



August 7, 2023

Office of the Secretary
PCAOB
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BY EMAIL

Re: Docket Matter No. 051: Amendments to PCAOB Auditing Standards related to a Company's Noncompliance with Laws and Regulations

The National Venture Capital Association (NVCA) is pleased to comment on the proposed Amendments to Audit Standards (“the Proposal”).¹

NVCA represents the U.S. venture capital (VC) and startup community. In 2022, VCs invested \$240 billion in U.S. companies.² Our members provide the capital empowering the next generation of American companies that will fuel the economy of tomorrow. As the voice of the U.S. venture capital and startup community, NVCA advocates for public policy that supports the American entrepreneurial ecosystem.

Venture Capital Background and Economic Impact

Venture capital has enabled the United States to support its entrepreneurial talent by turning ideas and basic research into products and services that have transformed the world. Examples of venture-backed companies include Moderna, Genentech, Zoom, SpaceX, Ebay, and Amazon. Venture capitalists create partnerships with institutional investors to combine the capital held by pension funds, endowments, foundations, and others. VCs combine patient capital with their talent and expertise to make high-risk, long-term equity investments into innovative young companies.

¹ Available at https://assets.pcaobus.org/pcaob-dev/docs/default-source/rulemaking/docket-051/pcaob-release-no.-2023-003---noclar.pdf?sfvrsn=fe43e8a_4.

² NVCA 2023 Yearbook, data provided by PitchBook; available at https://nvca.org/press_releases/nvca-2023-yearbook-u-s-vc-fundraising-reaches-new-heights-amid-industry-challenges/.

Venture funds are generally partnerships that last ten to fifteen years, building investments far longer than any other asset class. VCs do not simply pick winners; they actively work with entrepreneurs to develop startups into successful companies. VCs work alongside the entrepreneurs, often taking board seats, providing strategic advice and counsel, opening their contact networks, and generally doing whatever they can to help their portfolio companies succeed.

A recent survey of companies backed by venture capital showed that four out of five respondents spent at least 70 percent of their total expenses on two activities: wages and compensation and research and development. This statistic highlights the extent to which venture capital finances job creation and innovation despite the risks inherent in funding companies expected to operate in revenue loss positions for years.³

Despite the long odds, venture capital is a major economic engine of job growth, spurs innovation, and creates new business models that change the world. New research found that employment at VC-backed companies between 1990 and 2020 grew 960 percent, whereas total private sector employment during that same period grew only 40 percent. VC-backed jobs are distributed broadly across the entire U.S. with 62.5 percent of VC-backed jobs outside the states of California, Massachusetts, and New York.⁴ This illustrates a fundamental trend in the modern economy: the path to greater economic opportunity for American workers runs through technological progress and long-term investment.

Venture-backed companies comprise over half of companies that make initial public offerings (IPOs) each year (including 40 percent of climate technology companies),⁵ are responsible for around half of new FDA-approved cures, and are causally responsible for the rise of one-fifth of the current largest 300 U.S. public companies.⁶

Summary

- The total cost of audits under the Proposal would outweigh the benefits to venture capital and public company investors especially if the proposed change applied to audits of emerging growth companies (EGCs).
- America's entrepreneurial ecosystem will be negatively impacted by the Proposal's greatly expanded public company audits.

³ *Venture Capital Investment at Work*, American Startups and Job Growth Coalition (April 2021), available at <https://nvca.org/venture-capital-investment-at-work/>.

⁴ *An Analysis of Employment Dynamics at Venture-Backed Companies Between 1990 and 2020*, NVCA, Venture Forward, and the University of North Carolina Kenan Institute of Private Enterprise (February 2022), available at https://nvca.org/wp-content/uploads/2022/02/Employment-Dynamics-at-Venture-Backed-Companies_FINAL.pdf

⁵ *Initial Public Offerings: Updated Statistics*; Professor Jay Ritter, University of Florida; available at <https://site.warrington.ufl.edu/ritter/files/IPO-Statistics.pdf>.

⁶ *The Economic Impact of Venture Capital: Evidence from Public Companies*; Illya A. Strebulaev, Stanford University Graduate School of Business and Will Gornall, University of British Columbia Sauder School of Business (July 2021); available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.

- Private venture capital funds (VCFs) would experience unnecessary collateral impacts from the proposed changes in scope and depth of audit procedures.

Specific Comments

These changes will be detrimental to the American entrepreneurial ecosystem

The proposed changes to audit procedures would negatively impact America's entrepreneurs and their investors both directly and indirectly. Direct impact would arise from greater cost and complexity of public company audits. Growing venture-backed companies move through their later stages by anticipating either an IPO or acquisition by a public company. The process necessitates financial statement preparation and auditing that meets PCAOB standards for publicly traded companies. This process is one of the major expenses that pre-IPO companies face. The vastly expanded scope that these changes propose will greatly increase that cost as well as the complexity of such an audit. This will erect yet another significant hurdle to growing companies accessing the public capital markets. Indeed, this hurdle may drive promising companies to become early acquisition targets before they have even had the opportunity to test the IPO market.

