



February 15, 2012

VIA Email

Technical Director
File Reference No. 2011-200
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Re: Proposed ASU: Consolidation (Topic 820) – Principal Versus Agent Analysis

Introduction

The National Venture Capital Association (“NVCA”) represents the vast majority of American venture capital under management.¹ Venture capital funds provide start-up and development funding for innovative entrepreneurial businesses. NVCA’s member firms, the funds they manage and the vast majority of the companies in which they invest are private entities.

NVCA appreciates the opportunity to comment on the Exposure Draft of the Proposed ASU on Consolidation – Principal versus Agent Analysis (“the Proposal” or “the ED”).

¹ Venture capitalists are committed to funding America’s most innovative entrepreneurs, working closely with them to transform breakthrough ideas into emerging growth companies that drive U.S. job creation and economic growth. According to a 2011 IHS Global Insight study, venture-backed companies accounted for nearly 12 million jobs and \$3.1 trillion in revenues in the United States in 2010. As the voice of the U.S. venture capital community, the National Venture Capital Association (NVCA) empowers its members and the entrepreneurs they fund by advocating for policies that encourage innovation and reward long-term investment. As the venture community’s preeminent trade association, NVCA serves as the definitive resource for venture capital data and unites its 400 plus members through a full range of professional services. For more information about the NVCA, please visit www.nvca.org.

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Background

NVCA has filed comment letters at every step of the recent revisions of GAAP standards in this area, primarily because of the impact these standards have on the financial statements of venture capital firms and venture capital fund general partner entities. These general partner entities (“GPs”) consist of the venture capital professionals who manage and participate in venture capital funds or “investment companies.”

Beginning with the proposed EITF 04-05, we have outlined the “real world” reasons why GP financial reports are not useful to the users of these statement – lender, landlords and owners – if they consolidate the asset and liabilities of the fund partnerships they manage.²

We have also noted the importance of understanding the relationship between venture fund limited partners (“LPs”) and the GP. The structure of venture capital fund partnerships is such that that the GP is neither purely a managing principal nor purely a managing agent. We have previously noted that

“the Fund 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.... LPs certainly do not view the GP as having a controlling financial interest or a dominant ownership in the fund. They view [GPs] as managers of the fund and advisers to the fund.”³

General Comments

Our interest in this standard is practical and based on the needs of venture firm financial statement users. Consolidation of operating company investments with the financial statements of the investment manager will impair the usefulness of the financial statements for both entities and require extensive supplemental disclosure equal to the current financial statements. More specifically, consolidation obscures important information about management fees while showing consolidated assets that dwarf the assets actually available to satisfy the obligations of venture capital advisors.⁴

The users of venture capital firm financial statements – banks, landlords, owners – have uniformly rejected the consolidated statements and requested unconsolidated statements even though this is not GAAP. If the result of the current amendments is that venture fund GPs will be required to consolidate fund assets, it will mean more non-GAAP financials or more supplemental disclosure to provide users the information they need. Therefore, a decision as to

² See NVCA comment letter on ASU 2010-10, File Reference No. 1750-100, January 7, 2010, p.4, note 5, quoting NVCA comment letter on EITF 04-05, dated February 19, 2005.

³ *Id.*

⁴ *Id.*, p. 3. For examples, see the sample balance sheets that would result from GP consolidation of venture capital funds submitted by U.S. Venture Partners in its comment letter to File Reference EITF 0405, dated February 21, 2005; see also, comments of Adams Street Partners, dated February 18, 2005.

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consolidation based entirely on the factors outlined in the Proposed ASU, that does not consider the practical uses of these financial statements may run contrary to the needs of this most important constituency – financial statement users.

Our second general comment responds to a question that is raised in more than one of the specific questions in the ED – is the ASU operational. We applaud the general thrust of the Proposal. The implementation of a quantitative analysis of all fact and circumstances along with the elimination of the single bright-line test regarding kick-out rights offer the potential for significant improvements in the GAAP standard. However, more examples or interpretive language would help ensure consistent conclusions when the new rules are applied by multiple accounting firms to multiple venture capital fund partnerships.

Many of the factors emphasized in the Proposal are highly relevant to the principal-agent analysis. Unfortunately, in the context of the venture capital fund partnership, the Proposal is difficult to evaluate. As noted, venture fund GPs are a hybrid of a classic principal or agent. The GP typically receives a management fee that is a fixed percentage of committed capital. Furthermore, the GP's relatively small share of the fund's equity limits its exposure to partnership losses compared to the LPs.

On the other hand, the typical fund has an investor advisory board, not a governing board of directors. Furthermore, the GP has full discretion to make investments subject only to the partnership agreement. Participation rights are unusual and kick-out rights are diffused in a manner consistent with the fact that LPs intend that the GP will make unilateral investment decisions with a long-term realization horizon.

While the Proposal's shift to a more nuanced approach on consolidation is appreciated and appropriate, we cannot say that the Proposal is sufficiently clear as to result in consistent, decision-useful GAAP financial reporting and obviate the practical alternatives that currently predominate in situations where venture capital funds are required to consolidate under either GAAP or IFRS.

Specific Comments

Question 1: When determining whether a decision maker is a principal or an agent, the proposed amendments require the analysis to consider the decision maker's overall relationship with the entity and the other parties involved with the entity. This analysis would be based on a qualitative assessment. Do you agree with this approach? If not, why?

