NATIONAL VENTURE CAPITAL ASSOCIATION
Funding innovation. Empowering entrepreneurs.

August 22, 2017

VIA Email

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803
comments@pcaobus.org

RE: Docket Matter No. 43/Release No. 2017-002, *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements* and Docket Matter No. 44/Release No. 2017-003, *Proposed Amendments to Auditing Standards for Auditor's Use of Specialists*

INTRODUCTION

The National Venture Capital Association ("NVCA") represents the vast majority of American venture capital under management.[1] Venture capital funds invest across the spectrum of company stages of development, typically from early stage startup through IPO or acquisition.

NVCA's comments are informed by its CFO Task Force. This group is made up of the Chief Financial Officers and Operating Partners of more than 100 of our member firms. Most of our CFO Task Force Members are CPAs and many have audit experience

[1] Venture capitalists are committed to funding America's most innovative entrepreneurs, working with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. As the voice of the U.S. venture capital community, the National Venture Capital Association empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community's preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites its nearly 400 members through a full range of professional services. For more information about the NVCA, please visit www.nvca.org.

with leading national firms. They are responsible for the financial statements of hundreds of venture capital funds. Our task force members also offer a perspective on the audit process related to hundreds of companies across numerous industries.

The typical venture capital fund ("VCF") is a limited partnership in which the bulk of the capital commitments come from pension funds, foundations, endowments, insurance companies and other institutional investors. VCFs must provide these limited partner investors ("LPs") with audited financial statements prepared in accordance with ASC Topic 946 on Investment Companies. As such, VCFs report assets at fair value in accordance with ASC Topic 820. The most important elements of VCF financial statements are the values of their portfolio company assets. Because many of these portfolio companies do not yet have proven business models or technologies they are valued based upon "level 3" inputs. Therefore, fair values exhibit a great deal of estimation uncertainty. Realized returns from exits can range from liquidation value to many multiples of the fund's investment.

We are filing a comment letter on these two PCAOB Proposals for several reasons. First, NVCA's members -- although they are primarily private entities -- are intensely interested in these PCAOB rules. Audit firms use the same procedures for auditing private funds as they use for publicly traded ones. These procedures are driven by PCAOB standards and examination practices. We noted this in our lengthy letter in response to the 2014 Staff Consultation Paper, *Auditing Estimates Including Fair Values.* That letter[2] sets out the difficult and persistent problems that arise from auditors' use of standardized audit procedures to test the values of venture capital assets. Excessive audit procedures around uncertain estimates of value waste scarce resources and can convey an erroneous and inappropriate sense of precision. Furthermore, the use of valuation techniques that are not useful to marketplace participants is inconsistent with the requirements to Topic 820. I will not belabor these points or repeat the comments in our earlier letter on fair value audits. However, the comments in that letter remain valid. I commend them for your further consideration.

We are combining our comments on these two proposals because, as noted in the Staff Consultation Paper, *Auditors' Use of the Work of Specialists,* there is significant overlap between issues arising from audits of estimates and auditors' use of specialists. This is especially true for VCFs. The reasons for this are set out in NVCA's letter in

[2] https://pcaobus.org/Rulemaking/Docket043/042_NVCA.pdf

response to the SCP on Use of Specialists. Unnecessary, ineffective and inappropriate use of valuation specialists is a major contributor to the excessive cost and effort that VCFs continue to experience in obtaining GAAP audits. Rather than reiterate those points here, I will reaffirm those views, incorporate that letter[3] by reference and commend our comments there for your further consideration.

This letter is abbreviated compared to our earlier letters. One reason for this is that we know that both the PCAOB Chairman and senior staff are aware of our concerns and have provided our members meaningful opportunities to explain them. We very much appreciate the way the PCAOB has engaged with NVCA to date and we hope to continue to engage with the Board and the staff as any changes to these audit standards are implemented.

Finally, this letter is brief because we are not auditors and will not be responsible for interpreting or implementing any new standards. We will, of course feel the impact of any new standard. Therefore, rather than attempt to parse the proposed language we will offer some observations on the negative impact we expect from these amendments as well as some recommendations on mitigation.

COMMENTS AND RECOMMENDATIONS

Auditors' implementation of any new standards will be driven by PCAOB oversight. Auditors' "default" position will be to do more checks and require more documentation of valuations and to use more experts. From our perspective, <u>existing</u> rules, inspection priorities and peer reviews are already driving enhancements to audit procedures. Our members already see an ongoing trend toward more documentation and more unnecessary testing.

The difficulty of auditing inherently judgmental assumptions and other inputs has already caused an undue emphasis on testing of things that can be audited, but are not material. Specifically, for estimates in which the most meaningful inputs are entirely subjective, auditors place undue emphasis on testing inputs that are the easiest to audit, even when such assumptions *per se* may have only a limited impact upon an estimate. For example, in auditing a discounted cash flow, auditors can spend considerable time evaluating whether the correct discount rate was used when it is the

[3] https://pcaobus.org/Rulemaking/Docket044/045_NVCA.pdf

estimate of future cash flows that is the most meaningful input and creates the most volatility.

