



National Venture Capital Association

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**VIA Email**

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*Re: SEC Proposed Rule Concerning Management's Report on Internal Control over Financial Reporting – Release Nos. 33-8762; 34-54976 (File No. S7-24-06); and*

*PCAOB Proposed Audit Standard – An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals -- Release No. 2006-007 (Rulemaking Docket No. 021).*

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.

VC firms form and manage the funds that invest in start-up and early-stage businesses, which they commonly call “portfolio companies.” Venture capital investing relies on the ability

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<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 U.S. 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).

of venture capital funds (“VCFs”) to exit those investments through a liquidity event, with the proceeds being distributed to their investors.

Although venture firms’ focus is on private companies, both the state of the regulatory environment for public companies and the state of the overall US environment for capital formation are critically important to venture capitalists and the companies they fund. For the types of small, high-growth technology companies that are the focus of many venture funds, investment dollars must be devoted to key business goals if those companies are to survive and hopefully grow. Money spent on unproductive regulatory compliance can quickly undermine the ability of small start-ups to disrupt the market share of entrenched incumbents or break through skepticism to create entirely new industries. This is especially true in the ever-growing number of technologies and products where the competition is truly global.

Because venture capital investing relies on the ability of VCFs to exit those investments through one of two liquidity events – IPO or acquisition – the impact of the Sarbanes-Oxley Act (“SOX” or “the Act”) on both exit strategies has rippled through the entire venture capital community.

Section 404 of the Act (“SOX 404”) is clearly one contributing cause in the general slowdown of the U.S. IPO market.<sup>2</sup> NVCA members see SOX 404 as disadvantaging U.S. companies seeking access to public capital markets, diverting resources away from more productive activities and adding significant new deadweight expenses. This affects the going-public process directly. Companies with net income below a certain threshold cannot attract a critical mass of IPO investors. SOX 404 compliance costs reduce the net incomes of companies, which disguises their value to potential purchasers of a public stock offering. This is true despite new rules allowing for deferral of full SOX 404 compliance for IPOs because venture capital investors prudently insist that full SOX compliance must be assured before the company goes to the public markets. Therefore, the progress of venture-backed companies toward an IPO is

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<sup>2</sup> McKinsey & Co., *Sustaining New York’s and the US’s Global Financial Services Leadership*, (2007), p. 97. This study, commissioned by the City of New York found that SOX 404 compliance “can be overwhelming for smaller companies that lack the infrastructure necessary to comply efficiently.”

artificially delayed both by diversion of resources and the lower net earnings that come from the unproductive expenses of SOX 404.

Similarly, venture capital-backed companies pursuing an acquisition strategy are affected by the Act's implementation cost burden. Acquirers are now prudently insisting that companies of interest be SOX-compliant before any deal is finalized. However, this prudence often forces young, thinly capitalized start-ups to become compliant at a time when, in the current environment, the costs of doing so are most excessive.

Equally important to the current considerations of the cost-benefit balance of SOX 404 compliance is the absence of the often-cited lower cost of capital that was supposed to offset the high cost of SOX 404 for issuers and investors. Our members do not see it and there is certainly no proof that investors will pay a "cost of capital premium" for SOX 404 compliance.<sup>3</sup> Therefore, the fact that IPO investors are increasingly drawn to foreign stock markets and non-U.S. IPO companies is not surprising.

## **I. BACKGROUND ON NVCA'S COMMENTS**

We are encouraged that there seems to be widespread understanding and concern regarding the problems that have come from the implementation of SOX 404. We have hoped that the efforts of the SEC and the PCAOB would result in a substantial change in the Section 404 cost-benefit balance.

Unfortunately, much of the behavior at the root of the problem is now entrenched and we are skeptical that well-intentioned efforts that emphasize better implementation will be sufficient. Having read both the SEC Release on Proposed Rules Concerning Management's Report on Internal Control over Financial Reporting ("SEC Release") and the PCAOB's Proposed Audit Standard and Related Other Proposals ("PCAOB Release"), we conclude that a significant

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<sup>3</sup> Interim Report of the Committee on Capital Markets Regulation, Section V: Sarbanes-Oxley Section 404, pp. 124-125 (November 30, 2006).

change in the way the Commission and the Board interpret the Congressional intent of SOX 404 is needed.

Given the many external pressures that have driven auditor behavior in response to the regulatory mandates under SOX 404,<sup>4</sup> we believe that the following actions are necessary to achieve a significant correction in the SOX 404 cost-benefit balance.

