and service concerns have arisen and continue to arise in obtaining audit or accounting services since SOX. We believe these problems are most acute for smaller companies and for the newer, private companies in which venture funds invest.

We are aware of the suggestion that an exception from Section 404 attestation requirements could exacerbate concentration in the accounting profession. On the other hand, if fewer auditors are tied up with the type of detailed process-level internal controls evaluation that has characterized 404 attestation work to date, perhaps the supply of accountants available to smaller companies would increase. In any case, concentration of the accounting profession has a clear impact on smaller companies, as noted in the Draft Report.

Efforts to enhance competition should include close monitoring of the impact of all regulatory decision on the situation as well as implementing the recommendations in the Draft Report.

CONCLUSION

NVCA again commends the Committee and its many members and staff for an outstanding contribution to the understanding of the regulatory situation of smaller public companies. We also urge the Committee to include recommendations in its final report – those we have highlighted in particular -- that will improve the capital formation climate for pre-public companies. The excellent Draft Report can also be improved by noting the impact that public company regulations have on private companies as well.

Sincerely yours,

Mark G. Heesen
President

ATTACHMENT B

January 9, 2004

FILED ELECTRONICALLY

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

RE: PCAOB Release No. 2003-017, PCAOB Rulemaking Docket Matter No. 008, Proposed Auditing Standard – An Audit of the Internal Controls over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

Introduction

The National Venture Capital Association (NVCA)[1] represents the vast majority of American venture capital under management. NVCA member firms and the funds they manage provide the start-up and development funding for innovative entrepreneurial businesses.[2]

VC firms form and manage the funds that invest in start-up and early-stage businesses, commonly referred to as "portfolio companies." Venture capital investing relies on exit strategies whereby venture capital positions in portfolio companies are exited, with the proceeds being distributed to investors. Regardless of the likely exit strategy, portfolio companies operate with minimal staff and a necessarily narrow focus on achieving business objectives – research, market definition, product development, manufacture and sales. Though very few of these venture-backed companies are subject to the Sarbanes-Oxley Act ("SOXA" or "the Act"), as a practical matter, the Public Company Accounting Oversight Board (PCAOB) Rules on auditing internal controls will have a significant impact on them.

[1] The National Venture Capital Association (NVCA) represents more than 430 venture capital and private equity firms. NVCA's mission is to foster the understanding of the importance of venture capital to the vitality of the U.S. and global economies, to stimulate the flow of equity capital to emerging growth companies by representing the public policy interests of the venture capital and private equity communities at all levels of government, to maintain high professional standards, and to provide research data and professional development for its members.

[2] In 2002, venture capital (VC) funds invested $21.2 billion in 2500 companies, the fourth largest amount ever in the history of venture capital. Eighty-five percent of these companies were in information technology, medical/health or life sciences. The success of venture investing is encouraging greater capital flow to these types of companies. At the end of 2002, VC firms had an estimated $253 billion under management, up from $32 billion in 1990.

Impact of PCAOB on venture capital and entrepreneurship

Successful exits of venture capital investments occur either through an initial public offering ("IPO") or through acquisition by another company, often a public company. A company in a pre-IPO, or a pre-acquisition, situation needs to prepare its financial statements on the assumption that it will soon be subject to SOXA. Therefore, management must implement policies and procedures to enable them to prepare Section 404 reports.

Because of the uncertain timing of either exit event, many venture-backed private companies have concluded that they must be SOXA-compliant, even if an acquisition or an IPO is not imminent. Therefore, Section 404 compliance is a fact for companies that are clearly outside the intended reach of SOXA.

General comment

Our comments relate primarily to the impact of PCAOB rules on private companies that are not SOXA "issuers" and the need for PCAOB rules to allow auditors to exercise appropriate judgment in performing an audit of internal control over financial reporting. However, these comments are generally applicable to small publicly traded companies also.[3]

With regard to both types of companies, our main concern is that Section 404 be implemented in a cost effective manner. The Proposing Release states a similar view:

> "For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal controls."

PCAOB Release No. 2003-17 ("Proposing Release"), page 6. We believe that this statement sets up a test that should be applied to every aspect of PCAOB Rules**:** does the standard provide sufficient flexibility for the auditor to exercise judgment in the extent of testing and, as to use of the work of others, including the work of management?

Specific comment on Proposed Audit Standard, Appendix A to Proposing Release, ("Proposed Rules") pertaining to private and smaller publicly traded companies

One of the basic tenets of auditing is that auditors must exercise their professional judgment and expertise in determining the scope of the specific audit procedures to be performed. The Proposed Rules acknowledge that the auditor should apply the concept of materiality at both the financial-statement and the individual account-balance level. However, the Proposed Rules specifically limit the auditor's flexibility to exercise its professional

[3] As we read the Act and PCAOB Rule 3100, we do not believe that audit firms, including PCAOB-registered audit firms, will be required *by law or regulation* to apply the proposed PCAOB rules to the audits of private companies.

judgment and expertise by requiring audit evidence to be obtained for "all" items in several situations. For example, the Proposed Rules state:

> "The auditor should perform a walkthrough for ***all*** of the company's significant processes." *Proposing Release,* page A-31, paragraph 79 [emphasis added].
>
> "The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself (or by using the work of others) for ***all*** relevant assertions related to ***all*** significant accounts, relevant assertions, and significant processes…" *Id.,* page A-29, paragraph 74 [emphasis added].
>
> "The auditor should evaluate ***all*** controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements, which may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 50." *Id*., page A-15, paragraph 24 [emphasis added].
>
> "Monitoring – The auditor's understanding of management's monitoring of controls extends to and includes it monitoring of ***all*** controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements." *Id.,* page A-23, paragraph 50 [emphasis added].
>
> "As part of this evaluation, the auditor should review ***all*** reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls relating to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports." *Id.,* page A-40, paragraph 114 [emphasis added].

