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BY EMAIL

Re: Fair Value Disclosures; Tentative Decisions on Topic 820

Dear Ben:

Thank you again for your attention to the concerns that David Larsen and I expressed on behalf of my client the National Venture Capital Association on our call last month. NVCA appreciates your openness to working with us to try to address them.

While I know we have raised many of our basic concerns before, we would like to raise them once again as the Boards reconsider their tentative decisions regarding fair value disclosures. As you know we are particularly concerned with the risk of unintended consequences that arises in mandating “a quantitative disclosure of the unobservable inputs and assumptions” used in fair value measurements for venture capital funds (“VCFs”). We also hope that the requirement to disclose a description of the valuation process will allow sufficient flexibility to provide the most meaningful disclosure and avoid disclosure of unnecessary or counter-productive details.

I. Quantitative Disclosure of Unobservable Inputs and Assumptions

Quantitative disclosures tend to obscure and add extra cost to the inherently subjective nature of valuations of most assets held by venture capital funds.

As we have noted before, many venture-backed companies simply have no revenue, much less EBITDA or other metrics common to quantitative valuation techniques. Valuations of securities of venture-backed start-up companies and many other unquoted securities are the result of judgments based on information that is nearly always far more qualitative than quantitative. Furthermore, in the great majority of instances, each asset (portfolio company) is a unique business organism, the value of which is best measured through the seasoned judgment of the venture capital professional who deals directly with the

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company. Given the episodic -- often binary -- nature of changes in the fortunes of companies that make up a venture fund's portfolio, venture investors place the most credibility on the judgments of fund managers in determining these valuations. Because of the many unique variables that are assessed in the context of valuing each of these individual companies, we do not see a cost-effective, decision-useful way to make financial statement disclosure of aggregated quantitative information that has been applied across a VCF portfolio.

We are concerned about the likely misinterpretation of quantitative metrics.

If one were to devise a disclosure that emphasized even a common quantitative metric that could be a reference point in a majority of the valuations, such a quantitative metric would not necessarily be meaningful in the same way across the entire portfolio. An example may help illustrate this point. Assume at the end of 2010 the companies in a VCF portfolio had a range of values that could be described as being consistent with a range of 1.5 to 3.5 times projected 2014 revenues. Disclosure of this fact would not be meaningful without also including many types of information that are not quantitative. Typical examples are: the size of the market opportunities, the quality of management, the expected market shares, the competitive landscape, the intellectual property position of the companies, the dependency or correlation of the business plans to other industries or geographies, the extent of available capital from alternative sources, and the economic and non-economic rights and obligations associated with funds' holdings in the portfolio companies relative to other investors' rights.

While VCFs often value their portfolio company interests by reference to the valuation at the latest round of financing, these valuations alone are not meaningful absent the qualitative information that led to the determination. For example, disclosure that a fund's valuations are on average 10% or 20% higher or lower than the latest round of financing provides a limited partner investor with no basis to evaluate the quality of valuations. A higher deviation from the last round could mean that the valuations are of lesser quality or less reliable. On the other hand, it could also mean that the portfolio is, on average, better able to generate cash from operations and therefore needing capital less frequently. Without much more information of a qualitative nature, the quantitative information is not useful. Furthermore, any attempt to include enough information to allow a reader to make such assessments in the financial statements will necessarily be unwieldy. It would also add cost and raise serious issues with implementation and auditing.

New quantitative disclosures could lead to inappropriate conclusions.

It is seemingly axiomatic that a reporting entity should not be required to create quantitative information for disclosure purposes that it does not use in valuations. However,

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this is not the first time that NVCA has felt the need to advocate for language in a FASB standard that may seem to state the obvious.¹ This is because, in practice, especially in the current regulatory environment, auditors and preparers feel compelled to comply with the letter of the standard, even if the result is irrelevant to the objective of the standard. Given the words of the rule tentatively approved by the FASB, some preparers or auditors may decide that any quantitative information that is reasonably available needs to be disclosed.

In the venture capital context, the proposed rules could create other perverse incentives. For example, VCFs that opt to provide quantitative disclosures (however excessive, unreliable or irrelevant) may be viewed by some users as having better quality valuations, independent of the substantive quality of the valuation assessments and judgments. Thus the Boards' efforts to provide better information would have the opposite effect. Should users come to favor financial statements with such information it would result in substantial new cost, and waste, across the venture industry—while possibly also being misleading.

Disclosure of such quantitative information is not cost-effective in the private company reporting context.