- Eliminate the external audit of the effectiveness of internal control over financial reporting (“ICFR”).

While the statutory language of 404(b) requires auditors to attest to management’s assessment of internal controls it does not require a separate audit of the effectiveness of the controls.<sup>5</sup> The SEC’s rules and the PCAOB’s auditing standards should be revised to eliminate the requirement for the auditor to attest to the effectiveness of an audited company’s ICFR.

- Use an economically sound method of cost-benefit analysis in evaluating the success of SOX 404 implementation.

The problem with excessive SOX 404 cost is well known. However, the benefits are incremental and difficult to measure. The SEC should develop a cost-benefit analysis of any new standards based on an actual review of market behavior and reaction to the new rules. Neither the SEC nor the PCAOB has sufficiently defined the metrics that will be used to

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<sup>4</sup> As we noted in our comment letter on the Draft *Report of the Advisory Committee on Smaller Public Companies*: “Accounting firms’ fear of liability from civil sanctions and criminal sanctions by the SEC, the PCAOB and prosecutors, not to mention civil securities class action suits, drives conservative judgments and excessive work. Furthermore, it is also widely understood that accounting firms have economic incentives to expand the scope of their internal controls audits.” Available at: <http://www.sec.gov/rules/other/265-23/26523-378.pdf>, p. 11.

<sup>5</sup> Sarbanes-Oxley Act Section 404(b) reads, in its entirety: “INTERNAL CONTROLS EVALUATION AND REPORTING. – With respect to the internal control assessment required by subsection (a) each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.” While the Board cites ambiguous language in SOX Section 103 as statutory justification for the audit of ICFR effectiveness, (PCAOB Release at 16), nowhere does either Section 404 or Section 103 say or clearly imply that the auditor is to replicate management’s required assessment of the effectiveness of ICFR.

determine a successful reform outcome. Commissioner Kathleen Casey's recent statements are instructive here. At the PLI's *SEC Speaks* Conference this month in Washington, she said that recent judicial rebukes of the SEC's cost-benefit analysis

“offer an opportunity to more fully incorporate economic analysis into our decision making, rather than simply viewing it as a purely mathematical exercise or a postscript to a predetermined policy outcome. Investors and our markets deserve a more rigorous analysis than merely following gut instincts or embracing the ‘it feels good, so it must be right’ approach. In our rulemaking, this requires a process that ensures a full appreciation of the economic implications of various policy choices and fully estimates the costs and benefits associated with our actions.”<sup>6</sup>

- Defer compliance with SOX 404(b) for smaller companies until the results and analysis of a sound cost-benefit study are complete.

Deferral of the costly auditor attestation of ICFR for smaller companies (including smaller accelerated filers) is appropriate “unless and until” the cost-benefit imbalance of SOX 404 compliance is clearly corrected.

The task of developing new rules and standards that will bring about more efficient implementation and are scalable in their application to all sizes and ages of companies must be accomplished in the face of pressures that may be beyond the scope of the proposed new standards to fix. Still these pressures must be considered and new rules need to work despite them. Therefore, the SEC and the PCAOB must ensure that the new SOX 404 auditing standard eliminates the regulatory basis and neutralizes the effect of the other pressures that drive auditors' excessive cautious and costly implementation.

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<sup>6</sup> Commissioner Kathleen L. Casey Remarks Before SEC Speaks, Washington, D.C. February 9, 2007. Available at: <http://www.sec.gov/news/speech/2007/spch020907klc.htm>

## II. GENERAL COMMENTS ON POLICY ISSUES THE COMMISSION SHOULD ADDRESS

The need for SOX 404 reform was the specific topic of remarks made by Commissioner Casey in her SEC Speaks address.<sup>7</sup> We concur with her remarks as to a number of important matters.

First, the Rules that both the Commission and the Board approved created the problem. They need to “own” the problem and find a solution. Second, the test of success is not whether these current rulemaking processes arrive at theoretically sound rules. Instead, the test is whether the new rules “alter the behavior [SEC] policies have driven.”<sup>8</sup> Finally, Commissioner Casey seems to acknowledge that digging out of the SOX 404 hole may take as long as it took to get into it. Ongoing evaluation of the costs and benefits of new rules is part of the Commission’s and the Board’s regulatory responsibility. Therefore, new rules should be implemented cautiously in recognition of the failures to anticipate the great cost that came from these sweeping audit and attestation requirements.

