



National Venture Capital Association

July 12, 2007

VIA E-Mail

Ms. Nancy M. Morris

U.S. Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549-1090

*rule-comments@sec.gov*

Re: *Release Nos. 34-55876 & 55912 (File No. PCAOB-2007-02) Proposed Rule on Auditing Standard No.5, An Audit of Internal Controls over Financial Reporting that is Integrated with an Audit of Financial Statements.*

INTRODUCTION

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

NVCA has submitted at least four separate comment letters to the Commission or to the PCAOB regarding the standard for Sarbanes-Oxley Section 404 audits of internal controls over financial reporting (“ICFR”), each of which stated our central concerns.<sup>2</sup>

---

<sup>1</sup> 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 US 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](http://www.nvca.org).

<sup>2</sup> See e.g., NVCA comment letter to SEC, File No. S7-24-06: SEC Proposed Rule Concerning Management's Report on Internal Control over Financial Reporting (Release Nos. 33-8762; 34-54976); (Feb. 23, 2007). available at <http://www.sec.gov/comments/s7-24-06/s72406-94.pdf>

Therefore, we will not restate the significance of the impact that the Commission's and the PCAOB's implementation of SOX 404 has had on venture capital. Our key remaining concerns can be stated in response to three of the specific questions in Release No. 34-55912.

RESPONSE TO SPECIFIC QUESTIONS IN JUNE 15, 2007 ADDITIONAL SOLICITATION OF COMMENT, Rel. No. 34-55912.

Release Question No. 6: Will AS-5 reduce expected audit costs under Section 404, particularly for smaller companies and result in cost-effective, integrated audits?

It has been more than two years since the first recognition that the implementation of SOX 404 has been enormously costly for smaller companies that have had to comply with the rule and also presented a risk of serious harm to the smallest public companies. We commend the SEC for its recognition of the problems and its effort to enact solutions. However, as we move into potential implementation, there remains significant uncertainty as to whether AS-5 will ensure that reform measures are meaningful and carried out in a way that will result in significant relief for smaller companies.

The venture capital industry believes that three drivers are critical in this regard. First, we are gravely concerned that the accounting profession will not change its high cost practices and that Auditing Standard No. 5 does not provide specific enough guidance to compel them to do so. Second, an oligopoly of the Big Four accounting firms exists for SOX 404 audit work. Smaller firms have no choice if they hope to access the public capital markets and they have no bargaining leverage with the Big Four. Therefore, we do not think that AS-5 will bring about reduced costs or cost-effective audits. Because of these concerns, we strongly recommend that the Commission require -- prior to adoption of AS-5 -- full field testing to determine whether AS-5 will reduce costs.

Release Question No. 1: Is the standard of materiality appropriately defined throughout AS-5 to provide sufficient guidance for auditors?

Materiality is not sufficiently defined in AS-5 because AS-5 instructs the auditor to use the same definition as is used in audit of financial statements. While it is appropriate that the AS-5 definition of materiality be the same one that is used in the securities laws generally, that definition, unfortunately, is so amorphous as to set no real boundaries. The expansion of the materiality standard to a point that it is more a concept than a true standard is not new and does not affect Section 404 only.<sup>3</sup> However, the application of this amorphous definition to so costly an exercise as the SOX 404 audit is a leading cause of the excessive cost.

Fortunately, the Commission has the authority to amend the definition of materiality for financial statements and should direct the Chief Accountant to undertake a thorough reexamination of Staff Accounting Bulletin No. 99 with an eye toward making the SEC's definition of materiality in financial reporting concrete and operational. The goal of such a revision should be to provide auditors and management with a standard that can be applied in financial reporting practice instead of one that maximizes enforcement options for the SEC and the private bar.

Until such action is taken, the definition of materiality in AS-5 will not provide sufficient guidance for auditors to conduct risk-based, cost-effective audits of ICFR.

Release Question 4: Does the definition of material weakness in Paragraph A7 (which is consistent with the definition that the SEC adopted) appropriately describe the deficiencies that should prevent the auditor from finding that ICFR is effective?

Central to the notion of risk-based audits is the standard used to measure the adequacy of review of the effectiveness of ICFR. In our February 23 comment letter,

---

<sup>3</sup> See Sauer, Richard C., "The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws," 62 Business Lawyer 317 (Feb. 2007).

NVCA recommended various changes to AS-5 that would increase the acceptable level of risk under the standard.<sup>4</sup> We recommended that the Foreign Corrupt Practices Act (“FCPA”) definition of “reasonable assurance” be incorporated into AS-5 so that “every definition that bears upon ‘the level of detail and the degree of assurance’” required in the audit standard reflect the securities law definition of reasonable assurance.<sup>5</sup> [emphasis supplied]. Because the definition of “material weakness” in Paragraph A7 is based on FASB Statement No. 5 rather than the more practical FCPA notion of reasonable assurance, it will result in auditors requiring excessive work in order to find that a company’s ICFR is effective.

