National Venture Capital Association

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VIA Email

Technical Director – File Reference No. 1520-100
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1520-100

LETTER OF COMMENT NO. 52

RE: *Invitation to Comment: Valuation Guidance for Financial Reporting (No. 1520-100, January 15, 2007)*

The National Venture Capital Association (NVCA) is pleased to respond to the Board's Invitation to Comment (ITC) on valuation guidance for financial reporting. NVCA represents the vast majority of American venture capital under management.[1] Our member firms and the funds they manage provide start-up and development funding for innovative entrepreneurial businesses.[2]

The typical venture capital fund is organized as a limited partnership in which the venture capital firm serves as the general partner ("GP") and investment manager. Venture capital funds

[1] 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.

[2] Venture capital occupies a unique and valuable role in the U.S. economy. From 1970 – 2005 venture capital funds invested $385 billion dollars into more than 23,703 U.S. companies. Companies that received venture financing between 1970 and 2005 accounted for 10 million jobs and $2.1 trillion in revenue in 2005, corresponding to 9.0% of US private sector employment and 16.6% of GDP respectively. These companies registered 4.1% and 11.3% gains in jobs and revenues respectively between 2003 and 2005 while national employment grew only 1.3% and U.S. company revenues rose 8.5%.

("VC funds" or "VCFs") make the majority of their investments in equity securities of operating companies, normally referred to as "portfolio companies."

The majority of the investment capital in each fund comes from limited partner investors ("LPs"), most of which are pension funds, foundations, endowments, insurance companies and other institutional investors. The success of venture investing is based on the long-term collaborative work of entrepreneurs, inventors, scientists, venture capitalists and the investors who provide the patient capital to fund start-up companies. On financial reporting issues, NVCA attempts to reflect the collective views of this venture capital community, which includes users as well as preparers of VC fund financial statements. For example, NVCA participated in the FASB's development of the Fair Value Measurement Standard, Statement No. 157 ("Statement 157") in order to ensure that application of the fair value measurement standard to VC fund financial reporting could be accomplished in a cost-effective way.

Our comments here on the questions presented in the FASB's ITC will address two general questions. The first is whether the venture capital community would benefit from the FASB involvement in providing valuation guidance beyond Statement 157 regarding the assets of venture capital funds. The second question we address is whether FASB should assume a formal role in encouraging the development of valuation guidance related to Statement 157 in general.

A Consensus as to the Proper Application of Statement 157 to Venture Capital is Developing.

Many VC funds' partnership agreements specify that annual financial reports will be prepared according to GAAP and audited by an independent CPA firm.[3] In addition, VCFs provide their LPs with quarterly financial reports which include the values of fund assets – stock in privately

[3] Generally, the *Audit and Accounting Guide, Audits of Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies,* applies to these financial statements.

held operating companies. As a result, the proper application of certain aspects of fair value accounting to venture capital funds has been and remains the source of a healthy debate.

In light of the venture capital community's interest in continued use of GAAP standards in financial reporting, NVCA became involved in the FASB's development of Statement 157 and filed two comment letters on the October 2005 working draft exposure document of the Fair Value Measurement Standard. Our basic recommendation was that the Standard needed to very clearly state that reasonable, not exhaustive, efforts are needed to obtain relevant inputs for determining the value of unique, volatile and illiquid assets such as securities of venture-backed portfolio companies.

We continue to be wary of the risk that application of Statement 157 to estimating portfolio company values, absent a financing event, could evolve into requirements that are burdensome and economically wasteful. NVCA thinks that the practices that continue to develop through unofficial collaborative efforts of VC fund financial statement users, preparers and their technical advisers offer a constructive approach to implementing the principles and general guidance in Statement 157. In particular, we believe that each fund, in collaboration with its LPs and advisers, is best positioned to produce the most relevant, useful and cost-effective financial reports.

The FASB Should Refrain from Providing Additional Guidance for Venture Capital or Private Equity Fund Reporting on Fair Value.

The Board's Statement 157 provides a complex framework for valuation of assets for which market data is not readily available. Despite its complexity, it provides useful high-level guidance that financial statement preparers can interpret and apply. It also provides a useful framework for users of fair value financial statements. As noted, there are situations in which Statement 157 is difficult to apply to venture capital. In these situations, preparers, users and expert advisers have joined in unofficial efforts to develop a consensus. We believe that preparers and users of VCF financial reports are able to develop satisfactory GAAP-compliant valuation reporting criteria on a cost-effective basis.

The process of developing Statement 157 revealed the difficulty of a centralized approach to developing valuation guidelines. It is no criticism of the FASB to say that crafting a measurement standard that applied to the simple but illiquid assets of venture capital funds as well as to the complex but highly liquid assets of other businesses or investment funds was a challenge. It appears that the final product, Statement 157, provides a sufficiently flexible framework of principles for measuring the value of our asset class. However, further refinement through the FASB would not be a cost effective exercise for venture capital or, we think, for the FASB.

The "marketplace" of preparers and users can best determine the correct cost-benefit balance in terms of the appropriate methods and metrics for valuing illiquid assets like the securities of venture-backed operating companies. As we discuss further in the next section of this letter, we think the FASB, and its staff, can play a very constructive role is assisting development of this "marketplace consensus" with technical advice and constructive criticism when such assistance is requested. Therefore, we do not see the need for an affirmative FASB role in providing fair value guidance for our asset class.

