November 3, 2014

VIA Email
Office of the Secretary
PCAOB
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RE: PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements*

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. We are pleased to respond to the above referenced Staff Consultation Paper for a number of reasons set out below.

The typical venture capital fund ("venture fund" or "VCF") is organized as a limited partnership in which the venture capital firm serves as the general partner ("GP") and investment manager. The majority of the investment capital in each fund comes from limited partner investors ("LPs"), the majority of whom are pension funds, foundations, endowments, insurance companies and other institutional investors. Most VCFs invest in start-up companies whose path to success is quite uncertain. Their progress is measured over years and the investment outcome is usually binary: a

[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.

success that yields a return to the fund or failure and liquidation. Therefore LPs agree to a commitment of funds for a period that ranges from seven to ten years reflecting the long-term, illiquid nature of venture capital investing. The vast majority of venture investors expect, and in many cases, require audited financial statements prepared in accordance with GAAP.

NVCA's comments are informed by the active input of its CFO Task Force. This group is made up of the Chief Financial Officers and Administrative Partners of more than 100 of our member firms. Most of our CFO Task Force Members are CPAs and many were once auditors 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 represented in the diverse portfolios of the funds that they oversee and other career experiences.

Our members generally use Investment Company accounting, which requires that portfolio company investments be reported at fair value in accordance with ASC Topic 820. Many of these portfolio companies do not yet have proven business models or technology, making them more difficult to value based purely current financial metrics or external public market comparables. Many define new categories and are unique in their business models and products. Level 1 or even level 2 fair values are not achievable for the vast majority of fund assets for nearly the entire life of the portfolio company as a venture fund asset. Only upon an "exit" of the investment through its sale or issuance of securities to the public are level 1 or level 2 inputs available. Therefore, nearly all VCF assets are valued based upon level 3 inputs.

General Comment

NVCA is responding to this paper for a number of reasons. Our members' funds and many of their portfolio company investments are crucial to the process of innovation and new business formation that fuels significant growth in the economy. Key to protecting investors' interests in venture capital is the focus on efficient use of resources, both human and financial. Efficiency in financial reporting, including in the audit process is therefore important. Time and money invested in the audit process is time and money that can't be invested in building portfolio company value. We are confident that venture fund investors understand and appreciate the great uncertainty involved in the point value of VCF assets.

While there are other areas in VCF financial statements that may require estimation, the auditor's procedures around the estimates of fair value for portfolio company investments is where most hours are spent. It is also the most likely subject of contention between the fund manager and auditors. Much of this contention is about the emphasis on the types of tools used in valuation and the difficulty of auditing the all-important qualitative judgment of venture capital professionals.

Because of the uncertainty around the value of nearly all venture fund assets, additional resources devoted to inherently subjective estimates of the value of each asset has limited yield in terms of fund value. Therefore, we are driven by cost-benefit concerns -- which our investors share -- to focus on developing efficient, reasonably auditable valuation estimation in accordance with the provisions of ASC 820. We discuss this in greater detail below.

While the vast majority of funds and portfolio companies are private companies, our audit processes reflect the PCAOB's oversight of the audit firms. In the experience of our CFO members, audit firms generally apply the same procedures when auditing private companies as when auditing public companies.

We recognize the importance and the difficulty of the auditors' role in financial reporting. While our comments focus on the challenges we have faced with audits, and ways in which we believe the audit process can be improved, we do not intend to criticize the profession. From our experience there is no question that members of the audit profession regularly and consistently demonstrate a level of professional skepticism and independence that is consistent with the role of preserving public trust.

Our goal is to assist the PCAOB and the audit profession in improving both the quality of venture fund audits and the efficiency with which they are conducted. We believe that this is possible if the PCAOB emphasizes greater respect for professional judgment and less reliance on quantitative means of estimating fair value.

Role of the PCAOB

We recognize the broad supportive role that the PCAOB plays in creating consistent quality in the audit process, particularly in the larger public accounting firms. This independent oversight provides meaningful value to the investors who are the primary users of our financial reporting. We share the PCAOB's and auditors' goal of delivering high quality financial information to our investors.

