



National Venture Capital Association

October 28, 2005

**VIA Email**

Financial Accounting Standards Board  
Technical Director – File Reference No. 1204-001  
401 Merritt 7  
P.O. Box 5116  
Norwalk, Connecticut 06856-5116

*Re: Proposed Statement of Financial Accounting Standards, "Business Combinations, a replacement of FASB Statement No. 141"*

**Introduction**

The National Venture Capital Association is pleased to comment on the Financial Accounting Standards Board (FASB) Exposure Draft of the proposed amendments to Statement No. 141 ("the ED"). NVCA represents the vast majority of American venture capital under management.<sup>1</sup> NVCA member firms and the funds they manage provide the start-up and development funding for innovative entrepreneurial businesses.<sup>2</sup>

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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, provide reliable industry data, sponsor professional development, and facilitate interaction among its members. For more information about the NVCA, please visit [www.nvca.org](http://www.nvca.org).

<sup>2</sup> Venture capital occupies a unique and valuable role in the U.S. economy. From 1970 – 2003 venture capital funds invested \$338.5 billion dollars into more than 21,600 U.S. companies. Prominent U.S. companies that received venture financing during their growth phases include: Microsoft, Federal Express, AOL, Apple, Office Depot, Intel, Home Depot, Cisco, Compaq, Genentech, Amgen and Starbucks. More recent beneficiaries of venture funding include: e-Bay, JetBlue, Seagate, and Google. Source: "Venture Impact 2004: Venture Capital Benefits to the U.S. Economy," a study commissioned by the NVCA and conducted by leading economic analysis and forecasting firm Global Insight (formerly known as DRI-WEFA), p. 2. The study found venture capital funded companies were directly responsible for 9.4% of total U.S. private sector employment and 9.6% of company sale. *Id.* at 3. Global Insight constructed a database of more than 20,000 U.S. companies that received venture capital investment at some point between 1970 and 2003. From this database, Global Insight was able to measure the number of jobs and revenues these companies contributed to the U.S. economy in the years 2000 and 2003. A copy of the study is available at <http://www.nvca.org/pdf/VentureImpact2004.pdf>.

Venture capital funds invest in start-up and early-stage enterprises, commonly referred to as “portfolio companies.” When portfolio companies succeed, the venture fund’s investment is returned to investors who often provide capital for new venture funds. Venture investing’s virtuous economic cycle relies on exit strategies whereby venture capital positions in portfolio companies gain liquidity. Acquisition has always been, alongside an initial public offering, one of only two means for venture capital funds to achieve liquidity at the end of their long-term investments. Since the enactment of the Sarbanes-Oxley Act, successful venture-backed companies are now even more likely to be party to a business combination.

Regardless of whether they choose a business combination or an IPO liquidity event, venture-backed companies operate with minimal staff and a purposefully narrow focus on achieving business objectives – research, market definition, product development, manufacture and sales. For this reason, NVCA is always concerned that the potential costs of implementing any new accounting standard do not outweigh the clear benefits.

Furthermore, NVCA is committed to ensuring to the extent possible that the merger and acquisition market is robust. Only by providing venture fund investors liquid returns can the venture capital industry continue to fulfill its discreet but unique and critical role in growing the American economy.

NVCA contributed to the development of Standard No. 141 in 2000 and 2001 by working with the FASB to re-orient its approach toward testing goodwill for impairment and away from mechanical amortization. In doing so, NVCA was guided by two basic ideas. First, we believe that the accounting for business combinations should reflect the practical considerations of the parties to the combinations rather than complex accounting theories. Second, we know that accounting treatment of aspects of a combination can affect the decision making of acquiring companies which can affect the economics of venture investing.

The ED changes fundamental aspects of business combination accounting. In the interest of brevity we will not restate the thoughtful critical comments that have already been submitted to you by persons and organizations with broad technical accounting experience and expertise. NVCA’s general comments are in the second section of this letter. First, we want to address two proposed changes specifically -- fair value of non-financial assets and recording all contingent assets and liabilities.

These two proposed changes in particular will add additional unnecessary valuation costs to transactions involving growing companies without an improvement in financial reporting. Both involve theoretical valuations, which are especially problematic when applied to the assets and liabilities of innovative new companies. Such companies can undergo volatile changes internally and their external environment can also change quickly. Moreover, with the constant demand for resources that growth creates, these kinds of companies are particularly sensitive to the costs of obtaining theoretical valuations – especially when the valuations are of questionable worth. Therefore, for similar reasons, we recommend the Board drop both the new requirements

to apply fair value and the requirement to record contingent assets and liabilities in the final standard.

### **Specific comments on the ED**

(1) Expanded use of fair value accounting elevates theory over reality in business combinations accounting.

The ED proposes to require nearly all assets acquired and liabilities assumed to be measured and recognized at their fair values as of the acquisition date. The ED would require companies to apply fair value accounting to all aspects of a business combination including nonfinancial assets, such as contingent consideration and litigation. We do not believe recording nonfinancial assets at fair value will result in improved financial reporting for business combinations. Because of the nature of these items and the fact that these values will not be based on either actual or potential exchange transactions, the initial recorded fair values will be artificial and inaccurate. The need to make adjustments in subsequent periods is highly probable. Furthermore, in these subsequent periods, it will be extremely difficult to determine if changes to those recorded amounts are due to changes in fair value or initial measurement errors.

