National Venture Capital Association

February 19, 2005

VIA Email

Financial Accounting Standards Board
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File Reference EITF0405: "Investors Accounting for an Investment in a Limited Partnership When the Investor is the Sole General Partner and the Limited Partners Have Certain Rights."

The National Venture Capital Association (NVCA)[1] appreciates the opportunity to submit these comments on the proposed EITF guidance referred to above. NVCA represents approximately 450 venture capital and private equity firms. Our member firms organize and manage venture capital and private equity funds, usually through a wholly-owned management companies.

Over the past few years, NVCA has worked with the FASB and the AICPA on a variety of standards, interpretations and SOPs that would affect the way various venture capital entities would prepare their financial statements. As both an association of venture capital firms, and

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[1] The National Venture Capital Association (NVCA) represents approximately 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.

Venture funding is a major factor promoting innovation and entrepreneurial businesses. In 2004, venture capital (VC) funds invested $20.8 billion in more than 2800 companies, the fifth largest amount ever in the history of venture capital. Eighty-five percent of these companies were in information technology, medical/health or life sciences. The success of venture investing is encouraging greater capital flow to these types of companies. At the end of 2003, VC firms had an estimated $258 billion under management, up from $32 billion in 1990.

through our members, we have helped inform accounting standard decision makers on the workings of venture capital and the impact of proposed changes on the financial statements of venture capital funds and venture capital firms. We remain available to assist by way of information or expertise on the workings and purposes of venture capital.

Summary

We fully support FASB's efforts to make financial statements "credible, transparent and comparable." In general, we fear that application of the proposed consensus to EITF 04-5 would make venture capital fund financial statements unreliable, opaque and largely meaningless for comparison purposes.

The typical VC fund is organized as a limited partnership in which the venture capital firm serves as the sole general partner. Therefore, we are concerned with the apparent application of this EITF consensus to venture capital entities that serve as general partners to fund limited partnerships. It is our view that application of the proposed EITF consensus on Issue No. 04-5 to the GAAP financial statements of general partners of VC funds would impair their usefulness and further erode the relevance of GAAP to the private investment world. Therefore, at a minimum, we urge that general partners of venture capital partnerships be exempt from this interpretation. In addition, it is probably appropriate to review the broader impact that this proposal would have on a variety investment partnerships.

We have reviewed a copy of the letter sent by W. Stephen Holmes of Interwest Partners, an NVCA member, to FASB Chairman Robert Herz on the subject of EITF 04-5. While NVCA's perspective is somewhat different than that of Mr. Holmes, who wrote as a member of the FASB Small Business Advisory Committee, we heartily endorse his comments. Mr. Holmes' letter, a copy of which is attached for your convenience, effectively covers many points that this letter will only summarize regarding the impact of this interpretation on the financial statements of venture capital firms. It also has a graphical display of a typical venture capital structure and an example of the impact of one likely application of EITF 04-5 to a venture capital firm's balance sheet and income statement. We believe these are accurate and useful.

We understand that you will also receive comments from other venture capital firms, including NVCA members, which will further describe the problems that application of the proposed EITF 04-5 would causes venture capital.

Background

Venture capital and private equity funds are generally designed for a life limited to 10-15 years during which all investments are either sold or otherwise liquidated. The majority of the money in each fund comes from limited partner investors ("LPs") who can be institutional investors like university endowments, public pension funds, corporate pension funds, insurance companies or high net worth individuals. The venture capital general partner ("GP") also makes an investment of capital that is significantly smaller than the typical limited partner's investment. This amount ranges from 1% to 2% of the total committed capital of the fund. The typical limited partner commits at least 5% of the total fund capital.

The VC general partner makes fund investments in selected companies, usually referred to as "portfolio companies." In addition to serving on each portfolio company's board, the GP will often assist in recruitment, provide strategic advice, mentor CEOs, help build business relationships, etc., all with an eye toward adding to the value of the portfolio companies. In order to compensate and motivate the VC general partner, fund agreements ordinarily provide for a management fee and entitle the GP to a significantly greater portion of the potential returns of the fund's investments than its proportion of capital committed. Generally, agreements entitle the GP to 20% of the fund's returns after all LPs have received a return equal to their capital investment. In other words, the GP's return on its investment of time and talent comes in the later years of the fund's life at the same time the LPs begin to realize profitable returns on their venture capital fund investments.