### A. Impact on Smaller Public Companies

We support the direction of these proposals for limiting unnecessary auditor-driven requirements. We also applaud the SEC’s recently-approved deferral of compliance for IPO companies. While this addresses one compliance hurdle in the going-public process, it does not address the root problem – excessive cost for a limited benefit.

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<sup>7</sup> “We need to fix 404. No other issue in recent times has come to symbolize regulation gone awry than this relatively modest-looking provision of the Sarbanes-Oxley Act. While the spirit and letter of the law never contemplated the costly and burdensome result that this provision has generated, *the law’s implementation undoubtedly facilitated such a result*. The Commission and the PCAOB are now faced with attempting to undo *the regulatory framework and consequent market behavior that has driven this costly compliance regime*. . . . I look forward to considering the comments that I hope we will receive on these proposals. I am committed to fine tuning these proposals to ensure that we achieve the results we all hope for. In the end, however, I believe we will only be able to measure our success by whether our reforms are sufficient to *alter the behavior our policies have driven*. And that will require an *ongoing assessment and determination by the Commission* of whether we have achieved our goals.” *Id.* [emphasis supplied].

<sup>8</sup> *Id.*

As SEC Chief Accountant Conrad Hewitt has observed, ICFR audit costs tend to be “very regressive” in terms of their impact on smaller companies<sup>9</sup> – the companies upon which venture capital is focused. While the smallest 4500 publicly traded companies have been able to defer much of the compliance burdens of Section 404, the typical venture-backed IPO company is larger than \$75 million market capitalization. As noted in the Report of the SEC Advisory Committee on Smaller Public Companies (“ACSPC”), there are an additional three thousand companies with market capitalizations of less than \$700 million.<sup>10</sup> Together with the non-accelerated filers these companies make up less than seven percent of total equity market capitalization.<sup>11</sup> These smaller accelerated filers in particular have borne the brunt of the grossly expensive implementation of SOX 404 under PCAOB Auditing Standard No. 2 (“AS-2”). They should not be required to continue to waste resources on the AS-2 driven process when the cost-benefit balance for these companies is indisputably skewed toward cost.

We are aware that the Commission is sensitive to the timing of the current requirements for non-accelerated filers. We believe that further deferral is appropriate for non-accelerated filers as well as an expansion of the deferral of SOX 404(b) auditor attestation requirements to smaller accelerated filers. This is the case for two important reasons. First, the proposed revision of the SEC rules and PCAOB standards, while possibly a significant step forward for larger companies, are not “scalable” for smaller companies to the extent that SOX 404 compliance cost would be justified by the benefits. It will almost certainly take much more time, effort and debate to make them so. Second, even if the ultimate revisions of rules and standards are sufficiently sweeping to correct the cost-benefit imbalance, it will take some period of implementation before the results are known. SOX 404 compliance is such a complex mix of rules and guidelines, diverse participants and external pressures that the impact of any change will not be known until it has been implemented and, with the passage of sufficient time, evaluated.

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<sup>9</sup> Conrad W, Hewitt, SEC Chief Accountant, Unpublished Remarks before SEC Speaks, February 9, 2007.

<sup>10</sup> *Final Report of the Advisory Committee on Smaller Public Companies* (April 23, 2006), Appendix E, Table 1.

<sup>11</sup> *Id.*, Table 2.

Making smaller accelerated filers or non-accelerated filers part of this test would almost certainly bring about substantial waste. Therefore, now that the Commission is aware of the disproportionate impact of SOX 404 on smaller accelerated filers, serious reconsideration should be given to the ACSPC's Recommendation III.P.2 which would exempt companies with less than \$250 million in annual revenues<sup>12</sup> (or some similar metric) from the auditor attestation requirements of SOX 404 until the new rules have been implemented and fully evaluated. When it is widely acknowledged that SOX 404 compliance has placed small cap companies in a deep and expensive hole, the Commission should acknowledge the "First Law of Holes" and allow a moratorium on digging.

B. The External Audit of the Effectiveness of ICFR

The PCAOB's proposed new audit standard represents a serious effort to right the cost-benefit balance in the external ICFR audit. However, in the proposed form, the new Auditing Standard on Audits of ICFR -- so-call Auditing Standard No. 5 ("AS-5") -- will not reduce auditor work to the point where SOX 404 is cost effective.

