August 15, 2014

VIA Email

Director of Research and Technical Activities
Project No. 26-5E
Governmental Accounting Standards Board
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RE: Proposed Statement of the Governmental Accounting Standards Board
Fair Value Measurement and Application, Project No. 26-5E

INTRODUCTION

The National Venture Capital Association (“NVCA”) represents the vast majority of American venture capital under management.\(^1\) Venture capital funds (“VCFs”) invest across the spectrum of company stages of development, typically from early stage startup through IPO or acquisition.

Many governmental entities are limited partner investors in venture capital funds and are therefore users of venture capital fund financial statements. Indeed, governmental entities -- primarily pension funds -- represent a significant amount of the capital in venture capital funds. Venture funds prepare financial statements and report to their limited partner investors (“LPs”) at fair value under ASC Topic 946 as investment companies. Fair value is perhaps the most challenging aspect of VCF accounting. In applying ASC Topic 820, venture funds are required

\(^1\) 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. As the voice of the U.S. venture capital community, the National Venture Capital Association 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 nearly 400 members through a full range of professional services. For more information about the NVCA, please visit [www.nvca.org](http://www.nvca.org).
to determine a GAAP-compliant value on many assets that are classified in the Level 3 category. These values are a crucial part of the audited financial statements VCFs provide their LPs.

Some governmental entities also co-invest directly into the same private companies alongside venture capital funds in which they are LPs. Therefore, they are users of the same financial reports as VCFs and will be required to assign a fair value under the GASB standard to the same asset that the co-investing VCF values under Topic 820.

Therefore, while venture capital funds do not report under GASB standards, GASB standards directly affect the reporting requirements of venture capital funds and the ability to harmonize fair value reporting. Consequently, we are keenly interested in fair value guidance for governmental entities.

GENERAL COMMENTS

We commend the GASB for their effort on the proposed standard (“the Proposal”). We appreciate that in general the Proposal’s fundamental concepts and basic definitions are similar to the GAAP reporting standards under which venture capital funds currently prepare their financials and report to their investors, including governmental LPs. We fully support the disclosure requirements in the Proposal. They are reasonable and provide for a proper level of preparer discretion. On the other hand, we have concerns with the proposed measurement guidance. These concerns are driven by two overarching needs in the GASB standard:

- The need to remain consistent with the requirements of ASC Topic 820.
- The need to avoid unintended consequences that would require VCFs to measure or value assets differently than is required by ASC Topic 820.

In this regard, we question the need for an enunciation of fair value measurement separate from that contained in Topic 820. Obviously there is a need to adapt the language of Topic 820 so that it applies to governmental entities. Still we are concerned about unintended waste and confusion that would arise if VCFs, their LPs investors and their LPs-as-co-investors were required to apply different definitions and guidance on fair value. While the Proposal is an improvement over GAAP in some areas, a uniform standard is a practical necessity and even slight differences in language can cause problems in practice.

Therefore, our specific comments pertain to areas where our experience may assist the GASB in minimizing the risk of additional unintended requirements and costs for LPs (following GASB) and for the many VCFs with governmental LPs.

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2 Many of the financial reporting problems that currently vex VCFs stem from unintended consequences of Topic 820. Implementation of that standard has proven difficult particularly regarding measurement and disclosure regarding level 3 assets. However, VCFs and their LP investors have had several years of working through these difficulties and we see the risk of still more problems if the GASB standard and the GAAP standard are different.
Our main concerns are with guidance on the use of Net Asset Value (“NAV”) and Specific Valuation Techniques. However, our general comments apply to the entire standard: uniformity in measurement guidance between Topic 820 and this standard should be a paramount concern.

SPECIFIC COMMENTS

1. **Use of NAV.** NAV reporting is a crucial part of VCF financial reporting to its LPs. It is as crucial for VCF limited partners as it is for the venture funds. The vast majority of assets held in venture capital funds consist of securities in companies in the development stage. They are level 3 assets for which there is no readily determinable fair value. The guidance in paragraphs 73 through 75 appears to represent the current practice for LPs in venture funds.

   NAV is the appropriate means of determining fair value for holdings in venture capital funds. As stated in paragraph 73 and 74, the appropriate condition for use of a fund’s NAV as an LP’s estimate of fair value is that the NAV is calculated (or properly adjusted) as of the LP’s measurement date and the underlying assets are valued in a manner consistent with the FASB principles for investment companies (i.e. underlying assets are reported at fair value compliant with ASC Topic 820).

   In order to avoid unintended consequences that could undermine this essential part of VCF-to-LP reporting, we recommend that paragraphs 73 through 75 be modified to be still more explicit that a fund NAV calculated in accordance with FASB standards is adequate for purposes of paragraph 73. The GASB standard should make it clear that inherent in a government entity’s determination to use fund NAV as the basis for its fair value estimate for a VCF investment is the conclusion that the reported NAV is consistent with Topic 946 (investment companies). As such all the assets underlying the reported NAV are deemed reported at fair value consistent with ASC 820 and do not need to be tested under the new GASB standard. Such a provision would make it clear that GASB intends their standard to be consistent with GAAP on this point and, even if some auditors interpret it differently there is a “safe harbor” for NAVs calculated under GAAP.

