NATIONAL VENTURE CAPITAL ASSOCIATION
Funding innovation. Empowering entrepreneurs.

February 29, 2016

VIA Email

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File Reference No. 2015-350
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RE: *Proposed Accounting Standards Update*: Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement.

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

We appreciate the opportunity to once again participate in the comment process on the disclosure requirements regarding fair value measurements. We commend the Board for undertaking this effort to improve the quality of information available to investors in the notes to GAAP financial statements. Fair value measurement and

[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 (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 over 300 members through a full range of professional services. For more information about the NVCA, please visit www.nvca.org.

disclosures continue to be a challenging factor in the preparation and the audit process of venture capital fund (VCF) financial statements. Therefore we truly appreciate the emphasis the Board has placed on improving the quality, relevance and cost-effectiveness of notes on fair value measurements. Additionally, we appreciate the careful consideration given to the potential differences in requirements for private companies, which should benefit the vast majority of venture funds.

As with our previous letters, our comments on this Exposure Draft (ED) are informed by the expertise of NVCA's CFO Task Force, which is made up of approximately 100 of our member firms' Chief Financial Officers and Administrative Partners. These women and men are responsible for financial reporting for the vast majority of the venture industry worldwide. They provide uniquely valuable insights into the practical value of, and the practical restraints involved in providing meaningful information on the fair value measurements in VCF financial statements.

We are most encouraged by the fact that "the proposed amendments include language designed to promote the use of discretion by entities that reinforces that an entity can assess disclosures on the basis of whether they are material, thereby improving the effectiveness of the notes to financial statements."[2] We applaud the FASB's efforts to instill in preparers and auditors an appreciation for the fact that the effectiveness of notes to the financial statements is enhanced by the elimination of immaterial disclosures. We assume that the Board intends that the types of immaterial disclosures that should be excised would include some requirements that this ED specifically proposes to retain, modify or add to Topic 820.

However, we are concerned that language that would remain in Topic 820 will be interpreted as mandating certain disclosures notwithstanding this encouragement for preparers to use discretion and eliminate immaterial information. The proposed new requirements that preparers "<u>shall</u> provide range, weighted average, and time period used to develop significant unobservable inputs"[3] in 820-10-50-2 is an example.

Therefore, since we are in uncertain territory regarding the actual ability of preparers to exercise discretion based on their judgments regarding materiality, our specific responses below are prepared under the assumption that the disclosure requirements in Topic 820 will be mandated without regard to their materiality.

[2] ED, p. 3.
[3] *Id.*, p. 13 [emphasis supplied].

SPECIFIC RESPONSES

ED Question 1: Would the proposed amendments result in more effective, decision-useful information about fair value measurements? If not, please explain why. Would the proposed amendments result in the elimination of decision-useful information about fair value measurements? If yes, please explain why.

Disclosure Requirements Removed

We see the proposed removal of the Requirements numbered 1 through 3 set out at the bottom of page 2 and top of page 3 of the ED[4] as enhancing the overall decision usefulness of VCF financial statements. We also see the deletion of these requirements from Topic 820 as wholly consistent with the goal of eliminating distracting, immaterial information from the notes on fair value.

We appreciate that the ED proposes to exempt private companies from the requirement to disclose the "change in unrealized gains and losses for the period included in earnings (or changes in net assets) on recurring Level 3 fair value measurements held at the end of the reporting period." As noted, the private company exemption from these disclosures would exempt most venture capital funds from the need to make these disclosures. We are concerned however, with the practical effect of retaining these requirements in Topic 820 for public companies. It is possible that requirements on public companies will be integrated into the audit procedures for investment funds, which would then be applied to private companies (including those funds whose sponsors may be subject to SEC oversight as registered investment advisers).

More substantively, we believe that some remaining requirements do not appear to provide relevant information, even for public company financial statement users. Item 4 on page 3, which is an exemption for private companies, highlights such a disclosure.[5] Information about changes in unrealized gains and losses for Level 3

[4] "1. The amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy; 2. The policy for timing of transfers between levels; 3. The valuation policies and procedures for Level 3 fair value measurements; 4. For private companies, the change in unrealized gains and losses for the period included in earnings (or changes in net assets) on recurring Level 3 fair value measurements held at the end of the reporting period." ED, p. 2-3.
[5] This particular disclosure was noted in the FAF's Post Implementation Review of Statement 157/Topic 820. ("We learned that preparers and practitioners are concerned with the decision-usefulness of the Statement 157 disclosures. They cited concerns about disclosure overload, particularly as it relates to Level 3 disclosures, including the Level 3 rollforward."[emphasis supplied). Financial Accounting Foundation, *Post Implementation Review, Statement 157, Fair Value Measurement* (February 2014), page 8.