As a General Matter, the FASB Should Assume a Very Limited Role in Providing Valuation Guidance.

For many of the reasons stated above, we recommend that the FASB assume a very limited role, not just with respect to our industry but in the overall development of detailed valuation guidance. In particular, the FASB should neither encourage nor affirmatively involve itself in the process of developing valuation guidance since its official involvement with developing such valuation guidance risks undermining important financial reporting goals.

For example, the FASB has moved toward principles-based standards despite the ever-present demand for bright-line tests and detailed rules. Once it is fully implemented, Statement 157 may prove to be a good example of a standard that sets out principles that can be applied based on the general guidance provided in its Appendixes. Attempts by the FASB to develop --

or even to sponsor the development of -- valuation guidance, could fall into the trap of solving a single problem, but inadvertently creating many more problems in the process.

The most distinct risk we see in FASB-sanctioned guidance would come from its inappropriate application to areas for which it is not designed. The ITC seems to express a current concern that "constituents may analogize to non-authoritative [non-FASB] sources for valuation guidance." ITC, p. 2. However, based on current practices, we see a greater risk that auditors will require analogy to inappropriate guidance literature because it bears a FASB imprimatur of some sort. We believe financial reporting on valuation will benefit more from guidance that evolves from the push and pull of users and preparers. We fear the tendency to gravitate toward available authoritative guidance and analogize to it, even in situations for which it was not designed. If the FASB plays a role in developing guidance for one industry, there is a significant risk that accountants and auditors will err toward applying it in other areas, even if it conflicts with the unofficial consensus of users and preparers that has developed for these other areas.

Again, we want to emphasize our belief that the FASB can play an important role in assisting the development of valuation guidance under Statement 157. We merely see a more constructive role for FASB in responding to marketplace requests for assistance rather than in driving the process of development. In other words, we encourage a passive rather than an active use of FASB's expertise in a "bottom-up" approach to developing valuation guidance. This contrasts for good reason with the kind of top-down process that it uses in developing FASB principles-based standards.

For example, if an unofficial group of users, preparers and experts were working to develop a consensus on valuation guidance for their industry, they could encounter difficult questions as to the proper interpretation of Statement 157. In this case, it would be very useful if the FASB staff, particularly the staff members with expertise on Statement 157, were available for informal consultation on the issues that the unofficial group had identified. Such consultation would clearly have the potential to improve the quality of guidance that is developed in the marketplace as well as the FASB's institutional awareness of ongoing developments. This approach has the additional advantage of using FASB's expert resources efficiently. Finally, this approach avoids the risks we discussed already that arise from attachment of the FASB's imprimatur to detailed fair value guidance.

Existing Appraisal Organizations Should Have No Official Level of Involvement in Developing Valuation Guidance.

The valuation profession provides needed services in many areas. However, the nature of venture capital fund assets creates a significant cost benefit hurdle for the usefulness of outside valuation services. It is the general view in the venture capital community that outside valuation professionals lack the necessary experience to add significant benefit to the valuation process. Generally, neither LPs nor GPs of funds believe that there is benefit in obtaining outside valuations or verifications. The tools available to such firms are simply not useful in this situation. Therefore, we believe that investors – those who understand the long and uncertain path these companies must negotiate – consider the judgment of venture capitalists, the oversight of LPs and auditors as the best basis for reporting fair value of venture-backed companies.

Granting that we speak primarily from a start-up company perspective on this question, we see problems with assigning existing appraisal organizations any special role in the development of valuation guidance as a general matter. It is our experience that valuation professionals are inclined to promote the value of independent third party valuations of all assets under every circumstance. Moreover, while in no way intending to impugn the integrity of these organizations or their members, it is clear that they have a financial motivation and a professional bias in favor of extensive analysis and elaborate valuation procedures. We think this bias toward extensive 3rd party valuation processes is almost guaranteed to undermine cost-effectiveness implementation of Statement 157 should they be given a special role in developing valuation guidance.

Process for Issuing Valuation Guidance

It follows from our earlier recommendation of a passive role for the FASB that it need not consider what process it should follow for issuing valuation guidance. Instead, we think that the FASB should emphasize that valuation decisions are based on individual facts and circumstances and made according to the principles and general guidance in Statement 157.

On the other hand, should the FASB decide to, in some way, encourage others to develop valuation guidance we strongly recommend that it take care to actively discourage the impression that it endorses any guidance, or at least require that any guidance state clearly that its uses should be limited to its intended, specialized scope.

Conclusion

NVCA believes that the collaborative efforts of users, preparers and their advisers are developing a consensus on the application of Statement 157. We believe that the FASB should provide assistance, upon request, to unofficial groups that undertake to develop such a consensus. *We do not believe that the FASB should provide "official" guidance unless it is at* the same high level of Statement 157. Should the FASB assume a role in providing valuation guidance we strongly discourage the FASB granting any special role to appraisal organizations in developing valuation guidance. Finally, we would encourage the FASB to ensure that any guidance that it did assist in developing be limited in use to the scope for which it was designed.

Sincerely yours,

Mark G. Heesen
President