



October 29, 2015

**VIA Email**

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington DC 20006-2803  
*comments@pcaobus.org*

RE: Staff Consultation Paper, *Auditors' Use of the Work of Specialists*

INTRODUCTION

The National Venture Capital Association ("NVCA") represents the vast majority of American venture capital under management.<sup>1</sup> This letter is intended to both comment on the Staff Consultation Paper ("SCP") noted above and to supplement the comment letter NVCA submitted on the 2014 SCP, *Auditing Estimates Including Fair Values*. This letter updates our comments regarding audits of fair values of venture capital funds ("VCFs") and adds our perspective to the staff's more recent consideration of the link between auditors' use of the work of specialists and the audits of fair values. We hope this additional and updated information will be useful and that it will receive the staff's full consideration even though we are submitting it after the close of the official comment period.

We have reviewed the SCP on *Auditors' Use of the Work of Specialists* and we agree with the Chief Auditor's staff's conclusions that there is significant overlap

---

<sup>1</sup> 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 300 members through a full range of professional services. For more information about the NVCA, please visit [www.nvca.org](http://www.nvca.org).

between issues arising from audits of estimates and auditors' use of specialists. Indeed, many of the concerns that prompted us to file a comment letter on the 2014 SCP, *Auditing Estimates Including Fair Values* involve the impact of valuation specialists. The Introduction section of NVCA's 2014 letter adequately frames the points I hope to convey in this letter. Since that letter is available in the PCOAB comment file,<sup>2</sup> I will dispense with repeating them here.

NVCA's members have largely completed the 2014 audit season. Through our CFO Task Force<sup>3</sup> we have received sufficient information to conclude that fair value audits remain a serious concern in the venture capital industry.

NVCA members recognize the importance and the difficulty of the auditors' role in auditing the valuation of assets that are inherently difficult to value. The task of arriving at a single-point fair value for VCF assets confronts the inherent subjectivity in valuing early stage (often pre-revenue) companies where established industry benchmarks and valuation metrics are often non-existent. This difficulty prompts auditors to use valuation specialists who are technically proficient in the theoretical principles of valuation, where many models and concepts have been developed to explain why market participants reach their conclusions as to valuation. However, valuation of VCF assets requires an understanding of venture investing and the innovative types of companies in which most funds invest. Therefore, many valuation specialists actually compound the auditors' challenge because they lack the venture-specific background needed to appropriately value venture fund assets.

As noted in our November letter, most securities held by a typical venture capital fund are "Level 3 assets" and must be reported to investors at fair value on a quarterly basis. The absence of solid information about the market for most VCF-held securities creates difficulties anticipated in Topic 820. As we noted in our November letter:

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.<sup>4</sup>

Nonetheless these fair values need to be audited to the specifications of top accounting firms, which naturally reflect PCAOB standards. Because of the difficulty

---

<sup>2</sup> [http://pcaobus.org/Standards/Staff\\_Consultation\\_Comments/017\\_National\\_Venture\\_Capital\\_Association.pdf](http://pcaobus.org/Standards/Staff_Consultation_Comments/017_National_Venture_Capital_Association.pdf).

<sup>3</sup> NVCA's CFO Task Force is made up of the Chief Financial Officers and Administrative Partners of more than 100 of our member firms.

<sup>4</sup> *Supra*, Note 2, page 4.

of auditing uncertain values of VCF assets, auditors have increasingly relied on quantitative inputs and the judgment of valuation specialists.

In many cases, valuation specialists provide independent expertise and analysis needed to meet the audit standard. Valuation specialists can also help to document what are usually highly subjective conclusions as to value. Increased use of valuation specialists as part of the audit process has helped auditors to better understand valuation models and the tools and terminology employed by valuation specialists in documenting fair value estimates.

While this is a positive development, it seems that many audit firms have relied too much on the judgments of their internal valuation specialists. This is unfortunate given the fact that many valuation specialists lack a complete understanding of Topic 820 and its emphasis on the assumptions that market participants use in valuation. In general, the models and methods specialists employ are often not among the tools or methods that market participants employ, especially for VCFs. The conclusions of audit firm valuation specialists are no more accurate than those of VCF professionals or their advisers who apply Topic 820 to VCFs on a regular basis.<sup>5</sup> Still it is not uncommon for an auditor to favor the specialists' valuation procedures over those of the reporting fund.