investments is not useful without also knowing the changes to realized gains and losses with respect to such investments. In a typical investment portfolio reporting period, a portion of previously unrealized gains and losses becomes realized. These realizations result in reversals of prior unrealized gains, reducing the amount of the change in unrealized gains and losses during the quarter. Disclosing changes in unrealized gains or losses apart from realized gains and losses would mask the actual valuation change of the portfolio and therefore preclude the user actually understanding its volatility. Only in situations where the financial statement issuer holds the same securities in the same amount at the beginning of the period as at the end of the period would the change in the unrealized value alone be meaningful to investors. The volatility reflected by a disclosure of unrealized gains and losses alone would give a misleading indication of portfolio volatility.

For these reasons, we hope that the FASB will closely consider whether these disclosures and all other disclosures from which the ED would exempt private entities are truly useful for public company investors as well. This is particularly important where disclosures are now to be truly mandatory. In light of the Board's intent to reduce requirements to make minimum disclosures, the bar should be raised so that specific mandatory disclosures are certain to provide information that is relevant and useful to users. In the example above, the desired disclosure as articulated in the ED clearly does not meet that standard.

Disclosure Requirements Modified

The first two proposed modifications to disclosure requirements noted on page 3 of the Exposure Draft[6] would improve disclosure. They would result in disclosures that are more decision useful for venture investors. However, we find the "clarification" regarding measurement uncertainty worrying and difficult to evaluate. The discussion of Measurement Uncertainty in the ED[7] sets out the many reasons for focusing on measurement uncertainty at the measurement date rather than sensitivity to hypothetical changes in the future. It also describes the sound basis upon which the Board declined to require quantitative information on measurement uncertainty.

[6] "1. For private companies, no longer require a reconciliation of the opening balances to the closing balances of recurring Level 3 fair value measurements. However, private companies would be required to disclose transfers into and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities. 2. For investments in certain entities that calculate net asset value, require disclosure of the timing of liquidation of an investee's assets and the date when restrictions from redemption will lapse only if the investee has communicated the timing to the entity or announced the timing publicly. 3. Clarify the measurement uncertainty disclosure to communicate information about the uncertainty in measurement as of the reporting date rather than information about sensitivity to changes in the future." ED, p.3.

[7] *Id.*, pages 35-39.

However, it is not clear to us whether the replacement of the key term "sensitivity" with "measurement uncertainty" is intended to substantively change the focus of the disclosure. We believe that most users of VCF financial statements understand that valuations change over time and that those valuations are sensitive to changes in a number of factors and assumptions. The proposed emphasis on measurement uncertainty rather than sensitivity may serve only to call into question the reliability of financial statements of early stage VCFs. Where a portfolio is comprised of many companies with significant variability in outcomes, measurement uncertainty for valuations can greatly exceed the materiality of the valuation. In practice, it is understood that notwithstanding the inherent challenges in measuring certain fair value inputs, fair value determinations can be made in accordance with GAAP, which are based upon reasonable estimations within an appropriate range, even though the range may exceed materiality. Our experience suggests that users of VCF financial statements understand that their investments involve substantial risk that valuations are subject to numerous subjective inputs and the ultimate financial outcomes may differ materially from the results presented. Consequently, there is broad acceptance that, given the wide range of possible ultimate outcomes, there is a greater tolerance for uncertainty in the reported interim values. However, it is not always clear that this greater tolerance of variability is expressed in greater latitude in assessing materiality.

Therefore, we are concerned about: the details of any new disclosures; whether they would be useful to investors; and, the impact it could have on audit practices. Specifically, would audit practices seek to compel VCFs to achieve the impossible task of narrowing measurement uncertainty to be less than a general concept of materiality? Therefore, we recommend that any substantive change in the required disclosures regarding sensitivity or measurement uncertainty be more explicitly explained and that commentary be provided which addresses any anticipated practical impact of that change.

New Disclosure Requirements

ED Question 5: The proposed amendments to paragraph 820-10-50-2(bbb) require that a reporting entity disclose the weighted average of significant unobservable inputs used in Level 3 fair value measurements. Are there classes of financial instruments for which this disclosure is inoperable or does not provide meaningful information? If yes, please describe those classes of financial instruments and explain why.