The Proposed Rules further limit the ability of auditors to exercise their professional judgment and expertise by limiting the extent to which auditors may use the work of others, including management and internal audit. Auditing standards historically have allowed the independent auditor to consider the work of internal audit when determining the nature and extent of their audit procedures. The Proposed Rules embrace this concept, but, also, limit the areas where reliance can be placed upon the work of internal audit. For example, work of internal auditors cannot be used for assessing: (1) the controls that are part of the control environment; (2) controls over the period-end financial reporting process; (3) controls that have a pervasive effect on the financial statements, such as information technology general controls; or (4) walkthroughs. This is overly restrictive, especially in the small company or private company context. If the auditor has determined in its professional opinion that the internal audit is sufficiently competent and objective, there should not be such limitations.

Under current auditing standards, auditors are able to use their assessment of the effectiveness of senior management controls and monthly boards of directors' oversight of company operations in their audits of smaller companies to limit the nature and extent of their work in a <u>financial statement</u> audit. Similarly, the Proposed Rules appear to acknowledge that the integrity and actions of senior management in small and medium-size organizations are key components of establishing strong internal controls in those companies. *Proposing Release, Appendix E.* For the same reasons, auditors of small and medium-size companies should be allowed, if warranted based upon their professional judgment and expertise, to use the work of management in their audit of internal controls over financial reporting, especially in performing walkthroughs.

We believe that by limiting the auditor's ability to exercise their professional judgment in each of the above situations, the Proposed Rules will impede the PCAOB's goal of implementing Section 404 in a cost effective manner. Indeed, many aspects of the Proposed Rules would have the opposite effect. They would require the auditor to unnecessarily increase the amount of work to be performed, which will result in higher costs with little added benefits to financial reporting.

We have an additional concern regarding the Proposed Rules – the requirement that the auditor evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. *Proposing Release,* page A-25, paragraphs 56-59. Many of NVCA members serve on boards of directors and audit committees for their portfolio companies. These boards of directors and audit committees are responsible for the appointment and oversight of the external auditors. The Proposed Rule's requirement that auditors evaluate the effectiveness of the audit committee's oversight of internal control over financial reporting creates an unnecessary ambiguity in the relationship between the audit committee and the external auditor.

Comments on Proposed Rules related to venture-backed private companies, in particular

The "COSO Report" titled, *Internal Control – Integrated Framework*[4], provides the basis for the current proposed rules. *Proposing Release,* page 5. The COSO Framework explains that internal control in smaller companies can be less formal and structured. COSO, *Internal Control – Integrated Framework, Executive Summary, page 1.* This is an especially important consideration for developing auditing rules that will be applied to private, venture-backed companies.

In venture-backed companies, internal controls, systems and periodic testing of internal controls by management are commensurate to the risk that management and private investors, who sit on the board, find acceptable. There is no standard approach to these very subjective cost-benefit determinations.

In this private company context, the following statement has particular meaning. "The primary benefit [of internal controls over financial reporting] is to provide the company, its management, *its board and audit committee, and its owners* and other stakeholders with a reasonable basis to rely on the company's financial reporting." *Proposing Release*, page 5 [*emphasis supplied*]. In a venture-backed company, the current owners are members of the board and the audit committee. While we recognize that an auditor's 404 report will necessarily

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[4] Committee of Sponsoring Organizations of the Treadway Report, *Internal Controls -- Integrated Framework* (1992).

assume that the company will become a public company, or part of a public company, during the coming fiscal year, the PCAOB's 404 Rules must allow the auditor to accommodate the fact that costs and benefits are weighed differently for a private company than for even the smallest publicly traded company.

For example, the COSO framework notes that the control environment is "the foundation for all other components of internal control, providing discipline and structure," *Internal Control – Integrated Framework, Executive Summary, page. 2.* Accordingly, an auditor should be able to weight aspects of the control environment in determining how much they need to test other aspects of internal control in a private company.

In many small companies, a key control consists of the fact that financial management and authority is centralized at the CEO or CFO level. If this is the case in a given company, the auditor should be permitted to assign significant weight to those facts alone in determining whether to test other functions. If, in addition, the board meets monthly to review the company's finances in detail – a common practice in portfolio companies -- the auditor should have the latitude to find it unnecessary to do additional extensive testing to determine whether the owners (board members) have "a reasonable basis to rely on the company's financial reporting," *Proposing Release*, page 5. Internal control costs, and the cost of evaluating internal controls should be weighed against their benefits to financial reporting. If there is no real benefit, a particular review or test should not be required.

The COSO Framework's emphasis on control environment has particular application in the private company context. The board of directors' cost-benefit choices should, by themselves, carry significant weight absent some indication of special financial reporting risks. Just as the Proposed Rules should provide auditors with the flexibility to make appropriate cost-benefit judgments for smaller public companies, they must be still more flexible for the appropriate balance to be struck in a private company 404 report.

Conclusion

NVCA encourages the PCAOB to expand the scope of special internal control considerations for small and medium-sized companies in the Proposed Rules. We also request that the Rule note that different considerations apply in preparing a report for a private company. Without such special considerations, the audits of internal control over financial reporting for these companies will be unnecessarily costly, both in external auditor fees and management and board time that will be devoted towards Section 404 compliance. We would be pleased to discuss these and any related matters with Board members or staff. Please feel free to contact NVCA's Vice President Jennifer Connell Dowling, our outside SEC counsel, Brian Borders (202 822 9306), or me to discuss these matters.

Sincerely yours,

Mark G. Heesen
President