As a result, in some cases, the involvement of valuation specialists has inhibited rather than enhanced the audit process involving fair value determination. Undue reliance on internal specialists brings complexity, confusion, and delay into the audit process through unnecessary and sometimes even counterproductive procedures.

Many valuation problems arise, in our view, from an incorrect reading of the FASB standard, Topic 820. Examples include:

- the unquestioned use of "price times quantity" as the sole input when the security being valued is not actively traded;
- the use of option pricing models ("OPMs") when such models do not reflect market participant assumptions or the specific facts and circumstances associated with the investment being valued. Auditors sometimes refuse to accept valuations for venture capital portfolios unless an OPM is applied to each company in the portfolio, notwithstanding the fact that market participant funds have not used an OPM.<sup>6</sup>

---

<sup>5</sup> The technical authorities for determining fair value under GAAP can differ significantly depending upon the type of transaction being accounted for. A fair value determination for income tax purposes would be based upon still another set of rules or principles.

<sup>6</sup> This practice in particular became more widespread in 2012 when the AICPA published its initial draft of its Practice Guide entitled "Valuation of Privately-Held-Company Equity Securities Issued as Compensation" (commonly known as the "Cheap Stock Guide"). Although expressly "off-label" for use in applying Topic 820 to fund investments, this document became attractive to auditors as a means of making quantitative assessments of inherently subjective valuation approaches.

- A focus on precision in mathematical inputs to a model rather than far more subjective inputs even when the subjective inputs are far more material to the valuation.

In general, it seems that audits have become biased in favor of anchoring valuations to quantitative observable metrics -- perhaps to ensure that nothing in the audit work papers can be proven wrong -- whether those inputs would have a material impact on valuation or not.<sup>7</sup> In other cases, audit firms have insisted on the use of models so that the valuations used for financial reporting conform to the results of the model, independent of whether the results from the model actually represent Topic 820 "fair value," i.e., the amount that would be received in an orderly transaction based on market participant assumptions.

On the other hand, sometimes models are "massaged" so that the results of the model approximate the fair value estimate that resulted from using market participant assumptions. In these cases it seems that the use of the models is solely about the documentation. Clearly requiring this type of documentation to be prepared by fund personnel or the use of fund resources for outside valuation specialists does not improve the quality or reliability of the financial statements.

Therefore, we believe that both the quality and the efficiency of audits can be improved through PCAOB guidance that emphasizes limits to the role of specialists in the audits of VCF assets and the importance of subjective judgment and auditor discretion regarding hard-to-value assets, in general.

Appendix A is a compilation of three short examples, and Appendix B consists of two more in-depth case studies submitted by our task force members. We believe that the basic problems identified in our 2014 letter on auditing fair value are illustrated by these examples and case studies.

- Topic 820 requires that fair value be measured based on "the assumptions that market participants would use in pricing the asset...,"<sup>8</sup> not methods that valuation specialists prefer.
- Often 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' judgment regarding intangibles – quality and track record of the management team, size of a perceived future market, momentum in a market sector, etc.

---

<sup>7</sup> When the AICPA "Cheap Stock Guide" raised awareness of these models the audit professions' increasing reliance on them coincided with anecdotes of additional scrutiny by the PCAOB of fair values estimates and the documentation thereof. This practice, analogous to a physician's practice of defensive medicine, merely imposes additional compliance costs as the price of getting a clean audit opinion.

<sup>8</sup> ASC Topic 820-10-35-9.

- VCFs use a variety of quantitative and qualitative tools<sup>9</sup> to assess a fair price and almost always assess the asset in terms of a range of values, not a point estimate.
- The fact that valuation models depend upon user-selected assumptions undermines the seeming objectivity and precision implied by their quantitative nature.

