



National Venture Capital Association

January 9, 2004

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Public Company Accounting Oversight Board  
Attention: Office of the Secretary  
1666 K Street, NW  
Washington, DC 20006-2803  
[comments@pcaobus.org](mailto: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)<sup>1</sup> 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.<sup>2</sup>

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.

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<sup>1</sup> 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.

<sup>2</sup> 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.<sup>3</sup>

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

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<sup>3</sup> 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 its 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 financial statement 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*<sup>4</sup>, 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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<sup>4</sup> 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.

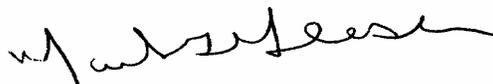
In many small companies, a key control consists of the fact that financial management and authority is centralized at the CEO or CFO level. If this is the case in a given company, the auditor should be permitted to assign significant weight to those facts alone in determining whether to test other functions. 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