Every indication we have seen is that the proposed changes will accelerate and exacerbate the trend for auditors to do more and more work on matters that do not present a risk of a material misstatement. Therefore, the proposed standard on *Estimates* would be greatly enhanced by a clear recognition that the reasonable range of estimated values for some assets exceeds their materiality. Furthermore, we believe that any new standard should recognize that when the most relevant aspects of a valuation are inherently judgmental no amount of additional audit work will produce a value the uncertainty of which is less than the materiality standard. Nor can the use of experts to review inherently judgmental valuation inputs improve an audit when estimation uncertainly is greater than materiality.

We appreciate that the proposed new standards are written with an eye toward balancing risks and costs. The proposed text can be read to allow auditors a degree of flexibility in the conduct of fair value audits or the use of specialists. However, the consequences for an auditor subject to PCAOB oversight of doing too little work remain exponentially more troubling to the auditor than those for doing too much work. Given this reality, there is a glaring absence in the proposed language of any caution to avoid excessive work or any comfort regarding the exercise of professional judgment or discretion. Therefore, we are concerned by the absence in the proposed standards of encouragement to use judgment and to assess the cost-effectiveness of audit procedures or the use of specialists.

Further adding to this risk of wasteful audit work are long lists in the proposed standards of matters that the auditor should evaluate or consider. For example, proposed AS 2501.15 sets out a minimum of five "[f]actors that are relevant to identifying significant assumptions…."[4] Similarly 2501.16 requires the auditor to evaluate seven specific issues regarding the "reasonableness of significant assumptions [in a fair value estimate], both individually and in combination."[5] Seven more "factors" are identified in 2501.17 that an auditor should "take into account … in evaluating the reasonableness of [significant assumptions based on the company's intent and ability to

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[4] *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements,* P. A1-6. Available at https://pcaobus.org/Rulemaking/Docket043/2017-002-auditing-accounting-estimates-proposed-rule.pdf
[5] *Id.,* P. A1-7.

carry out a particular course of action]."[6] Nothing in these various lists directs consideration of a cost-benefit balance or whether further testing and analysis will meaningfully improve the auditor's ability to assess the reasonableness of the estimate overall.

We believe it is likely that auditors will assume that each of these factors or considerations will need to be addressed in a granular way absent explicit language to the contrary. Therefore, if the Board intends for auditors to exercise professional judgment and apply these standards in a risk-based manner, we think it imperative that the standards explicitly state that not all listed factors and considerations should be part of a typical audit. More generally, the PCAOB should signal that wasteful, self-protective auditing practices are inconsistent with overall PCAOB standards. Otherwise, "factors to be considered" will become part of mandatory check lists to be documented, leading to excessive and meaningless audit procedures.

The Board intends that these standards be implemented in a risk-based, cost-effective manner. Release No. 2017-003 justifies application of the Use of Experts amendments to Emerging Growth Companies (ECGs), in part on the assumption that the new requirements will be implemented in a risk-based and "scalable" manner.[7] While we hope this is true, we are certain that the Release is correct where it says that "even a small increase in audit fees could negatively affect [small companies'] profitability and competitiveness."[8] Experience drives us to skepticism about the likelihood of risk-based or scalable implementation. Therefore, we strongly recommend that the Board commit to a systematic and objective post-implementation review of the impact of any new standards on the costs and benefits of audits for smaller companies, including ECGs should the SEC accept the PCAOB's recommendation to apply these new standards to ECGs.

Summary of Recommendations

- The new standards need to explicitly recognize that there are situations in which estimation uncertainty exceeds materiality. In such situations, there may be limited value to applying additional testing and audit procedures, when the

[6] *Id.,* P. A1-8.
[7] *Proposed Amendments to Auditing Standards for Auditor's Use of Specialists*, P. 58. Available at https://pcaobus.org/Rulemaking/Docket044/2017-003-specialists-proposed-rule.pdf.
[8] *Id.*

additional procedures won't reduce estimation uncertainty to any meaningful degree.

- To promote professional judgment and risk-based application, the standards should explicitly state that not all listed factors and considerations should be part of a typical audit.

- The Board should send a general signal that wasteful, self-protective auditing practices are inconsistent with overall PCAOB standards.

- The Board should schedule a systematic and objective post-implementation review of the impact of any new standards on the costs and benefits of audits for smaller companies, including ECGs, should the SEC decide to apply these new standards to ECGs.

Conclusion

NVCA appreciates the opportunity to participate in the PCAOB's rulemaking process and the Board's consideration of our views. We stand ready to work with the Board and the staff on this and other important matters. Please feel free to contact me at (202) 864-5925 or bfranklin@nvca.org or Justin Field, Vice President of Government Affairs at (202) 864-5929 or jfield@nvca.org.

Sincerely yours,

Bobby Franklin
President & CEO