## **Recommendations**

1. Relating to Auditors' use of valuation specialists, we urge the PCAOB to:
  - a. Make it clear to auditors that valuation specialist, whether a third party or auditor-affiliated, should enhance not restrict the auditor's exercise of independent judgment in assuring that valuations are in keeping with the nuances of Topic 820 regarding hard-to-value assets. Auditors should look to valuation specialists and their tools as inputs to be considered in the audit process rather than outputs that can override the auditor's independent judgment or the fund manager's expertise in determining and documenting the fair value estimate in the first place.
  - b. Consider studying the accuracy of valuation specialists' conclusions on Level 3 fair values, e.g., back-test their findings to see to what extent a valuation specialist's conclusions resulted in fair value estimate that came closer to the valuations at which real transactions occurred within a 6- to 9-month period following the determination, relative to similar situations in which no valuation specialist was employed.
2. In addition we would like to reiterate and augment the recommendations in our November 3, 2014 letter as relevant to this SCP as well. 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

---

<sup>9</sup> 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.

- is within the range and has provided reasonable explanation for how they determined their point estimate, audit requirements are met);
- c. Actively engage with accounting and valuation trade organizations to encourage the development of training programs and materials that educate relevant professionals. Training and materials should approach fair value determinations with a focus on market participant assumptions. They should encourage specialists to base their analysis on a better understanding of the market participant's perspective and acknowledge that some determinations are inherently subjective; and
  - d. Create a private sector advisory group of preparers and auditors with specialists 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 staff on this and other important matters. We would be pleased to arrange a meeting or conference call with some of the NVCA CFO Task Force members and PCAOB staff so that we can further explain examples of situations they have experienced in dealing with their auditor's interpretation of audit requirements and accounting rules.

Please feel free to contact me at 202 864 5925 or [bfranklin@nvca.org](mailto:bfranklin@nvca.org) or John Taylor, NVCA Head of Research at 646 571 8185 or [jstaylor@nvca.org](mailto:jstaylor@nvca.org).

Sincerely yours,



Bobby Franklin  
President & CEO

Appendix A – Examples  
Appendix B – Case Studies

## Appendix A – EXAMPLES

The observations and cases set out here and in Appendix B were collected from NVCA CFO Task Force members<sup>1</sup> and advisers to venture funds and other investment funds, with whom we work. These are examples, not a comprehensive compilation. As some of our member firms have broader mandates than just early stage venture capital some of these examples relate to later stage companies, some of which may have publicly listed securities. However, all of them involve auditing fair value and some involve an auditor's use of a valuation specialist. 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.

1. Fund invested in a portfolio company using a combination of equity/warrants and debt. The portfolio company was reported as a Level 3 holding by the Fund. As part of its initial reporting of the investment, the Fund allocated the purchase price based upon its estimate of the relative fair value of debt and equity. In connection with this initial allocation, the Fund manager sought input from both the Fund auditor and portfolio company management and the allocation methodology was agreed to and the approach was determined to be thorough and sound.

Almost a year later, the portfolio company's auditor – from the same firm as the Fund's auditor -- decided they didn't like the analysis upon which the Fund and the portfolio company allocation was based. The portfolio company auditor questioned the approach that affected at most 1% of value being allocated to equity over debt. In other words, the maximum impact to the value of the Fund's equity could have been \$10 million on a \$1.5 billion enterprise value.

The portfolio company auditor required the portfolio company to engage an outside valuation expert to use a number of academic models including a Monte Carlo simulation. The portfolio company had concluded that the academic approach would require material extra effort (including significant external valuation support) and would have minimal impact on the results.

Weeks of discussion ensued among the portfolio company auditor, the portfolio company and the Fund with significant support provided by the Fund and its advisers to the portfolio company and its auditor. Effectively, the portfolio company auditor was uncomfortable with the arms-length nature of the original allocation agreement and determined that the original documentation for the allocation did not have sufficient support in academic literature. As a result, a massive "make-work" exercise had to be undertaken, which at the end of the day resulted in no change to the initial allocation. It is situations like this, where the audit firm is the primary beneficiary (through added audit fees) of the additional work they mandate that allow cynics to view the documentation requests as being particularly self-serving.

---

<sup>1</sup>The NVCA CFO Task Force is a working policy group made up of the CFOs of NVCA's venture firm members. About 100 of NVCA member firms participate in the Task Force.

2. Fund invested \$ 8 million in a convertible preferred security in September, at which time the underlying actively traded common stock was trading at \$ 4 per share. The Fund made the investment knowing that the underlying common shares were “thinly traded” and based their investment decision on the current and expected performance of the company, not on the “thinly traded” share price. Fund reported this investment as based on Level 3 inputs.