The ED's move to full fair value in business combination accounting distorts not only how items are recorded but how the cost of the transaction is defined. The ED would exclude acquisition related costs in measuring the fair value exchange between the buyer and seller. Rather, these items would be deemed separate transactions in which the buyer makes payments in exchange for services rendered, which would be expensed as incurred. Our experience is that, in reality, companies consider acquisition related costs as part of the cost of the business combination just like they consider asset acquisition costs part of the carrying amount of an asset. The same is true for adjustment and integration costs. We believe that these costs should continue to be capitalized following current accounting practices because such treatment better reflects the fair value of all acquired assets and the fair value of the combined entity.

Therefore, we urge the FASB to retain the guidance previously provided in FASB Statement No. 141 with regard to recording nonfinancial assets in business combinations.

(2) The requirement to record contingent assets and liabilities will diminish the reliability of financial statements.

The ED proposes to amend FASB Statement No. 5 to exclude from its scope assets and liabilities arising from contingencies acquired or assumed in a business combination. The ED would require such assets and liabilities to be measured and recognized at fair value on the acquisition date if the contingency meets the definition of an asset or a liability in FASB Concept

Statement 6, even if it does not meet the recognition criteria in FASB Statement No. 5. The term “probable” in FASB Concept Statement 6 has a much broader meaning and refers to “that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved...” However, the meaning of “probable” in FASB Statement No. 5 is much more specific because it requires that “the future event is likely to occur...” We believe that if all contingent assets and liabilities must be recorded using FASB Concept Statement 6, companies will be required to incur additional unnecessary valuation costs to initially value and subsequently re-measure these contingent assets and liabilities. We believe that the inclusion of these items will produce financial statements that are less reliable and less relevant.

Contingent consideration, in particular, should not be recorded because whatever fair value is assigned will be highly speculative. Contingent consideration has developed as a means for sharing risk in situations where the actual parties to the transaction cannot reach agreement on value. Therefore, an attempt to arrive at a fair value estimate of such a liability will likely require use of very costly valuation services to achieve a wholly theoretical market value. Furthermore, the significant uncertainty that such valuations can create may diminish the utility of these types of contingent arrangements, which have been a highly effective means for sharing risk and concluding business combination transactions.

Therefore, we recommend that the FASB retain the current guidance in FASB Statement No. 5 with regard to contingencies acquired or assumed in business combinations.

### **General Comments on the ED**

Several of the comment letters the FASB has received, including those from Paul Efron on behalf of Goldman Sachs and former FASB Chairman Dennis Beresford, contain well-reasoned criticism of some of the more significant proposed revisions of the ED. The Efron and Beresford letters accurately describe the ways acquiring businesses “define” the cost of an acquisition and the most accurate way to represent the financial condition of a combined entity. We strongly recommend that the FASB seriously consider their comments and recommendations.

We have also reviewed the March 21, 2005 letter from the expert committees of the Financial Executive International and the Institute of Management Accountants. We are impressed with the persuasiveness of their argument that the ED, in general, fails to meet FASB’s own standard of “decision-useful information.” We are therefore dismayed at the apparent failure of this letter to persuade the FASB on any major points prior to exposure of the proposed amendments. Nonetheless, we are hopeful that the Board will give serious consideration to the arguments and recommendations in the FEI-IMA letter as part of its current due process review.

The FEI-IMA comments in their March letter on “Fair Value – Marketplace Participants” (pages 15-18) dovetail with our own views on the question of whether valuations based on theoretical transactions can either approach a fair representation of economic reality in a business combination or can do so in a cost beneficial way.

### **Need for Implementation Guidance**

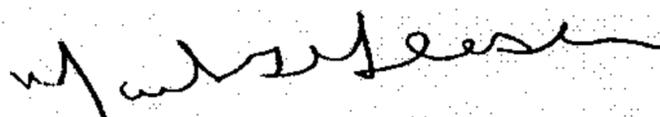
Overall, the proposed changes would likely add unnecessary complexity and cost to the accounting for business combinations. If the Board decides to issue this new standard on business combinations, additional specific implementation guidance on many of the new concepts contained in the ED will be essential. We believe such guidance is necessary because the ED will require companies to change widely-accepted accounting practices that have been in use for many years.

### **Conclusion**

For a variety of reasons, we believe that the proposed modifications will not result in improved financial reporting on business combinations. We are also concerned that the additional cost and complexity of accounting for business combinations as proposed in the ED would add unnecessary cost to such transactions and would negatively impact, at least at the margin, the liquidity of successful venture-backed companies.

We would be pleased to discuss these and any related matters. Please feel free to contact NVCA’s Vice President Jennifer Connell Dowling, our outside SEC counsel, Brian Borders (202 822 9306), or me to discuss these matters.

Sincerely yours,



Mark G. Heesen  
President