

October 8, 2009

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VIA EMAIL

Re: Proposed Accounting Standards Update, "Fair Value Measurement and Disclosure (Topic 820)," issued August 28, 2009. File Reference 1710-100.

Introduction

The National Venture Capital Association (NVCA) is pleased to comment on the above referenced proposed Accounting Standards Update, Fair Value Measurement and Disclosure ("the ASU"). NVCA represents the vast majority of American venture capital under management. NVCA member firms and the funds they manage provide the start-up and development funding for innovative entrepreneurial businesses.

NVCA's CFO Task Force consists of the CFOs and Administrative Partners of more than 100 of our member firms. With guidance from the CFO Task Force, NVCA has submitted comment letters on the various FASB proposal regarding fair value measurement under Topic 820 (former Statement 157.) We support the FASB's ongoing efforts to evaluate the costs, benefits and practicality of providing additional information to investors in vehicles like venture capital funds (VCFs).

Our comments will respond to the questions in the Exposure Draft regarding the operationality, usefulness and cost of the proposed additional requirements for sensitivity analysis in disclosures based on Level 3 inputs.

¹ The National Venture Capital Association (NVCA) represents more than 400 venture capital firms – 90% of the venture industry. 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.

1. Background and General Comments

The venture capital funds ("VCFs") that NVCA represents are US-based private funds. The do not report financial results under SEC rules or IFRS. The type of sensitivity analysis contemplated by the proposed ASU would be unprecedented for them. Therefore, we cannot respond to the ED's question regarding current practices based on any current requirements for sensitivity analysis. However, we can describe current financial reporting practices that comply with GAAP fair value requirements as well as VCFs' efforts to meet investors' expectations as to disclosures..

Venture capital funds consist primarily of assets that are valued based on Level 3 inputs. VCFs calculate the value of fund assets according to the framework set out in Topic 820, in accordance with Investment Company GAAP set out in Topic 946. Virtually all independent venture capital funds have been reporting under the *AICPA Audit and Accounting Guide: Investment Companies* for decades. This reporting includes disclosures that highlight the imprecise nature of venture capital asset valuation. We believe that venture investors are well informed as to the nature of the fair values provided to them.²

Venture investors, especially the sophisticated investment funds that provide the vast bulk of venture capital, have considerable input into the valuation and reporting practices of venture capital funds. Venture capitalists and venture investors participate in an ongoing dialogue on ways to improve financial reporting. Valuation and disclosure have been topics of considerable discussion and have produced unofficial, but important, guidance as to best practices.³ In none of those discussions, have venture investors expressed an interest in sensitivity analysis. There are good reasons for this.

By its nature, venture capital investing is long-term, often beginning when a company is no more than an idea. By their nature, fund assets are illiquid especially when companies are in

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 Typical disclosures are along the following line:

³ In September 2009, the International Private Equity Valuation ("IPEV") Board issued guidelines for private equity and venture capital. Information is available at http://www.privateequityvaluation.com/#Board. The IPEV guidelines build upon work over the past several years by IPEV and the US-based Private Equity Industry Guidelines Group ("PEIGG"), which produced Valuation and Financial Reporting Guidelines in 2003 and revised them in 2007. *See*, http://peigg.org/valuations.html. *See also* National Venture Capital Association, "Portfolio Company Valuation Guidelines,"
http://www.nyca.org/index.php?option=com content&view=article&id=109&Itemid=138.

their early stages. There is limited bid-ask spread until either a new round of financing or an expression of interest by a potential acquirer. Even where they exist, bid-ask spreads do not represent a true market of ready buyers and sellers.

Changes in the value of these assets occur episodically. They are usually determined by an outcome or an event. A company's value can rise or fall dramatically if, for example, the FDA approves trials for a new drug or not, a prototype product works or doesn't, the market reacts well to a new idea or not, or a large competitor works with the start-up or against it. In this regard, variations in value are often binary. The outcomes do not slide along a continuum based on assumptions about external factors like interest rates or variations in multiples. Rather alternative assumptions are often simply opposite ends of the spectrum, with success (the product or idea continues to advance) at one end and failure (time to wind down the company) at the other. Therefore, while useful for other securities, sensitivity analysis will not provide meaningful information regarding most VCF assets.