The process of testing and reviewing many of the largest firms' audit practices has caused audit firms to focus more diligently and more systematically on audit processes and approaches. Since the establishment of the PCAOB, audit firms have increasingly standardized audit procedures and centralized authority in their national offices. This has generally resulted in audits that favor quantitative metrics and models over more judgment-based factors.

Metrics and models can be useful to the funds in preparing financial estimates. They are some of the many tools that a VCF professional uses in developing estimates. However, in estimating the fair value of venture capital fund assets, there is no substitute for the business acumen and seasoned intuition of the fund partners. Indeed, a GP's understanding of the factors that contribute to assessing the most appropriate fair value of any individual investment is a decisive element in an LP's decision to make the long-term commitment inherent in venture investing.

Unfortunately, the accounting firms' trend toward centralization and quantitative models in valuation has reduced the willingness (or ability) of audit partners to exercise discretion and professional judgment in their audits. We see this occur repeatedly even though sound judgment may in fact be the most important factor in auditing inherently uncertain estimates.

FASB Fair Value Standard --Topic 820

NVCA has worked with the FASB on developing and evaluating the fair value standard since its first exposure draft in 2005. Through various means NVCA and its CFO Task Force members have had an ongoing and constructive dialogue with the FASB regarding the language and the interpretation of Topic 820. We have been encouraged by the FASB's openness to our perspective regarding some of the challenges of implementing Topic 820. Most of the comments in this letter have already been delivered to members of the FASB and its staff.

Topic 820 recognizes that, with the exception of level 1, fair value cannot be determined with precision. While the accounting standard requires that the fund account for its Level 3 investments using a point estimate, the standard recognizes that there is a range of possible values for a specific investment. This simply reflects reality. In practice, investing professionals read level 3 fair value estimates with the understanding that a point estimate for fair value implies a level of precision that is illusory. We recognize that this tension is inherent in assessing the fair value of assets that are difficult to value. However, it is necessary for all stakeholders in the reporting process, including regulatory agencies to appreciate the necessary judgments and subjectivity in these assessments.

Estimating and Auditing Fair Value in Venture Capital Funds

The key language of Topic 820 creates a tension that plays out in venture fund audits. While Topic 820 requires a point estimate of fair value, it also requires that fair value be measured based on "the assumptions that market participants would use in pricing the asset…."[2] The market participants in early-stage venture-backed companies are the venture capital funds that purchase their stock. For a typical venture fund asset the most crucial "assumptions" that venture capital "market participants" use in either assigning a value or making an investment are based on the venture professionals'

[2] ASC Topic 820-10-35-9.

subjective evaluation of business operations and company progress. Often the critical elements of this judgment are intangibles – quality and track record of the management team, size of a perceived future market, momentum in a market sector, etc. Venture professionals use a variety of quantitative and qualitative tools to assess a fair price for such stock and almost always assess the asset in terms of a range of values – high, middle and low – rather than a point estimate.

Valuation models have their uses, and we understand their utility for preparers of financial statements and their auditors.[3] However, the fair values that result from these models are based on assumptions that the user selects. They have no more inherent precision than fair values bases on more subjective or judgmental inputs. Therefore, venture capitalists, the "market participants" and acquirers of portfolio company stock often do not use these models as the basis for pricing the securities in which they invest.

Over the past several years, our CFO Task Force members have observed a change in audit processes that has emphasized mathematical models over more subjective judgments. We understand the difficulty of auditing subjective judgments and we appreciate the need for audit firms to document the basis for their conclusions. However, our experience is that auditors in many cases are requiring that VCF fair values tie to a mathematical solution to the exclusion of more valid subjective factors. Ignoring the subjective assumptions of the market participants and basing fair values solely on quantitative assumptions that fit into a formula is arguably inconsistent with the requirements of Topic 820. Furthermore, it may also be that this focus on mathematical precision and documentation of what are essentially "management's assumptions" is inconsistent with the applicable audit standard.[4] Finally, and perhaps most important, the implementation of Topic 820 by some accounting firms has failed to provide VCF investors with information on asset value that is worth the cost and effort it takes the fund to produce it.