The entrepreneurial ecosystem is affected by the viability of smaller and newer public companies. Therefore, increased cost in both fees, internal costs and management time of audits will continue through the life of a post-IPO company. As acknowledged in the Securities Exchange Commission's policy toward smaller public companies, the cost of audits, and other requirements fall disproportionately on the thousands of small and mid-cap public companies. Therefore, there is no doubt that the total cost of these expansive changes will have a disproportionate impact on these companies.

The Proposal fails to even attempt to quantify costs or benefits from these proposed changes. This lack of data, along with the risk that these changes will incentivize excessive audit procedures creates significant uncertainty for companies contemplating an IPO. This failure is especially glaring in the Proposal's discussion of whether these proposed changes should apply to Emerging Growth Companies (ECGs). The Proposal blithely concludes that, even for ECG audits the benefits of these expanded audits will exceed the costs.⁷ The Proposal's speculative narrative touches on the reactions of audit firms, capital market impacts, and competitive forces in over 3,000 ECG business environments without a hint of rigor.⁸ Yet this is the Proposal's basis for recommending that the SEC override the presumption in law that new PCAOB rules should not apply to ECGs."⁹ That such a bold conclusion is supported by not even a cursory attempt at quantitative economic analysis is itself a fatal flaw of this Proposal.

⁷ Proposal, *supra*, Note 1 at pp 91-94.

⁸ Id. pp 93-94.

⁹ 15 USC 7213(a)(3)(4), JOBS Act Sec. 104 (2012). ["Any additional rules adopted by the Board after April 5, 2012, shall not apply to an audit of any emerging growth company, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after

Finally, private venture capital funds would need to anticipate changes in their audits as well. We acknowledge that technically, audits of public companies and private companies are done under different audit standards. However, the same Big Four and national audit firms that audit public companies also audit private VCFs. These firms would no doubt revise their private entity audit procedures following the extraordinary revisions that would follow enactment of the proposed changes to PCAOB standards. Furthermore, the same auditors, trained to comply with new PCAOB standards would surely carry some of that training over to audits of private funds. Therefore, as they have experienced during previous major changes in accounting or audit standards, VCFs would devote more fund assets to audits, reducing funds available for investment and returns to VCF investors.

The Proposal would create costs that greatly exceed the benefits to investors

The Proposal would require the auditor to “identify, through inquiry and other procedures, laws and regulations applicable to the company with which noncompliance could reasonably have a material effect on the financial statements.”¹⁰ The vagueness of the proposed requirement will surely cause auditors to do excessive work and use the services of 3rd party experts to an excessive degree. Given the malleability of the key terms, “could,” “reasonably,” and “material,” auditors will surely err on the side of unnecessary work. This would be a rational reaction given the ability of PCAOB examiners to apply their own interpretation of these key terms in hindsight. The elimination of the direct - indirect distinction will add to the auditor’s uncertainty.

It is perhaps the PCAOB’s own uncertainty as to how these many proposed changes would be implemented that explains the Proposal’s failure to either analyze or estimate the cost associated with these changes. It is not idle speculation to cite the lesson of the implementation of the ill-conceived Audit Standard No. 2 on audits of internal controls over financial reporting that lead to that Standard’s replacement.¹¹ Given the novelty, scope, and ill-defined terms of this Proposal the long and difficult experience with AS 2 could well be repeated if these proposed changes went into effect. The wasted time, talent and money that went into compliance with AS 2 from 2004 to 2007 should provide a cautionary tale to the Board.

considering the protection of investors and whether the action will promote efficiency, competition, and capital formation.”)

¹⁰ Proposal, *supra* Note 1, p. 6. [emphasis supplied].

¹¹ See “SEC Approves PCAOB Auditing Standard No. 5 Regarding Audits of Internal Control Over Financial Reporting; (July 25, 2007). Available at <https://www.sec.gov/news/press/2007/2007-144.htm>.

Conclusion

NVCA urges the PCAOB to withdraw this Proposal and, at a minimum to quantitatively analyze all the costs and benefits of every major element of these proposed changes and to fully reconsider any expansion of the role of auditors into matters of legal compliance. We specifically suggest that the Proposal exclude the recommendation that the SEC override the presumption against this proposed Standard's application to emerging growth companies. We appreciate the Board's consideration of our comments and would be pleased to work on ways to amend the Proposal to better consider the health of the American entrepreneurial ecosystem.

Sincerely,

A handwritten signature in black ink that reads "Bobby Franklin". The signature is written in a cursive, slightly slanted style.

Bobby Franklin
President & CEO