SOX 404 cost excesses are driven primarily by the requirement that the auditor attest to the effectiveness of ICFR. Regulations, not the language of the Act, are the basis for this expansive auditor role in the SOX 404 scheme.<sup>13</sup> Sound policy arguments support the total elimination of the audit of ICFR effectiveness.

- Without question, improvements in the quality of financial reporting began well before SOX 404 was implemented. New management responsibilities and board practices will continue to have a significant impact on the quality of financial reporting with or without the external audit of ICFR effectiveness.
- The primary value of SOX 404 is the requirement that management report on the effectiveness of internal controls.

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<sup>12</sup> *Id.*, p. 48.

<sup>13</sup> See *supra*, note 5.



- The outside audit of ICFR effectiveness provides some additional assurance, but the benefit is only incremental and the cost is unacceptable.
- Were the external audit of effectiveness eliminated, audit firms would still review ICFR as part of the financial statement audit and the PCAOB would still review financial statement audits.

C. Auditor Liability

We have consistently promoted ACSPC Recommendation V.P.1, which proposes a protocol for accounting that would protect the good faith preparer from regulatory action or legal liability as a means of reducing the liability driven portion of excessive audit costs. In fact, NVCA has a history of working with the accounting profession to restore common sense to the private securities class action system, which adds enormous costs and drives dysfunctional behavior in both issuers and auditors.

A safe harbor for reasonable auditor judgments would be a small step toward both the larger reform goal and the immediate challenge of restoring the use of judgment and common sense in SOX 404 auditing practices. It is beyond dispute that auditors' liability concerns drive costly auditing and conservative decisions. The safe harbor approach is a sound means for addressing this problem.

D. PCAOB Audit Standards on ICFR

The SEC has the obligation to ensure that AS-5 balances the benefit to investors against the cost to the economy and capital formation, in particular. The SEC's oversight must reflect a broader view of investor protection than the PCAOB has exhibited. It is important to keep in mind that the issuers are the auditors' clients and that the auditors are not government examiners. The SEC should ensure that AS-5 provides the intended benefits of SOX 404(b) and no more.

#### **IV. COMMENTS ON SEC RULES AND GUIDANCE PROPOSALS**

**A. The Commission should seriously consider elimination, or substantial limitations on the auditor attestation for the effectiveness of ICFR.**

The SEC's rule revision proposals, in conjunction with its Proposed Guidance, reflect a significant effort toward limiting costs that result from unnecessary auditor involvement in SOX 404(a) management assessments of ICFR. However, as noted above, there are serious impediments to a cost-effective SOX 404 process so long as auditors are required to attest to the actual design and operational effectiveness of ICFR. No matter what SEC rules require and no matter what the Auditing Standards say, the depth and breadth of the auditor's review will be driven by liability and economic pressures on audit firms. The liability threats on the Big Four accounting firms and the absence of significant competition in public company auditing services will continue to drive costs that exceed the incremental benefits of the auditor attestation.

As noted already, NVCA's principal focus is on smaller companies. Therefore, we say with great certainty that the cost-benefit imbalance is insurmountable so long as the SEC requires an audit of the effectiveness of ICFR for smaller companies. For larger companies, however, there may be cost-effective alternatives to the elimination of SOX 404(b) requirements.

The language of SOX 404(b) requires the auditor to attest to management's assessment of ICFR. Were the Commission to change its rules to eliminate the audit of effectiveness and retained the requirement for an audit of management's review, it might make a substantial impact on SOX 404 costs for all companies. Of course, the audit standards would need to be conformed as well. However, an elimination of auditor liability arising from an attest to the company's ICFR's effectiveness, along with clear SEC guidance as to what management is required to do in its assessment, could substantially reduce auditor test work and auditor fees.

On the other hand, if an audit of effectiveness must be retained, the "design-only" approach to this audit could substantially improve the cost-benefit balance. A design-only audit of ICFR would bring external oversight to management ICFR systems and provide incremental

assurance that management had designed its ICFR effectively. Furthermore, a design-only audit would entail some review of operational effectiveness as the auditor spot-checked the implementation of the design.

B. The revised SEC rules and proposed guidance for management on reporting under SOX 404(a) provide an important step toward limiting excessive costs in completion of the management's 404(a) obligations.