Auditing estimates requires the exercise of judgment. Auditors need to have (or have access to) expertise with in-depth familiarity with the company's long-term industry trends, opportunities and challenges, financial metrics upon which similar companies trade, etc. Auditing venture capital is particularly challenging because it

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[3] These tools include, but are not limited to options pricing models, probability-weighted estimates, Monte Carlo simulations, and discounted cash flow, where any cash flow exists. When a portfolio company reaches a more advanced stage, market comparable data may be available.

[4] *See* AU Section 328.32. ("Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions provide a reasonable basis for measuring fair values in the context of an audit of the financial statements taken as a whole.")

requires an understanding of not only the venture investing space, but also of the types of companies in which the fund invests.[5] This is even more challenging when evaluating investments in groundbreaking companies with new business models or technologies where there is no existing market.

Still the standard requires that fair values be based on the assumptions that market participants use. Therefore, an audit of a VCF should be based on an auditor's exercise of a reasonable professional skepticism and independent judgment, in consultation with appropriate experts. An auditor should be able to audit fair values based on an evaluation of the assumptions, qualitative and quantitative, that the market participant actually uses and satisfy her or himself that those fair value estimates were arrived at in accordance with GAAP. This evaluation should not require extensive work by the preparer or the auditor to develop assumptions that fit a quantitative paradigm that a fund ("market participant") does not use.

Our comments reflect a broad trend in the audits of venture capital funds. We would be pleased to arrange a meeting or conference call with some of the NVCA CFO Task Force members and PCAOB staff to offer some specific examples of situations that they have experienced in dealing with their audit firms' interpretation of audit requirements. We believe these examples illustrate situations in which the additional effort and cost by the preparer and the added work done by the audit firm did not enhance the quality of financial reporting or utility of the financials to VCF investors.[6]

Recommendations

Our observations regarding our experiences with audits of portfolio company valuations are representative of a broader set of issues with the auditors' processes and procedures. We offer the following suggestions for improving this process:

1. Auditors should be encouraged to use their professional judgment in evaluating the critical judgments made by VCF professionals rather than solely imposing a model-based fair value. Consideration of all quantitative and qualitative judgments made by market participants in setting values in open market transactions is key to a thorough and accurate assessment of the fair value of underlying VCF investments.

[5] And in the context of B2B companies, understand that company's business requires an understanding of trends in target customer companies.
[6] Our CFO Task Force Members also frequently note that field and local audit professionals have expressed similar frustration with the "tick and tie" requirements that usurp their ability to exercise their own professional judgment in auditing fair value estimates. We understand these requirements are driven by the need for documentation they must have in the event of a review of their audit work papers.

2. Materiality and cost/benefit considerations should receive greater emphasis as an element of audit quality. It is critical that the cost to investors of documentation and audit procedures be commensurate with the usefulness of estimates that are inherently subjective, imprecise and variable.

3. We recommend that the PCAOB:

    a. Publicly acknowledge the role of judgment and support the auditing profession in situations where there are factors that are inherently subjective. Emphasis should be on the audit process and assessment of all qualitative and quantitative factors, rather than a more narrow focus on specific mechanical models;

    b. Consider a "safe harbor" for auditors who are able to establish ranges for estimated values. (For example, to the extent that the audit client's reporting is within the range and has provided reasonable explanation for how they determined their point estimate, audit requirements are met);

    c. Encourage training programs on fair value and other areas where subjective estimates are regularly made; and

    d. Create a private sector advisory group of preparers and auditors with expertise in the technical areas and industries where fair value determinations and other estimates are regularly involved to advise the Board.

Conclusion

NVCA appreciates the opportunity to participate in the PCAOB's consultation process. We stand ready to work with the Board and the staff on this and other important matters. Please feel free to contact me at 703 778 9278 or bfranklin@nvca.org or John Taylor, NVCA Head of Research at 646 571 8185 or jstaylor@nvca.org.

Sincerely yours,

Bobby Franklin

Bobby Franklin
President & CEO