At December 31, Fund valued the investment at \$ 7.9 million given slight changes in expected cash flows and the interest rate environment. Auditor decided to trifurcate the value of the investment as the principle component, the coupon, and the conversion feature. At December 31, the underlying common was trading at \$ 1.50 because of announced degradation in performance (which was anticipated by the Fund based on their due diligence).

The auditor’s internal valuation specialists preliminarily concluded that the security should be valued at \$ 6 million due to the decrease in value of the option component of the security (using an option model with the \$ 1.50 share price). After the Fund manager had discussions with the auditor, and the auditor’s national office, auditor was able to realize that the security being valued was not actively traded and therefore should not be blindly valued using the “actively traded input”, but should be valued using market participant assumptions.

Using the inputs to the Fund’s valuation process and calibrating to the initial transaction, the Fund’s auditor ultimately concluded that the Fund’s estimation of the fair value at \$7.90 million had understated the value. The Fund therefore adjusted its fair value estimate to report the security as being valued at \$ 7.95 million.

3. In making its initial investment decision for its investment in portfolio company A, a Fund valued its investment using a scenario analysis—weighting various expected outcomes, i.e., level 3 inputs. The Fund had determined that the most likely acquirer of its position at that time would be another venture capital fund and the scenario based analysis is a common approach used by venture capital funds. As a result, the Fund Manager determined that continuing to use the same approach as at initial investment or “entry” was appropriate. Therefore, at its first reporting date, the Fund used a similar scenario analysis taking into account calibration at entry and changes in expected outcomes. Notwithstanding the fact that the Fund’s methodology was consistent with market participant assumptions in the exit market, the Fund’s auditor initially insisted that investment be valued solely using an option model. Only after extensive discussion with the auditor and the auditor’s national office that it was concluded that the fund’s approach used market participant assumptions and was an acceptable approach to value the investment.



## Appendix B – CASE STUDIES

### CASE STUDY 1

#### BACKGROUND:

The Company used in this example had been performing very well and actually had a number of outside investors willing to finance the Company at an uptick from the prior round of financing. The prior round, Series B, had a “post-money” valuation of approximately \$50M. Additionally, the Company closed on a Series C financing on December 18, 2013, or approximately two weeks before the valuation measurement date. Even though this information was communicated to the auditors working on the engagement, the auditors insisted that we run a series of OPM calculations on the Company to try to determine the appropriate valuation. The data table below provides further information regarding the wide array of values that were calculated using the OPM.

#### VALUATION SUPPORT:

##### Summary of Share Price by Valuation Technique

Actual Series C Price Paid \$ 1.127

Share Class	OPM Back Solve	OPM @Current FD	CASCADE	Original Issue Price
C	\$ 1.127	\$ 1.670	\$ 1.346	\$ 1.127
B	\$ 0.605	\$ 1.428	\$ 1.219	\$ 1.000
A	\$ 0.312	\$ 1.212	\$ 1.219	\$ 1.000
Common/Other	\$ 0.078	\$ 0.551	\$ 0.219	

Based on the instruction of our auditors, we ran an OPM Back Solve calculation to determine the implied equity value based on the price (\$1.127/share for the Series C) of the most recent financing. In this instance, the OPM Back Solve method implied that the equity value of the Company would be \$34M, a value that was 55% below the current fully diluted post money valuation of \$75M.

This valuation level would have resulted in a write down of our holdings to approximately 30% below our current cost basis. Given that the recent round was led by a new outside investor, and additional new investors were eager to invest at an uptick, we felt strongly that this calculation was not indicative of the correct value of the Company as of the measurement date.

Additionally, we also ran an OPM based on the current fully diluted post money valuation. Due to downside preferences in place to protect the new investor, the OPM calculation in this instance would actually have resulted in a write up to the current round of financing that closed just prior to the valuation date. This OPM calculation was again deemed to be inappropriate as the outside investor priced the round independently within weeks of the valuation date and therefore was deemed to pay a fair price for the shares.