We support a qualitative approach to determining whether a partnership should consolidate its interests in the entities in which it invests. We appreciate the fact that the Proposed ASU reflects a move away from the rigid criteria in Statement 167. While the Principal-Agent analysis set out in the ASU may well lead to a useful unconsolidated presentation, we cannot be certain based on the ASU. See our comments on Question 2, below.

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Question 2: *The evaluation of a decision maker's capacity would consider the following factors: a. The rights held by other parties; b. The compensation to which the decision maker is entitled in accordance with its compensation agreement(s); c. The decision maker's exposure to variability of returns from other interests that it holds in the entity. Are the proposed factors for assessing whether a decision maker is a principal or an agent appropriate and operational? If not, why? Are there any other factors that the Board should consider including in this analysis?*

The interests of users -- bankers, landlords and owners -- of venture capital firms (or GP) financial statements will be best served if the final ASU is clearer that the entire relationship of the GP to the partnership, as well as the needs of the actual users are part of the principal-agent analysis. The first two sentences of proposed 810-10-25-87 (ED p. 50) state the broad range of factors to be considered in the Principal-Agent analysis; however, it would be clearer if the standard also included consideration of the overall economic relationship between the fund's LPs and the GP. Furthermore, even if it is not directly relevant to the Principal-Agent issue *per se*, we think that the needs of the users of the GP financial statements should be an important consideration in the question of consolidation.

As noted, a venture capital firm's financial statements are useful if they present the liabilities of the firm and the actual assets available to the firm to meet its obligations. Consolidation of fund assets would defeat this purpose. Therefore, it is important that the needs of the financial statement users be included somewhere in the decision making process regarding consolidation.

We know that venture fund GP financial statement will be misleading to the users of such statements if they include the assets or liabilities of the venture capital funds. Therefore we strongly recommend that the consolidation analysis include a meaningful consideration of the LP-GP relationship and the needs of users. If such consideration is given, we think GAAP financial statements of venture capital fund GPs will accurately reflect their "real world" balance sheet and, therefore, provide their users with relevant information. Otherwise, such statements will either be prepared on a non-GAAP basis or will need to be supplemented with a "real world" balance sheet. Neither result is desirable.

Question 3: *The proposed Update would require judgment in determining how to weigh each factor in the overall principal versus agent analysis. Do you agree that the proposed amendments, including the related implementation guidance and illustrative examples, will result in consistent conclusions? If not, what changes do you recommend?*

We support the use of judgment in determining the weight of each factor. As noted under Question 2, we think the overall economic relationship between the GP and the LPs and well as the interests of users of the GP financial statements should be part of the analysis.

Question 4: *Should substantive kick-out and participating rights held by multiple unrelated parties be considered when evaluating whether a reporting entity should consolidate another entity? If so, do you agree that when those rights are held by multiple unrelated parties, they*

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should not in and of themselves be determinative? If not, why? Are the guidance and implementation examples illustrating how a reporting entity should consider rights held by multiple unrelated parties in its analysis sufficiently clear and operational?

We strongly support the replacement of the current rule on kick-out rights in favor of a qualitative analysis based on all relevant facts and circumstances. However, we think that the interpretive guidance regarding kick-out rights should recognize that the interests of LPs, not just GPs, may be served by judicious limitation on kick-out rights. In the venture capital context, LPs can have a strong preference for continuity of the GP, absent extraordinary circumstances. Venture investing is long-term and a positive return on an investment may require continuity in the GP. Thus partnership agreements that call for development of a broad consensus among multiple LPs regarding removing the GP are generally in the interests of both the LPs who have decided to invest with a certain manager as well as the GP, whose profits are realized only after years of active engagement with investee companies. These aspects of venture investing are “relevant facts and circumstances” in analyzing kick-out rights. The guidance in the Proposed ASU should reflect the fact that the absence of unilateral or simple-majority kick-out rights can serve the interests of LPs and can be indicative of an agent GP as much as a principal GP, depending on the circumstances of the investment fund.

Question 12: *The amendments in this proposed Update would require a general partner to evaluate its relationship with a limited partnership (or similar entity) by applying the same principal versus agent analysis required for evaluating variable interest entities to determine whether it controls the limited partnership. Do you agree that the evaluation of whether a general partner should consolidate a partnership should be based on whether the general partner is using its decision-making authority as a principal or an agent?*

We think the consolidation decision should include a consideration of the needs of the users of the financial statements. A strict binary choice regarding consolidation based solely on the Principal-Agent analysis could result in a need to consolidate fund assets onto a venture fund GPs financial statements. Since it is clear that users of such financial statement find no value in consolidated balance sheets, their needs and the usefulness of the financial statements should be a consideration in “whether a general partner should consolidate a partnership....”

Non-public Entities Exemption

Our comments are applicable to private entities that act as general partners of venture capital funds. We recognize that there may be users of financial statements that have different needs than those which we have highlighted. To the extent that the users of publicly-traded entities’ financial statements are different that those we have emphasized, we urge the Board to tailor the standard to fit this distinction between users of privately-held partnership financial statements and those of publicly-held firms.

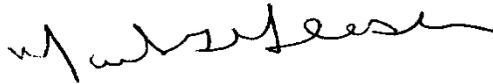
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Conclusion

We support and appreciate the move the FASB has made with this Proposed ASU toward greater flexibility and wider latitude for judgment in determining whether to consolidate partnership assets and liabilities. Our recommendations would improve the standard for the benefit of venture capital firms and the users of their financial statements.

We would be pleased to provide any assistance that we can make available. Please feel free to contact me or Jennifer Connell Dowling, Senior Vice President, at 703 524 2549.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Mark G. Heesen", written in a cursive style.

Mark G. Heesen
President