We appreciate that the Proposal would exempt private companies from this new requirement. As we noted earlier, while this would at least in theory exempt most VCFs from the need to make these disclosures, we are concerned that other factors could vitiate that relief. Furthermore, whether a fund is private or public we certainly see no investor demand for this information currently. Given that fact, we question the need to create a new requirement for these specific disclosures at all.

Disclosing the weighted average of various inputs does not provide meaningful information for a user, particularly absent agreement as to the best means by which to calculate each weighted average. For example, for five companies whose valuation metrics include a multiple of revenues, is the weighting to be based upon the total revenues, the total enterprise values or the total equity values of those five companies? Would the weighting be treated differently if the VCF had vastly differing ownership percentages in each company or if some companies had issued significant debt or securities that were senior to those held by the VCF? Unlike the disclosure of ranges, we fear that disclosing a calculated weighted average will mislead a user as to the significance of that single data point unless there is more, and lengthy disclosure of specified and commonly understood methodologies by which such calculations would be performed. Given the fact that most VCF investors are provided significantly more useful and detailed information about the composition of the VCF portfolio by means other than the financial statements, we see little value in this added disclosure.

Question 8 in the ED raises an apt question: "[a]re there any other disclosure requirements retained following the review of Topic 820 that should be removed on the basis of the proposed Concepts Statement or for other reasons?" As noted on Pages 1-2 of the ED, the proposed changes in this ED apply Proposed Topic 235 by saying that "an entity shall provide required disclosures if they are material [and the Board should] [e]liminate phrases like 'an entity shall disclose at a minimum,' which make it difficult to justify omitting immaterial disclosures." As we read the new requirement to disclose "the weighted average of significant unobservable inputs used in Level 3 fair value measurements," we question whether this requirement is not the type of specific mandatory requirement that Proposed Topic 235 seeks to eliminate. While preparers would in theory be able to decline to disclose such information if it were not material, we see the specificity of the proposed language as similar to "shall disclose at a minimum." This could well lead to a *de facto* mandate for public companies and perhaps for private companies as well.

Therefore, absent a clear indication that investors would use this new information in making decisions, we recommend that this new requirement be withdrawn for all entities. In any case, we see the private company exemption as wholly appropriate and we applaud the Board for proposing it.

ED Question 6: The proposed amendments to paragraph 820-10-50-2(bbb) require that a reporting entity disclose the time period used to develop significant unobservable inputs. What would be the costs associated with including this disclosure? Would this disclosure provide more effective, decision-useful information?

It is difficult to discern what would be disclosed as "the time period used to develop significant unobservable inputs." It is confusing in that valuations are intended to be determined as of the measurement date and relevant metrics are based on market participant assumptions as of the measurement date. We wonder how a date or time period other than one that is close in time to the measurement date would align with GAAP? (We note that the illustrative disclosure in the ED[8] implies that the relevant time period could include numerous years).

The discussion in paragraph BC46 of the ED cites prepayment rates and weighted average cost of capital calculations as examples of inputs for which disclosures may be useful. However, the proposed illustration suggests that a time period would be disclosed for each input, which implies that this information is somehow useful. However, if the valuations accord with GAAP -- assumptions as of the measurement date -- we agree with the point noted in BC46 that "this information would be obvious [to most users] and would not be used in their analyses."[9] Therefore, if it is the intent to add this disclosure, it would be helpful if the content of the intended disclosure could be clarified further. It would be particularly helpful to see an explanation of the requirement's alignment with the requirement that valuations reflect market participant assumptions as of the measurement date.

As with the new "weighted average" disclosure discussed under Question 5 above, we appreciate the exemption for private entities. However, we similarly question whether the private company exemption will have the desired practical impact given standardized audit practices as note under Question 1. In addition, we question how the information could be relevant to long-term investments whether the assets being valued were in private or public investment funds.

ED Question 8: Are there any other disclosure requirements retained following the review of Topic 820 that should be removed on the basis of the proposed Concepts Statement or for other reasons? Please explain why.

As we discussed in our comments above, we believe that retaining certain requirements will not provide useful information to investors.

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[8] *Id.*, P. 21.
[9] *Id.*, p. 38.

CONCLUSION

NVCA appreciates the Board's efforts to improve the notes to financial statements and the notes on fair values in particular. We commend the FASB's and its staff's efforts to date and encourage it to persist in that effort. We hope our comments help further this important goal. We stand ready to work with the FASB on this and other important matters. Please feel free to contact me at 202 864 5925 or bfranklin@nvca.org or Justin Field, Vice President of Government Affairs at 202 864 5929 or jfield@nvca.org.

Sincerely yours,

Bobby Franklin

Bobby Franklin
President & CEO