The SEC's proposed "safe harbor" for management reporting under SEC Rules evinces the Commission's commitment to a very important goal – replacing the PCAOB auditing standard as the default standard for management's compliance with its SOX 404 assessment and reporting obligations. The Proposed Guidance on the Management Assessment of ICFR ("Proposed Guidance") appears to be based on appropriate standards of reasonable risk assessment and flexibility to make it possible for management to conduct its assessment in a risk-based manner.

There is one very important statement regarding smaller companies in the guidance that we believe deserves further emphasis. At the end of the section on *Identifying Financial Reporting Risks*, (Section A.I.a. of the Proposed Guidance), it says: "[I]n a small company with less complex business processes that operate on a centralized basis with little change in the risks or processes, *management's daily involvement with the business* may provide it with adequate knowledge to appropriately identify reporting risks."<sup>14</sup> The key phrase, "management's daily involvement with the business" describes an important part of the control environment in many venture-backed companies. Indeed, even when processes change as the company grows, a manager's daily involvement provides the opportunity to assess ICFR risks and to provide important mitigating controls on an ongoing basis. We believe the Proposed Guidance would be improved by more emphasis on these important factors in smaller companies.

Of course, so long as the auditor must attest to either the effectiveness of ICFR or to the management review, audit standards will drive the extent of the external auditor's work. There

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<sup>14</sup> SEC Release, p. 24 [emphasis supplied.]

are a number of aspects of the PCAOB's proposed standards and rules that could still require management to meet the audit standard for its assessment rather than the Proposed Guidance. Therefore, we note some specific recommendations for revisions to the PCAOB's proposals in our comment below. In addition, as a general oversight matter, the SEC should ensure that the audit standard is harmonized with its management guidance to a very fine degree. Only then will the SEC guidance become the *de facto* standard to replace the auditing standard's current status.

#### **IV. OVERARCHING COMMENTS ON PCAOB PROPOSALS**

The proposed new Audit Standard on ICFR outlines a framework that is a definite improvement over AS-2. The proposed standard focuses on making improvements in many of the major areas that have led to excessive cost in the past. If the new standard's top priority was making the SOX 404 audit as cost-effective as possible, it could result in greater efficiency and lower cost. However, the new framework will probably not significantly reduce SOX 404 audit costs for the following reasons.

- The depth and breadth of ICFR audit work remains the subject of auditor judgment and they retain significant leverage in deciding how much audit work is required to address risks that they define.
- Auditors' financial incentives are to exercise their professional judgment with a bias toward the need to do more work, not less.
- Auditors will expand their work in order to avoid liability. As long as auditors are required to attest to the effectiveness of ICFR, the liability risk associated with this work will be as much a driver of this work as the risk of a material weakness in ICFR.
- Auditors have already developed procedures and trained their staff on how to perform audits of ICFR, which means that significant changes to those procedures will result in additional costs for them.
- Recent experience indicates that even with pressure from issuers, the SEC and the PCAOB, the auditors are still performing excessive work and are able to demand commensurately high fees.

The only ways the PCAOB can correct the failings of AS-2 and address the cost-benefit imbalance in SOX 404(b) compliance, is to modify the auditor requirement in one of two ways:

- Eliminate the requirement for the auditor to attest to the effectiveness of ICFR; or
- Eliminate the requirement to audit the *operational* effectiveness of ICFR.

As we have noted above, most of the improvements to ICFR and most of the investor benefit of SOX come from management's work. The incremental additional assurance that the auditor can provide cannot be cost-justified. If the SEC and the PCAOB deem an auditor's role to be essential, a significant percentage of the potential incremental assurance can be obtained through an audit of the design of the issuer's ICFR. However, a design-only audit may not limit auditor work substantially unless it resulted in less auditor liability.

If the new standard is not modified in significant ways, it should be implemented with a two-year sunset provision during which time the SEC should exempt smaller companies from the requirements of SOX 404(b). An expiration date will ensure that the PCAOB and the SEC evaluate the cost-effectiveness of its implementation and do so in a timely manner.

## **V. GENERAL COMMENTS ON THE PCAOB PROPOSALS**

The PCAOB's primary goal appears to be maintaining an audit framework that achieves the PCAOB's own definition of "investor protection." As investors in start-up companies, venture capitalist believe their voices should be heard as clearly as those of investor advocates, many of whom represent groups that do not invest in smaller public companies. For most investors, an imbalance as severe as exists in SOX 404 compliance is not merely an excessive cost, it is a waste. While AS-5 reflects much effort to "enhance audit efficiency" of external audits of ICFR, the "cost" side of the cost-benefit balance does not receive sufficient emphasis in its Release or in its Proposed Standards.