We appreciate the Board's efforts to refine the cost-benefit analysis underlying this proposed ASU. Indeed, we contacted FASB staff during their earlier outreach efforts on this project and our members stand ready to assist in future efforts. We believe a careful evaluation will reveal that the proposed ASU cannot be applied to venture capital funds so that the benefits to investors exceed the costs to the funds in which they invest.

2. Specific Comments

The proposed ASU calls for disclosures as to the effect of "reasonably possible significant alternative inputs for Level 3 fair value measurements" that would increase or decrease the fair value "significantly." "Reasonably possible" alternative inputs are further defined in the Master Glossary as inputs that are "not remote but less than likely."

NVCA member firms believe that application of the new rules to VCFs would conflict with the Topic 820 principle that fair value measurement and disclosure not require "undue cost and effort." While we understand the interest of some financial statement users in having sensitivity information regarding certain investments, we believe that application of the proposal to VCFs fails a cost benefit analysis in at least three of the important parameters identified in the ED: operationality, usefulness and cost.

a. Operationality

The ability of VCF financial statement preparers to implement the requirement for sensitivity analysis will depend on refining at least three difficult aspects of the proposed rules. First they would need to arrive at an <u>operational</u> definition of "reasonably possible," or "more than remote but less than likely." They would also need to establish some quantitative definition of "significantly," which is not defined in the Master Glossary. Furthermore, VCFs would need to identify <u>which inputs</u> must be evaluated for reasonably possible alternatives and determine a means for measuring the significance of the effect.

The essential task in venture investing is to identify and nurture new enterprises in innovative businesses. The bulk of venture capital fund assets are securities or limited liability company interests issued by companies in the early stages of development, usually referred to as "portfolio companies." Valuing these assets with any quantitative precision is difficult. Efforts to do so are not the best practice in venture capital.

Many portfolio companies have no revenue and only a business plan, which is subject to ongoing revision as to how it will achieve profitability. As noted above, changes in values are best understood as event-driven. Aside from a recent financing, there are no clear market inputs. Start-up and development stage companies gain or lose value when they meet or miss milestones peculiar to their industries. Until certain business milestones are achieved, it is difficult to apply basic valuation techniques to arrive at a fair value for portfolio company securities. Metrics like risk-free interest rates, default rates, dividend rates, etc., do not have great relevance. As we noted in our 2005 comment on the Working Draft of the proposed Fair Value Measurement Standard:

[T]he best practices in portfolio company valuation emphasize neither formulaic valuation techniques nor professional valuation experts. The essential valuation expertise for a venture-backed company is the collective subjective judgment of the venture capital professionals who serve as the fund's [general partner]. Portfolio companies only produce investment returns when they are sold; therefore, the experience, intuition and critical thinking of venture capitalists are often the best tools for assessing the likelihood of success and are, therefore, best also for estimating the risk-weighted value of venture-backed companies.⁴

Attempting to overlay the sensitivity analysis requirement to the myriad qualitative and quantitative inputs that are integral to valuations of venture capital portfolio companies would be difficult. To do so in a way that would provide meaningful or decision-useful information to VCF investors would be exceedingly difficult, if not impossible.

Operationally, compliance would be a two-step process. Alternative inputs would need to be applied at the portfolio company level and then summarized and presented at the portfolio level. Our members who have attempted to develop a model for this process have seen no way to produce meaningful information through it.

b. Usefulness

As noted, the guidance is very difficult to apply in a meaningful way to VCFs. Therefore, the auditors will be the judges as to whether a given venture fund has complied. Obtaining auditor assurance could well be an expensive exercise. Still more important is the fact that this exercise will likely result in a wide divergence in the results, depending on the ability of

⁴ Letter to FASB Technical Director from the National Venture Capital Association, *Re: Statement of Financial Accounting Standard No. 15X*, "Fair Value Measurement": Comment on October 21, 2005 Working Draft (November 21, 2005), p. 4.

auditors to apply this guidance in a situation for which it is neither designed nor particularly relevant.