Many terms of the VC fund agreement reflect the long-term nature of venture investing. Since the prototypical venture investment is a start-up company with minimal operating history and negative net income, venture capital funds anticipate negative returns in the first few years of investment followed by positive returns from successful exit events in the middle to late years of the fund's life. Typical fund agreement terms require LPs to meet capital calls through an "investment period" that can range from five to ten years. Throughout the life of the fund, LP withdrawal, redemption or transfer of an LP interest is highly restricted and based on GP discretion. Each of these terms -- finite life of the VC fund, long life cycle of fund investments, restrictions on LP liquidity -- reflect the high level of commitment required of the GP and the LPs in a successful venture fund.

The rights of LPs to replace the GP also reflect the long-term commitment and stability required for successful venture funds. It is a standard term of fund agreements that replacement or removal of the GP requires more than a majority vote of the partners. Indeed, supermajority kick-out requirements of 75% are widely used. This is not merely for protection of the GP or to give GPs control. It reflects the commitment of all partners to this focused and finite investment approach.

Venture capital firm financial statements would be significantly confused by application of the proposal.

Venture capital firm financial statements do not consolidate the funds the firm manages as the sole general partner. This accounting practice, which is consistent with GAAP, reflects the various relationships between the firm and the fund. The GP does not own the fund assets; the fund partnership does and, therefore, the fund accounts for its assets under Investment Company accounting rules. The GP stands in both a management and an advisory relationship to the fund with the fund agreement specifying the GP's investment discretion and overall authority. The GP's capital commitment is very small relative to that of the LPs as a whole and small in comparison to that of the majority of LPs individually. None of the key aspects of the venture structure suggest that the GP should include the fund on its financial statements. Indeed, the proposed consolidation is inconsistent with the reality of each of these relationships and the relative financial interests of the investors in the fund. LPs certainly do not view the GP as having a controlling financial interest or a dominant ownership in the fund. They view them as managers of the fund and advisers to the fund.

The proposed guidance will cause a drastic increase in the scope of venture firms' balance sheets. Consolidated assets will dwarf the real assets of the venture capital firms. Users of the firm's GAAP financial statements could not be expected to understand the significance of these enormous fund assets absent extensive footnotes and non-GAAP alternative presentations.

Under EITF 04-5m making firm financial statements meaningful to users would add significant <u>foreseeable</u> cost. Furthermore, the proposed requirement could well lead to cost and complexity that we cannot foresee once bankers and other users of these statements attempt to understand the relevance of these balance sheet and income statement entries. Therefore, application of the consensus on Issue 04-5, as proposed, could seriously impair the usefulness of GAAP financial statements of venture capital firms.

Application of EITF 04-5 to venture capital firm GPs would likely have negative and unforeseen consequence on the relevance and use of GAAP financial statements.

As drafted, the EITF consensus would require VC firms to consolidate VC funds into their financial statements in cases where limited partner kick-out rights require more than a simple majority of limited partner support. We anticipate one of two reactions if this requirement is implemented. Neither is desirable from either a business or an accounting standards perspective.

We think two courses of action will be considered by venture capital firms. In one scenario, general partners of VC funds could overrule their business judgment and the preferences of many LPs and reduce the ownership requirement for exercise of kick-out rights to a simple majority. While this seems an easy solution, it would indeed run contrary to the business judgment of many venture fund managers. It also would not be favored by many LP investors since a key element of their investment decision is the management abilities of the GP. The risk that a simple majority of other LPs could remove the GP would run contrary to the desires of many venture capital investors.