While the Board seeks input on how many fewer hours will be required for auditors to conduct an audit under AS-5, the standard continues to give the auditor wide discretion in

determining the amount of work required for each audit. Therefore, only the audit firms can answer the question about hours.

On the other hand, how much money can be saved under AS-5 is a number upon which the auditors' issuer-clients can at least opine. We believe the cost impact will be minimal because the Big Four accounting firms have the final say. We have already noted the reasons – liability, economic incentives and lack of competition. Unfortunately, the PCAOB's Release fails to indicate that significant cost reduction is a goal of AS-5. Continued waste is the likely outcome.

While AS-5 emphasizes a risk-based approach to auditing, it fails to state that a cost effective audit requires the auditor to assume an acceptable level of risk that there will be material weaknesses in ICFR that neither management nor the auditor will be able to identify through a review process that provides “reasonable assurance” and no more.<sup>15</sup>

In the same vein, AS-5 does not seem to take into account the fact that management has many incentives to maintain effective ICFR under SOX 404(a). The auditing approach reflected in AS-5 seems to be based on a belief that management cannot be trusted to fully comply with SOX 404(a). It also seems to ignore the myriad other changes that were undertaken by issuers -- whether SOX-driven or voluntarily – that have improved the quality of internal controls over financial reporting. As long as the tone of the PCAOB standards suggests that auditors should not trust management to make sound judgments regarding the effectiveness of ICFR, the audit framework will never be cost effective for shareholders.

AS-5 is a continuation of the “better implementation” approach to improving the SOX 404 situation. It is a triumph of hope over experience. The PCAOB has issued extensive guidance under AS-2 aimed at improving the cost-benefit balance. With all this effort, the costs still outweigh the benefits. The only way to limit audit waste in ICFR work is for the

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<sup>15</sup> The SEC Release contains a better formulation of an appropriate reasonableness standard. The definition of reasonable assurance outlined at pages 14-15 of the SEC Release, for example, should be incorporated into AS-5.

implementation guidance to be crystal clear and unambiguous. This is difficult in the context of a risk based, top-down approach because the auditor is the one who determines what is “enough work” and what controls need to be evaluated and tested.

## **VI. SPECIFIC RECOMMENDATIONS FOR IMPROVING THE PCAOB PROPOSALS**

On the assumption that neither the SEC nor the PCAOB will recognize the need to make more far-reaching proposals for change, we offer the following recommendations for changes to the PCAOB’s proposed new standards and rules.

### **A. Improving AS-5 as a Standard for the Full Audit of the Effectiveness of ICFR**

#### **1. Guidance on scoping should be more explicit:**

AS-5 guidance for planning the audit should explicitly say that the auditor should begin the audit by reviewing the ICFR assessment performed by management. AS-5 says that one of the many things the auditor should consider when planning their ICFR audit is the “type and extent of available evidence related to the effectiveness of the company’s ICFR.” Once management has completed its assessment of ICFR in accordance with the proposed SEC guidance, there will likely be significant evidence that the auditor can use. The auditor should be required to use this evidence in planning and scoping their audit in order to limit unnecessary work. The auditor should then be required to report to the audit committee if the auditor determines that it needs to test significant accounts or significant processes that were excluded from management’s assessment.

#### **2. A risk based process should allow for rotational testing of significant processes:**

Audits of financial statements include the concept of “rotational” testing and an audit of ICFR should also embrace the same concept. Unfortunately, AS-5 explicitly excludes an important type of rotational testing. For example, if certain key processes have not changed from the prior year, there were no material weaknesses or significant deficiencies in those

processes in the prior year, and management's assessments of the significant processes did not uncover any problems, the auditor should be allowed (if not required) to use their professional judgment to test those processes on a rotational basis.

Walkthroughs should be done on a rotational basis as determined in the risk assessment. AS-5 requires walkthroughs of each significant process – an improvement over AS-2 which required walkthroughs of each major *class of transactions within each significant process*. The requirement to perform walkthroughs even if the auditor is satisfied that there have been no changes to controls tested in the previous audit is inconsistent with a risk based approach. Auditors should be strongly encouraged to use their prior knowledge in assessing risks and designing the level of audit testing, including which processes are appropriate for walkthroughs on a rotational basis. Walkthroughs are one of the testing methods that drive excessive costs. AS-5 requires the auditor to test both the design effectiveness and operational effectiveness, which are both linked to walkthrough testing. The cost of walkthroughs can be reduced by performing them on a rotational basis.

