crowdcheck

Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington D.C. 20549-1090

Re: File No. S7-09-13 February 2, 2014

Dear Ms. Murphy:

CrowdCheck, Inc., a company providing disclosure and due diligence services for online securities offerings, is pleased to submit comments with respect to the Commission's proposals for crowdfunding, File S7-09-13. This comment letter relates to two important aspects of financial reporting: the basis of accounting to be used to produce financial statements and the cost of auditing those financial statements on an on-going basis, the costs of which we have a unique appreciation for as we are a small business ourselves.

The basis of accounting

The Commission proposes to require financial statements to be prepared in accordance with US GAAP, which requires accrual accounting. Question 54 in the Proposing Release, however, asks whether issuers should be allowed to prepare their financial statements using a comprehensive basis of accounting other than US GAAP, such as an income tax basis, a cash basis or a modified cash basis. We believe issuers meeting certain conditions should be permitted to prepare their financial statements using an "other comprehensive basis of accounting (OCBOA)."

We think it is important to emphasize that the issue to be addressed is not "US GAAP versus cash accounting." The first question to be addressed is whether cash or accrual accounting should be required or permitted. The second question is that, if accrual accounting is required in some form, whether full US GAAP is an appropriate framework.

Most very small companies keep their financial statements on a cash basis. Preparing financial statements on an accrual basis is more complicated, and requires more judgment, than doing so on a cash basis. The audit process will likely be commensurately more complex (and thus expensive).

While accrual accounting may in some cases give a more accurate picture of a company's financial condition and performance, there are some companies for which the advantages of accrual accounting are more limited, and where the requirements of investor protection would not seem to call for accrual accounting. These are very small issuers and small start-ups.

For some very small issuers, such as small retail operations, the difference between cash and accrual accounting is likely to even out over the long run. For example, the cash financial statements of a small bakery that buys raw materials in bulk and sells products in small amounts may show some variations from month to month, but the annual financial statements required by Regulation Crowdfunding will give a reasonably fair picture of the issuer's financial condition.

Similar considerations apply to complete start-ups. One of the advantages of any accrual-based framework is the ability to match costs to revenues and thus both measure profitability and provide a basis for comparing one company's financial performance to another's. In the case of complete start-ups, these advantages are largely meaningless. Issues of revenue recognition are irrelevant to companies that have no or negligible revenues. Companies that are in true, pre-revenue, start-up mode cannot easily be compared to each other under any method of accounting. Meaningful measures of those companies' financial performance that investors are more likely to care about are cash balances and cash burn.

We note that the Congress is currently considering cash versus accrual accounting in the context of tax reform. While it is perhaps inevitable that tax accounting and financial accounting will diverge to some extent, especially for larger companies, it would be preferable if small businesses were required to make as few adjustments as possible between their financial reporting and their tax reporting. We suggest that the Commission consider permitting issuers seeking crowdfunding to prepare their financials on a tax basis, however that basis is ultimately determined by Congress.

Even if the Commission should choose to require some form of accrual accounting for offerings under Section 4(a)(6), we submit that full US GAAP would be unduly burdensome for small private companies, especially start-up companies in the technology sector. For example, such companies often rely heavily on the issuance of options to attract employees. Complying with US GAAP requirements with respect to option issuance, including complying with fair market valuation requirements, is especially complicated and burdensome for recent start-ups.

Further, it should be noted that it is unlikely the average retail investor buying securities in a Regulation Crowdfunding offering will be in a position to fully appreciate whatever unique advantages US GAAP accounting may provide in this context. From an investor protection perspective it is far more important that a good accounting has been done, whether pursuant to US GAAP or some other basis, and that the investors are educated as to what core things to look for to assess the wisdom of the investment.

We urge the Commission to consider permitting financials to be prepared under an OCBOA. The AICPA's Financial Reporting Framework for Small and Medium-Sized Entities may be one such framework, designed as it is for America's small business community.