The PCAOB’s shift of the definition of a material weakness from “more than remote likelihood” in AS-2 to “reasonable possibility” in AS-5 will have little effect on the level of work that auditors will require in order to meet that standard of risk.<sup>6</sup> Therefore, the definition of material weakness in AS-5 is no more consistent with the appropriate level of inquiry under SOX 404 than was the definition in AS-2. If AS-5 is approved by the Commission with the Paragraph A7 definition of material weakness, any improvement in the cost effectiveness of 404 audits of smaller companies will almost assuredly be minimal. Therefore, we strongly recommend modification to the definition of material weakness to make the threshold for defining a material weakness a more relevant (and cost-effective) “degree of assurance.”

Similarly, the Paragraph A7 definition of material weakness will thwart an appropriate finding of ICFR effectiveness because it applies not just to annual, but to interim financial reports as well. SOX 404 describes an annual requirement to review

---

<sup>4</sup> See Feb. 23 letter, *supra* note 2, at 15-18.

<sup>5</sup> *Id.* at 17. (FCPA defines “reasonable assurance” as “such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.” 15 USC 78m(b)(7).)

<sup>6</sup> Comment of Deloitte & Touche LLP, PCAOB Rulemaking Docket Matter No. 021, p. 10 (Feb. 23, 2007) (“We do not believe that the changes in the definitions will substantively impact the effort involved in the identification and evaluation of deficiencies, as we have always understood the concept of ‘more than remote’ and ‘reasonably possible’ to be the same.”); *see also*, American Bar Association, Section of Business Law, Committees on Federal Regulation of Securities and Law and Accounting comment letter to SEC, File No. S7-24-06: Management’s Report on Internal Control Over Financial Reporting, pp. 2-3 (Mar. 6, 2007); Comment of Committee on Financial Reporting, New York City Bar to SEC, File No. S7-24-06, p. 3-4 (Feb. 26, 2007).

ICFR, which is linked to the annual financial reports -- "as of the end of the most recent fiscal year of the issuer."<sup>7</sup> However, the definition of material weakness in AS-5 continues to focus on the risk that "a material misstatement of the company's annual *or interim* financial statements will not be prevented or detected." [emphasis supplied]. Just as it is consistent with the statute to scope the SOX 404 audit to the annual reporting period, material weaknesses should also be measured against an annual scale. The SEC Advisory Committee on Smaller Public Companies made this same recommendation as a means to make the SOX 404 process more cost effective.<sup>8</sup>

This point is particularly important for smaller companies whose operations can be volatile quarter to quarter. The impact of a control deficiency on the financial statements in one quarter may be quite different from its impact on the very next quarter. Particularly in light of the clear risk that auditors will err toward more work and less risk, a review aimed at the quarterly financial level has scant chance to be done cost-effectively. Therefore, the inclusion of interim financial statements in the definition of material weakness in Paragraph A7 describes deficiencies that are far less consequential than those which should prevent the auditor from finding ICFR effective under the standard established in SOX Section 404.

## CONCLUSION

We are at a critical inflection point and it has taken us a long time to get here. The good work of all involved will be for naught if the accounting profession does not get on board with cost reduction – or if implementation of the proposals fails. There are means by which we can mitigate these serious risks to reform. But the SEC must be deliberate and strong in their resolve. Taking the needed time to field test and placing the needed pressure on the Big 4 to join the effort is required. We have waited too long for this reform to take place – but we are willing to wait longer to make sure we get it right.

---

<sup>7</sup> Sarbanes-Oxley Act § 404(a)(2) (2002).

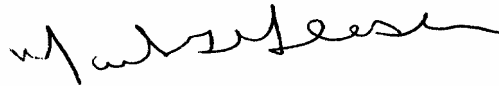
<sup>8</sup> SEC Advisory Committee on Smaller Public Companies, "Final Report of the Advisory Committee on Smaller Public Companies to the SEC," 54-56 (Apr. 23, 2006).

Despite what we would consider an urgent need for reform, we believe that the SEC should proceed cautiously. As builders of new enterprises, we can attest that while the plans often look solid on paper, implementation is another story. It is worth taking that added time to ensure that reform recommendations are positioned for success. AS-5 still needs significant revision if it is to lead to cost-effective audits of ICFR. Time spent revising it now would be consistent with the wisdom to “measure twice, cut once.”

Should the Commission approve the current version of AS-5, it should be field tested. Adopting AS-5 without field testing them first would be akin to purchasing a company without going through due diligence. Field testing ensures that: the recommendations will indeed reduce cost; all the players including the accounting profession are operating in the spirit of reform; and there are no unintended consequences. Understanding how the reform measures work in the real world before officially adopting them will allow the SEC to make adjustments as necessary without having to re-open a new process.

Small companies have already had more than their share of unintended consequences as it relates to Sarbanes Oxley. The SEC should be sure that the PCAOB has it right – and prove that its reform works. We remain willing to work with the Commission in this process.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Mark G. Heesen". The signature is fluid and cursive, with a long horizontal stroke at the end.

Mark G. Heesen  
President