3. The standard should include a relevant definition of materiality:

The definition of materiality and the materiality thresholds that the auditor must use in planning their audits of ICFR have been refined in AS-5. These changes are an improvement over AS-2. However we are still concerned that the auditor will use materiality thresholds that are too granular. This is due in part to the underlying definitions of materiality in accounting and auditing literature and in SEC guidance. These definitions are so all-inclusive that there are still only vague limits as to what an auditor can determine to be material. Since these determinations drive the scope of testing and the demands for documentation, AS-5 would likely again drive audit work that is far in excess of any reasonable cost-benefit balance. In order to reduce waste, the standard should include a quantitative materiality rule appropriate for the ICFR audit rather than relying on vague qualitative standards developed for disclosure purposes like SEC's Staff Accounting Bulletin No. 99.



4. Reasonable unpredictability should be the goal:

AS-5 paragraph 69 says that the auditor should “introduce unpredictability into the testing and respond to changes in circumstances.” Such guidance can be read to mean that the auditor/issuer relationship is adversarial in nature. While introducing unpredictability into audits is appropriate, care should be taken to avoid a suggestion that the audit of ICFR is a cat-and-mouse game of “Gotcha.” This will only increase audit waste. An appropriate caution should be included in paragraph 69 and the audit committee should have oversight of this aspect of the plan.

5. The Standard should emphasize “reasonableness” in auditing ICFR:

AS-5 should prominently incorporate the language of the SEC Release regarding the overarching application of “reasonableness” in each aspect of SOX 404 compliance. As a minimum, the auditor should not apply a more stringent standard of reasonableness than management is required to use in its assessment under SEC rules and guidance. In particular, the PCAOB’s proposed revision of Interim Standard AU sec. 230 defines “reasonable assurance” as “a high level of assurance.”<sup>16</sup> On the other hand, the SEC Release notes that the SEC’s definition of the key term “reasonable assurance” is “such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”<sup>17</sup> AS-5 should clearly state that its standard of reasonable assurance in ICFR audits is the same as the Commission’s. Furthermore, every definition that bears upon “the level of detail and degree of assurance” in the PCAOB’s standards that relate to ICFR audits should be closely reviewed to eliminate any potential disharmony with the standard management is required to use in assessing the effectiveness of ICFR.

B. Improving the Proposed Standard on the Use of the Work of Others

The proposed new PCAOB Standard on the Use of Work of Others is a definite improvement over the previous guidance. However, it should be more directive in order to be effective. For example, the guidance should explicitly say that the auditor should rely on the

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<sup>16</sup> PCAOB Release, p. A4-2.

<sup>17</sup> See SEC Release, p. 14-15.

work of management, internal auditors or outsourced auditors for other than high risk audit areas so long as the other auditor meets the standards of competence and objectivity in AS-5.

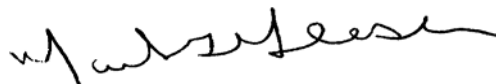
C. PCAOB Inspections Should Randomly Obtain Issuer-Client Input on Questions of Audit Efficiency.

We appreciate the PCAOB's plan to apply pressure for more efficient audits through its inspections of audit firms. However, efficiency will be difficult to determine if the PCAOB inspector relies solely on the work papers and explanations of the auditor. Therefore, as part of the PCAOB's audit inspection, its inspectors should communicate with issuers on a random and confidential basis to obtain objective input on the efficiency of audit. Such contact can be managed to avoid a diminution of auditor independence and ensure candor on the issuers' parts. A PCAOB inspection that seeks such input would send a necessary message to auditors that there is at least some risk in doing excessive or redundant work.

CONCLUSION

The prolonged difficulty and substantial waste that has resulted from SOX 404 implementation is a very serious matter for the American economy in general and for venture capital's ability to make a positive contribution to the economy. We strongly encourage the SEC and the PCAOB to assume responsibility for the problem that their rules have created. The facts supporting substantial change as well as the case for using a cost-based measure of success are overwhelming. Therefore, NVCA stands ready to assist the Commission and the Board as they move to the next step in solving this serious problem.

Sincerely yours,



Mark G. Heesen  
President