The Commission asks whether allowing issuers to use other bases of accounting should be predicated on the size of the raise. We do not believe that size of raise is a useful indicator of either the burden that would be placed on an issuer or of the usefulness of the financial statements to investors. In the event the Commission wished to limit use of non-GAAP financial statements, or encourage small businesses to "grow into" US GAAP gradually, we would suggest that financial statements prepared in accordance with an OCBOA be permitted unless the issuer's revenues for the most recent fiscal year exceed a specified level and the issuer's capitalization exceeds a specified level. We believe that above a certain level of capitalization, a company both has the resources to produce US GAAP financial statements, and above a certain level of revenues, those financial statements would have some usefulness to investors. We suggest that appropriate levels to set these measures might be $1milion in revenues and $10 million in total capitalization, although these measures should be coordinated with requirements for tax accounting as discussed above.

Burden of on-going audit requirements

Proposed Rule 227.202 requires a company that raises $500,000 or more within a 12-month period via a Section 4(a)(6) raise provide audited financial statements as part of its annual disclosures until such time as the company becomes a reporting company, the securities are purchased, retired, or redeemed, or the company ceases operations. Question 80 of the Proposing Release requests comment on whether the Commission should require the annual reports as proposed, including the requirement for an annual audit requirement. While the JOBS Act required a company provide audited financial statements at the point of offer under certain conditions, and required certain on-going disclosures on the part of the company, there is no on-going audit requirement in the statute. Given the considerable burden such a requirement would place on businesses, and the limited benefit of such a requirement, the Commission should not include this requirement in the final rules.

An on-going audit requirement will create an unpredictable on-going burden, both in terms of compliance cost and distraction, on small businesses that elect to use Section 4(a)(6) to raise capital. Since there is no fixed ending date for the requirement, except in cases of fixed-term debt, a company deciding whether to pursue a Section 4(a)(6) raise cannot accurately determine the cost-of-capital for the raise. Even if the cost of the initial audit is fairly low, given the open ended nature of the requirement a company will not be able to assume that cost is representative of the audit cost going forward, creating a danger that a company will be faced with an unexpectedly high cost in the future. It is not uncommon for accountants to charge a low initial fee for the audit of a small company, with the intention of charging higher fees as the company grows.

Additionally, the on-going audit requirement will subject the company to an annual distraction of being audited.

This cost and uncertainty is likely to have several negative impacts on the Section 4(a)(6) market: First, it will serve as a disincentive for high quality companies to seek investment via Section 4(a)(6). By raising the cost and burden of Section 4(a)(6) relative to other options such as Regulations A or D or more traditional bank loans which do not require annual audits, the companies that can pursue funding via those methods will not consider Section 4(a)(6), leaving the Section 4(a)(6) market as a "market of last resort" for less promising companies and denying potential Section 4(a)(6) investors good investment options. Second, the costs of compliance with the on-going audit requirement may incentivize a company to use funds to redeem the Section 4(a)(6) securities that would be better suited to growing the business and creating values for the company's stakeholders. Third, the cost of compliance will be an extra liability the company will need to deal with, possibly weakening its ability to compete and survive, harming both the company and its investors.

While the on-going audit requirement is designed to provide investors and potential secondary purchasers of the company's securities with updated information about the company, it is unnecessary given the other, less burdensome, on-going disclosure requirements contained in the statute and proposed regulation. Additionally, the on-going audit requirement is inconsistent with the treatment of other exemptions to registration utilized for small businesses, including exemptions that allow for considerably larger offerings. For example, Regulation A allows an issuer to offer up to $5 million dollars in securities per year, with the securities being freely tradable after the issuance without any audit requirement, let alone one that continues for the life of the security.

The proposed on-going audit requirement provides a uniquely onerous burden on small businesses that is unnecessary for investor protection and counter-productive to capital formation. The on-going disclosure requirements provided for in the JOBS Act provide significant information to both inform investors and discipline the issuer. If the Commission wishes to increase the amount of on-going disclosure required from the baseline provided by the statute it may consider requiring reviewed financials in cases where the company has issued between $100,000 and $1 million dollars worth of securities under Section 4(a)(6) within a 12-month period. This would provide for a third party to be involved in the on-going disclosure process at a lower and more certain price point, making Section 4(a)(6) more attractive for quality companies and therefore providing potential Section 4(a)(6) investors with better quality opportunities.

Thank you for your consideration,

/s/Brian Knight

Brian Knight
VP, CrowdCheck, Inc.