Furthermore, supermajority kick-out rights serve to reinforce the long-term nature of venture fund investing. A venture fund is a long-term, but finite investment. Disruptions in management continuity, like changes in the make-up of the LP group, are detrimental to the focused effort needed to produce returns through investing in start-up companies. Venture investors expect that the fund will produce returns in the middle third and the last third of the fund's life. Similarly, GPs work hardest and make critical decisions in the first half of the fund's life with the expectation of rewards in the out years. In these ways, supermajority kick-out rights serve important purposes for both LPs and GPs. Therefore, elimination of such rights would not be a favored means of avoiding the counterproductive result of these proposed new GAAP requirement.

The other choice, and one which we believe most venture firms will favor, if reluctantly, is to minimize the impact of GAAP accounting in this area. Many venture firms, as small private entities, are not required to prepare GAAP financial statements. This rule will provide a sound reason to avoid using GAAP: it will be easier to explain why the financial statements are not GAAP compliant in one area than it will be to explain a GAAP balance sheet which is ballooned by fund consolidations.

Some firms must prepare GAAP financials. These GPs, if they retain supermajority kick-out rights, will likely spend significant time and money repairing the informational harm done by the consolidation. While they could attempt to devise a responsible way to substitute another term for supermajority kick-out rights, one must ask if this would be a productive exercise. Based on what we know, VC firms who must use GAAP are most likely to prepare alternate presentations of the firm's financial statements and attempt to explain why the GAAP financials are no longer an accurate representation of the firm's financial situation. In any case, this exercise will be costly and will undermine the overall credibility of GAAP.

Therefore, no benefit will come to investors or other users of firm GP financial statements if the propose consensus is applied. Instead, significant cost and confusion will likely result. This result is clearly in conflict with the FASB's goal of making financial statements more credible, more transparent and more comparable.

Conclusion

We are very concerned at this proposal and its potential impact on venture capital fund financial statements. However, we are confident that the EITF and the FASB will carefully evaluate our comments and those of others involved in investment partnership structure and accounting. We are always available to provide any assistance that we can make available.

Sincerely yours,

Mark G. Heesen
President

1 Attachment
Letter dated January 19, 2005 from W. Stephen Holmes to Robert Herz w Attachments

January 19, 2005

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

RE: Small Business/Venture Capital Impact of EITF Issue No. 04-5: "Investors Accounting for an Investment in a Limited Partnership When the Investor is the Sole General Partner and the Limited Partners Have Certain Rights."

Dear Bob:

I am writing to follow up on our luncheon discussion during the December meeting of the FASB Small Business Advisory Committee. As I mentioned to you, some of my colleagues in the venture capital area have heard from their Big 4 auditors that EITF 04-5 (noted above) would apply to venture capital and private equity firms. I have since heard it confirmed that the EITF consensus on Issue 04-5, as proposed, would require VC firms to consolidate investment limited partnerships in the financial statements of the general partners, in cases where limited partner kick-out rights require more than a simple majority of limited partner support. (Super-majority kick-out rights are standard in these investment vehicles for a number of good business reasons.)

Since you expressed interest in the practical impact of the proposed EITF on the financial statements of sole general partners who serve as advisors to private equity and venture capital funds, I'll try to provide you my views in this letter.

As you are aware, venture capital firms are investment managers and advisors and earn a management fee for the pooled assets they manage. They have traditionally also served as the general partners to the funds they manage. The limited partnership structure is used so that limited partners are taxed on a flow-through basis. In order to achieve this tax objective for itself, the venture capital firm as general partner, is required to contribute some amount, usually1% to 2% of total equity investment in each limited partnership. Limited partner investors, who contribute the rest of the capital, include public pension funds, ERISA funds, endowments and other institutional investors as well as high net worth individuals. (I have included a simple diagram of the general structure of a venture capital firm and the fund it manages on the first page of an attachment to this letter.)

Under current practice, which follows generally accepted accounting principles, venture capital firm financial statements -- in some cases referred to as the management company financial statements -- do not consolidate the limited partnership funds for which the venture capital firm is the sole general partner. Important aspects of the legal relationship between the advisor, the fund partnership and the limited partners have influenced current practice. Partnership agreements generally define the discretionary investment and operating authority of the advisor. Since the partnership is the direct owner of the assets, the advisor has neither ownership nor custody of the pooled investment assets.