#### CONCLUSION:

After performing numerous OPM calculations on approximately fifteen portfolio companies, including the example discussed above, it was determined that it was not appropriate to use this model to value companies held within our portfolio. The example above is a good illustration of the wide level of variations that are produced when using an OPM based valuation technique. In using the OPM valuation technique for this specific company, we observed valuations that were both well above and well below the current price paid for shares of the Company within weeks of the valuation measurement date. After a significant amount of time working on OPM calculations and discussing them

with valuation specialists at the auditing firm, the auditors agreed with our original thesis that the investment should have been held at the Series C value.

In general, it is very difficult to determine the correct level of volatility for OPMs of early stage companies like most venture capital investments. With this major input difficult to determine, it is hard to say that the results of the OPM are reliable in the determination of valuations for these types of companies. We communicated to the auditors on numerous occasions that venture capital companies are valued by investors on a fully diluted basis, which therefore makes the output of the OPM calculations difficult to use in measuring the fair value of a company. We were still asked to perform OPM calculations on fifteen portfolio companies even though at the end of the audit not one OPM valuation was used as support for the fair market value of any of our portfolio companies.

## CASE STUDY 2

On 11/1/2012, PortCo held the first closing of its \$25M Series D financing round at \$275M post-money valuation [# common stock equivalents on a fully diluted basis times \$4.4009 per share, or +139% of prior round price]. The price (or pre-money value of \$250M) was set by a new institutional investor that had no previous investment in PortCo. The Series D Preferred Stock had a 1x senior preference to the other classes of outstanding preferred stock, and converted to common 1:1. The financing was oversubscribed. The company was performing very well (and better than it had at the time of its Series C financing priced at 1.843 per share). This PortCo had made substantial business progress since the closing of its Series C financing round. Venture Fund participated in the financing at its full *pro rata* share. The term sheet for the deal was agreed to and signed on 10/12/2012. The Price from the term sheet is copied below:

Price:

The "Original Purchase Price" will represent a fully-diluted pre-money valuation of \$250 million (including an unissued reserved employee pool representing 5.0% of the fully-diluted post-money capitalization) and a fully-diluted post money valuation of \$275 million. A capitalization table showing the Company's capital structure immediately following the Closing is attached.

The judgment of the Venture Fund's GP was that this very recent outside-led financing round was clearly the best market data in existence to support the Venture Fund's 12/31/12 valuation of PortCo.

However, because PortCo's valuation was approximately 5% of the Venture Fund's total NAV -- not an unusual situation in VCFs -- our audit firm required us to create a mathematical model to support our valuation. They asked us to prepare an OPM backsolve, even though the OPM backsolve is not the method used by any venture investor to price this or any other financing round.

We ran the model, which concluded with an Implied Total Equity value of \$136M, a number substantially lower than the \$250M pre-money value of the recently closed financing. Obviously this was a problem, because the judgment of the Venture Fund's GP was that the investment was now more valuable than it had been at the time of its prior year Series C financing round priced at \$1.843 per share.

We ran the model, which concluded with an Implied Total Equity value of \$136M, a number substantially lower than the \$250M pre-money value of the recently closed financing, and only slightly higher than the \$100M post-money value of the prior round. Obviously this was a problem, because the judgment of the Venture Fund's GP was that the investment was now significantly more valuable than it had been at the time of its prior Series C financing round priced at \$1.843 per share (approximately \$100m total). Indeed the fund GP placed the value at the more recent Series D \$250 pre-money valuation.

PortCo's current operating metrics projected 2013-2014 forward revenue much higher than the company's 2010 revenue. Also, as noted, the Series D round was led by an independent institutional investor.

Since our audit firm required a mathematical model to substantiate our 12/31/12 valuation, they then asked us to prepare a PWERM to support our GP's judgment that the investment should be valued at the price recently paid for its Series D preferred shares. We complied with their request and created a PWERM analysis. We were able to find assumptions that could be supported by market data (M&A and IPO comparables) and our GP was able to support his probabilities for each scenario of the PWERM analysis. In the end the valuation of securities that we calculated using the PWERM was within an acceptable range of our original proposed valuation which was based on the recent Series D financing round, and the Valuation Group at our auditor signed off on our audit report. This process took a significant amount time from both the Venture Fund CFO and Fund GP. It also took over two weeks for the audit firm to further question the analysis and review the model's assumptions. All of this substantially delayed the issuance of our audit report.