2. **Disclosure.** Paragraphs 77 and 78 set forth disclosure requirements. These requirements appropriate in both scope and detail. Paragraph B76 addresses the Board’s decision not to require certain disclosures that are currently required by the FASB. As NVCA

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3 Paragraph B76. (“In the development of the Preliminary Views, several disclosures were considered but ultimately the Board concluded that those disclosures should not be required to be provided in the government environment. Potential disclosures included (a) the amounts and reasons for transfers among Levels 1, 2, and 3; (b) a reconciliation of Level 3 inputs presenting an opening balance, purchases, sales, settlements, transfers, and ending balances; and (c) for fair value measurements categorized with the Level 3 fair value hierarchy, a description of valuation processes used (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period). The Board was not persuaded that this volume of information was essential to a user’s understanding of the underlying amounts recognized in the financial statements. The disclosure of transfers among the levels was perceived to be required by operation of the levels of inputs. That is, if a fair value moves from a Level 1 input to a Level 2 input, transfer of that amount from Level 1 to
has noted in various communications to the FASB, the mandatory nature of certain fair value disclosures in Topic 820 is unnecessary and counterproductive.\(^4\) Greater preparer discretion in determining the content and detail of notes will result in more effective disclosure. Paragraph B68\(^5\) appropriately recognizes the importance of each preparer’s judgment in these matters. Given our hope that the FASB will consider eliminating certain disclosure requirements\(^6\) -- at least for VCFs -- we heartily concur with the GASB decision to avoid these requirements for governmental LPs and to emphasize the use of judgment in making disclosures.

3. **Specific Valuation Techniques.** The Glossary and paragraph 26\(^7\) highlight specific valuation techniques with greater specificity than is included in ASC Topic 820. We question the need for the proposed standard to define and highlight these particular techniques. We see the potential for unfortunate and unintended consequences resulting from undue emphasis on specific valuation techniques, especially option pricing models (“OPMs”).

Most VCF asset values are based on “unobservable inputs.”\(^8\) The “best information available” about market participant assumptions is seldom the kind of information used in OPM-type mathematical models.

\(^2\) is required. There is no policy election and the reason is impounded in the definitions found in the levels. The Board also did not require a disclosure reconciling Level 3 fair value measurements. Financial statement readers nonetheless will be presented with the ending balance of Level 3 measurements, providing information that will indicate the relative significance of those measurements. Finally, the Board concluded that descriptions of valuation processes, policies, and procedures used have the potential to lengthen significantly disclosures without providing essential information to financial statement users.

\(^4\) Of special concern to VCFs is the disclosure of “Significant Quantitative Input Assumptions Used for Level 3 Fair Value.” While we find other fair value disclosures wasteful and unhelpful this one raises the greatest risk of giving investors a false sense of precision. Reconciliation / Roll Forward of Level 3 Fair Values in a disaggregated form by security type have also been identified as a disclosure that is costly and unhelpful for both VCFs and their LPs.

\(^5\) Paragraph B68. “The Board believes that providing general guidelines such as these should help provide transparency when a government has complex fair value measurements. The Board also believes that specific criteria for level of detail are impractical due to the diversity of assets and liabilities that may be measured at fair value and the facts and circumstances unique to each government. A government’s specific circumstances should dictate the level of disaggregation and amount of detail to disclose. The Board believes this is best left to professional judgment after consideration of the factors described in this Statement.” [emphasis supplied.]


\(^7\) Paragraph 26. (“The income approach to measuring fair value converts future amounts (for example, cash flows or income and expenses) to a single current amount (such as discounted present value). When the income approach is used, the fair value measurement reflects current market expectations about those future amounts. Valuation techniques consistent with the income approach include (a) present value, (b) option pricing models, such as the Black–Scholes–Merton formula, and (c) the multiperiod excess earnings method.”)

\(^8\) Glossary, “Unobservable inputs: Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.”
OPMs introduce many unknowable variables, each of which can individually change the derived “fair value.” OPM values have very little correlation to actual exit valuations and few, if any such variables are independently verifiable. Worse still such models falsely imply not only accuracy but a false sense of precision. Indeed, the most important variables and assumptions -- those that underlay the actual pricing decision of market participants -- are not captured in mathematical models like OPMs.

In our experience auditors (and the PCAOB) have interpreted Topic 820 to frequently require venture capital funds to use valuation techniques such as option pricing models even though they are not generally used by market participants. Their use is an unintended and unanticipated consequence of the implementation of Topic 820. As a result, extraordinary and wasteful cost and effort has gone into developing values based on mathematical models like OPMs.

The fact that the Glossary and Paragraph 26 would highlight “option pricing model” could result in an insistence on the inappropriate use of such models. We know that this sort of unintended consequence occurs even though the use of such models is inconsistent with practices and assumptions of market participants. Therefore, we recommend that the term “option pricing model” be eliminated from the Glossary and that the final sentence of paragraph 26 be modified to read: “Valuation techniques consistent with the income approach include present value and other applicable models used by market participants.”

4. **Unit of Account, Calibration and Control Premium/Discount.**

Each of these concepts is very important in fair value reporting. As with NAV reporting we strongly encourage the GASB to ensure that fair values calculated on a basis that is compliant with GAAP principles in these areas are “safe harbored” in the case of any inconsistent interpretation of the GASB standard.

**CONCLUSION**

NVCA appreciates the opportunity to comment. Once again, it is very important that venture funds and their governmental limited partners have fair value standards that are as uniform as possible. We stand ready to work with the Board on this and other important matters. Please feel free to contact me at 703 524 2549 or John Taylor, NVCA Head of Research at jstaylor@nvca.org or his direct phone, 646 571 8185.

Sincerely yours,

Bobby Franklin
President & CEO