As we discussed, I am concerned that the proposed EITF consensus guidance on Issue 04-5 will force venture capital firms to consolidate the assets and equity of the funds they advise. I believe that to require consolidation would distort the relationship between the fund and the firm/management company and confuse users of the firm/management company financial statements.

The proposed guidance will cause a drastic change in the balance sheet presentation of venture firms because new minority interests in the limited partnership funds will dwarf the actual assets of the firm. For example, a relatively large VC firm with equity of $10 million could advise, and act as the sole general partner for funds with hundreds of millions, even billions of dollars in assets. The inclusion of these assets and the related minority interest on the balance sheet of the firm would distort the balance sheet and severely impair the usefulness and perceived accuracy of venture capital firm financial statements.

Since you expressed an interest in seeing examples of the distorting impact I described, I have attached an example of what a consolidating balance sheet and income statement might look like in pages 2 and 3 of the attachment. The balance sheet assumes a large VC firm with $17 million in assets that manages funds with total commitments of $1 billion and half of that capital invested. The income statement assumes that the firm received advisory fees of $20 million on the $1 billion of committed capital and that the funds yield 15% in aggregate for total annual return of $75 million. While most VC firms, like InterWest, are much smaller than this example, these proportions would apply.

As you can see, the change is dramatic. As a result, I am certain that firms that are not currently required to obtain audited GAAP financials will never do so. I also am confident that most lenders will require a non-GAAP balance sheet that presents only the "real" assets of the firm once they understand the relationship between the firm and the fund assets. I also doubt that limited partners, particularly pension funds or non-U.S. investors, would agree that assets they thought were in a separate legal entity protected by legal agreements should be on a GP advisor's balance sheet.

Simply stated, I do not believe that consolidation of investment partnerships in the financial statements of general partners makes practical sense. It would balloon the assets of venture firms to such a distorted level as to make GAAP financials meaningless to bankers, firm members or any other users of those statements. It would suggest an ownership relationship between firm and fund that ignores the fact that the firm acts as an advisor and fiduciary to the limited partner investors in the fund or funds. Such confusion could only be explained through a profusion of footnotes that might need to describe the entire partnership agreement. These financial statements could need extensive explanation of the value of the consolidated fund assets, which are in most cases securities of early stage private operating companies – assets that are notoriously difficult to value accurately.

I know you are also concerned with accounting rules that create unnecessary complexity. I think this EITF certainly would do that if applied to investment partnerships like venture capital funds. I also note that "relevance" is a key criterion for FASB standards. One of the reasons I am pleased to serve on the Small Business Advisory Committee is my concern with the declining relevance of GAAP financial statements. I am sure you would also be concerned with a new requirement that diminishes the relevance and usefulness of GAAP financial statements. I believe this will be one practical impact of applying EITF 04-5 to venture capital and private equity investment advisors.

Over the past two years the private investment partnerships have come close to being swept up in the trend toward more stringent consolidation requirements and other new accounting standards. In each case, the practical impact of including such entities in the new standard has been noted and the FASB has reconsidered the breadth of the new requirement's scope. FIN 46 is a good example.

I understand the need for new standards to address abuses, old and new. However, my work always forces me to face their practical effect on the financial statements of ordinary businesses. In this case, I am certain that no benefit will come to investors or other users of venture capital firm financial statements. I am equally certain that significant practical cost and difficulty will arise from the inclusion of overwhelming new minority interests on firm balance sheets.

I hope this information is helpful to you. I enjoyed our discussion over lunch and I look forward to continuing to work with you and the many fine people of the FASB in the future.