As you know, VCFs are not public reporting entities. Users of VCF financial statements -- limited partner investors -- have access to significant amounts of information that falls outside of the financial statements and footnotes. Venture investors demand and receive far more valuable information about the portfolio and the positions that make it up than can be summarized in a footnote in the financial statements. Mandating that incremental disclosure be provided in the audited financial statements will clearly result in additional costs for VCFs and their investors. Mandating such additional disclosure in the financial statements would not seem to satisfy a reasonable cost/benefit analysis unless the information being provided is more relevant than the information they already receive through other means. In light of the fact that we cannot envision a set of disclosures that could concisely communicate relevant quantitative information about the unobservable inputs and assumptions used in the portfolio company valuations, it is difficult to even measure the benefit that would be required to offset the obvious cost. Therefore, cost-benefit consideration would argue for further exemption of private reporting entities from the new fair value disclosure requirements. Again, we recommend an exemption for unquoted securities, including equity securities and unrated debt securities issued by a private company.

¹ The “undue cost and effort” language that appeared on Statement 157 is an example. See Comment letter of NVCA, *infra*, note 2, for an explanation of the importance of that language in practice.

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II. Relevant Disclosure Regarding “A Description of the Valuation Process”

As discussed, VCF asset and portfolio company valuations are based primarily on subjective judgment. The type of disclosure that NVCA believes best communicates this critical fact addresses not only the subjective or qualitative judgment at its base but also the process by which fair values are developed. An example of this disclosure has appeared in more than one of NVCA’s comment letter on fair value issues.

Level III – Pricing inputs are unobservable and include situations where there is little, if any, market activity for the investment. Fair value for these investments are estimated by the General Partner using valuation methodologies that consider a range of factors, including but not limited to the price at which the investment was acquired, the nature of the investment, local market conditions, trading values on public exchanges for comparable securities, current and projected operating performance, financial condition and financing transactions subsequent to the acquisition of the investment. The inputs into the determination of fair value require significant judgment by the General Partner. Due to the inherent uncertainty of these estimates, these values may differ materially from the values that would have been used had a ready market for these investments existed. Investments that are included in this category generally are privately held debt and equity securities which represent approximately XX% of partners’ capital.²

This type of information does more than inform the investor of the essentially qualitative nature of venture capital fund valuations. It also, we believe, is the type and level of disclosure that would be the most meaningful “description of the valuation processes in place.” Therefore, we hope that this is the level of detail that the Boards contemplate regarding disclosure on the valuation processes of venture capital funds.

Conclusion

We certainly understand and support the goal of providing users of financial statements with information concerning the reporting entity’s determination of fair value. However, by virtue of the inherently subjective process by which fair value are determined for non-quoted securities, we cannot envision a set of disclosures that could concisely communicate relevant quantitative information about Level 3 portfolio

² Comment letter of NVCA on Proposed ASU Fair Value Measurement and Disclosure (Topic 820), File Ref. No. 1830-100 (September 7, 2010), p. 4. Available at <http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821245422&blobheader=application%2Fpdf>

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company valuations. Therefore, we believe the final standards should include an exemption from the proposed disclosures for non-quoted equity securities and unrated debt securities issued by private companies. In the alternative, we believe that private companies (including VCFs) should be exempt from these disclosure requirements.

Of course, any steps the Boards might choose to address venture fund disclosures need to take into account limited partner disclosure requirements. In nearly every instance, if a pension fund, endowment or other type of institutional investors is required to make disclosure about values of Level 3 assets, they will likely require the VCF to provide the necessary information.³ Therefore, the most effective exemptive relief would relate to the asset, e.g., non-quoted equity securities and unrated debt securities issued by private companies, rather than the reporting status of the preparer – private or public.

Finally, we recommend that preparers be given wide discretion in determining the appropriate information and level of detail for describing the valuation process for such securities.

On behalf of NVCA, thank you again for your willingness to discuss these issues with us and for your efforts to understand our concerns. We are always ready to discuss these or any other issues on which NVCA and its members can assist the Boards in their mission.

Sincerely yours,

Brian

Brian T. Borders, Esq.

For

The National Venture Capital Association

cc
Hilary Eastman, Senior Technical Manager, IASB
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³ As noted in NVCA's September 7, 2010 comment letter, *supra*, note 2, venture fund LPs are in a position to require the fund to furnish the necessary information required for any asset-specific disclosures, and NVCA's members expect that they would.