While NVCA members are primarily preparers of fund financial statements, our CFO Task Force includes representatives of fund of funds. As such, these CFOs provide us with the perspective of sophisticated LP investors. Based on their responses, we do not believe that VCF investors will find this type of sensitivity analysis useful. VCF investors know that they are invested for the long term. They know that returns are based on the segment of portfolio companies that succeed and they know that many fail. With this perspective, they see useful information in the quarterly updates they receive from the VCF general partner. They recognize the potential variability in these values but also recognize that the judgment of the venture capitalist who sits on the boards of the portfolio companies is the best gauge of fair value. They doubt the relevance of additional information based on hypothetical changes in quantitative inputs.

While it would not be difficult for VCFs to disclose the effect of a percentage variation in anticipated portfolio returns, this is a task that LPs could perform just as easily for each of their VCF investments. Indeed, it is likely that an investor in multiple VCFs, as most LPs are, would have more relevant experience and data for accurately estimating this range of results. Those who think it is worthwhile are probably already doing it.

c. Cost

The proposed sensitivity analysis would be very costly to venture capital funds. Additional costs would be incurred in a number of ways – both additional internal personnel costs, opportunity costs and, finally, external hard dollar costs.

Depending on the way the key terms of the new rule would be interpreted by the VCF's auditor, the fund could incur costs for additional auditor time and outside valuation experts. In addition, VCF general partners, as well as the finance staff of the sponsor venture capital firm would be required to put additional time into this exercise, diverting the human capital most needed to be focused on managing their nascent portfolio companies.

Given the lean staffing essential to surviving the long venture capital cycle, additional compliance requirement could well detract from the time and energy venture capital deal partners have to spend managing their portfolio company investments. Based on the ongoing dialogue between venture fund general partners and their limited partner investors, we believe that LPs would see this as a waste and a distraction. Moreover, in some VCF structures, the cost of financial reporting is a direct expense of the fund. This new cost, therefore, would be borne by the fund's LPs. In funds where financial reporting is part of the general partner's management fee, the fee could rise to accommodate these new costs.

In any case, the VCF investors will bear the cost of additional audit expense and any delays in producing financial reports that will likely result from the need to develop alternative inputs, attempt to determine their impact and compile the required additional disclosures.

These costs will be replicated across the more than thirteen-hundred and fifty US-based venture capital funds. Given the lack of specificity as to how the required sensitivity analysis would apply to VCFs it is very difficult to quantify the cost. However, the mere fact that the costs would hit each fund means that the total cost to venture capital would be significant. We think these expenditures of time and money would be wasteful because the information produced would not be meaning, or decision useful, to VCF investors.

d. Compliance with IFRS No. 7, Financial Instruments: Disclosure.

Since the vast majority of NVCA members are US-based, they report under US GAAP and do not currently have plans for compliance with IFRS No. 7. This is particularly true given the current state of IFRS regarding investment company financial reporting.

While NVCA has limited exposure to IFRS reporting practices, we are aware that IFRS, in general, does not contemplate the type of financial reporting that VCF investors demand. In particular, the consolidation requirements in IFRS, which do not allow for the investment company exceptions in US GAAP, render IFRS financial statements unhelpful for private fund LPs. Therefore, a typical fund in an IFRS jurisdiction provides supplemental schedules that follow the US GAAP investment company format in order to provide investors meaningful information on a non-consolidated basis.

For these reasons, we do not see the impact of IFRS No. 7 as relevant to the question of whether the new sensitivity analysis requirement should apply to venture capital funds.

3. Recommendation

In light of the difficulties of applying the proposed ASU to venture capital funds and the limited utility of the new information to VCF investors, we believe it would be appropriate for the FASB to exempt venture capital funds from compliance with the ASU. One convenient way to do so would be to exempt entities that qualify for reporting under GAAP Investment Company accounting rules.

Conclusion

NVCA appreciates the FASB's efforts in this area. We have attempted to assist the FASB in the past and we stand ready to continue to assist in efforts to improve disclosures regarding Level 3 fair value measurements. Please feel free to contact me or John Taylor, Vice President, Research at 703 524 2549.

Very truly yours,

Mark G. Heesen

President