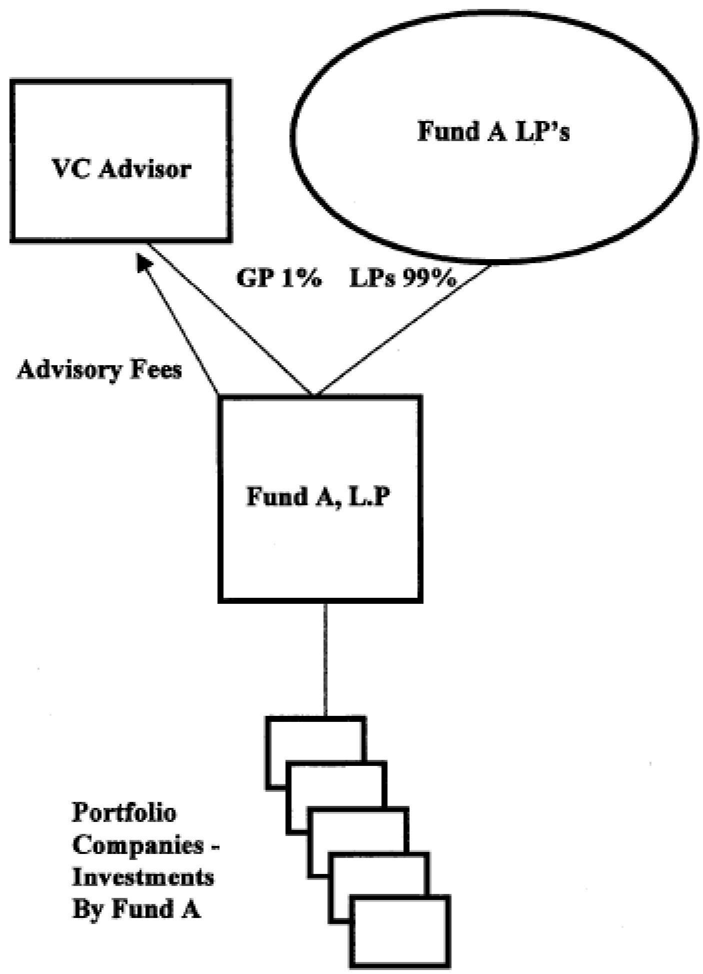
Very truly yours,

W. Stephen Holmes
General Partner, InterWest Partners
Member, FASB Small Business Advisory Committee

WSH/mm
Attachments

cc: Lawrence Smith, Chairman, EITF
Christopher Larsen, FASB-EITF staff

Example VC Advisor and Fund



VC Advisor
Consolidating Balance Sheet
31-Dec-04

		VC Advisor	Investment Funds	Eliminations	Consolidated VC Advisor
Assets					
Cash and cash equivalents	$	2,000,000	-	-	2,000,000
Investments		5,000,000	500,000,000	(5,000,000)	500,000,000
Advisory fees receivable		4,000,000	-	-	4,000,000
Plant, property, and equipment, net		5,000,000	-	-	5,000,000
Other assets		1,000,000	-	-	1,000,000
Total Assets	$	17,000,000	500,000,000	(5,000,000)	512,000,000
Liabilities and Equity					
Borrowings	$	1,000,000	-	-	1,000,000
Accounts payable and accrued expenses		6,000,000	-	-	6,000,000
Total Liabilities		7,000,000	-	-	7,000,000
Minority Interests		-	-	495,000,000	495,000,000
Equity		10,000,000	500,000,000	(500,000,000)	10,000,000
Total Liabilities and Equity	$	17,000,000	500,000,000	(5,000,000)	512,000,000
		-	-	-	-

VC Advisor
Consolidating Income Statement
For the Year Ending December 31, 2004

		VC Advisor	Investment Funds	Eliminations	Consolidated VC Advisor
Income					
Advisory fees	$	20,000,000	-	-	20,000,000
Other income, including realized and unrealized gain and loss		-	75,000,000	-	75,000,000
Total Income		20,000,000	75,000,000	-	95,000,000
Operating Expenses					
Compensation		10,000,000	-	-	10,000,000
Other operating expenses		5,000,000	-	-	5,000,000
Minority interest		-	-	75,000,000	75,000,000
Total Operating Expenses		15,000,000	-	75,000,000	90,000,000
Net Income	$	5,000,000	75,000,000	(75,000,000)	5,000,000