NATIONAL VENTURE CAPITAL ASSOCIATION
Funding innovation. Empowering entrepreneurs.

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BY EMAIL

VIA Email

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Re: Invitation to Comment: *Agenda Consultation*

As the voice of the venture industry, the National Venture Capital Association (NVCA) appreciates the opportunity to participate in the Board's Agenda Consultation. NVCA members manage venture capital funds (VCFs) that invest in thousands of startup and early-stage companies each year. As such, they are the primary users of their portfolio companies' financial statements. Venture capital funds also report to their limited partners as investment companies and some NVCA member invest in venture capital funds, and, as such, are users of VCF financial statements.

Our first response to the Invitation to Comment (ITC), as a whole, is to encourage the FASB to continue to prioritize the important projects set out on page 3 of the ITC, especially the Disclosure Framework, reducing cost and complexity and monitoring the implementation of recently-completed projects. We see real benefit to venture capital and the entrepreneurial ecosystem from pressing forward with these efforts. Therefore, we encourage the FASB to combine any efforts on the topics discussed in Chapters 1 through 4 of the ITC with the goal of reducing complexity. We also see the opportunity for reducing complexity in the area of employee share-based payments as Topic 718 applies to private companies.

Distinguishing Liabilities from Equities

Among the areas specifically raised in the ITC, we are most familiar and most interested in the classification of equity and liabilities, which is addressed in Chapter 3. NVCA and its members have participated in a number of the initiatives described in the ITC at pages 26-27 regarding classification of securities as equity or liability. We are also closely following the ongoing Targeted Improvements project on Liabilities and Equity.

As the ITC notes, equity is "the most residual claim on an entity's assets."[1] Equity holders stand in line behind holders of all instruments that truly represent debt. Debt holders on the other hand do not bear this last-in-line obligation of ownership. Some of the difficulties cited in paragraphs 3.8 – 3.10 may stem from focusing on distinguishing "the most obvious equities"[2] from all other instruments. We believe it is equally valid, and may be more useful to focus on the most obvious liabilities (i.e., "true debt").

From our perspective, as investors in startup companies, it is crucial to identify true debt instruments because their holders can compel the issuing company to deliver cash. These debt holders have the legal power to demand payment of cash in accordance with the terms of the instrument. Debt holders have all the legal remedies normally available to creditors, including forcing bankruptcy proceedings. Therefore, it seems to us that a good way to distinguish equity from debt/liability is to focus on the fundamental nature of debt, rather than the fundamental nature of equity. Under this analysis, an instrument that does not convey the power to deliver cash or, stated differently, to put the issuer into bankruptcy would not be classified as debt. Equity investments, regardless of various preference features would not be classified as liabilities unless they can ultimately put the issuing company into bankruptcy. This bright-line test would serve VCFs as investors and clarify the capital structure of companies.

As venture capital funds, our perspective comes from the fact that the securities that companies issue to VCFs in exchange for investment capital are neither debt nor "plain vanilla" equity. They are equity instruments with various preferences that reflect a variety of well-known practical considerations that arise in the normal course of

[1] Invitation to Comment, Paragraph 3.11.
[2] *Id.*

venture investing. There are exceptional circumstances in which these preferences actually have consequences, which is why they are the norm in venture investing. Through various FASB proposals, these preference features have raised questions as to whether these securities, or some portion of them, should be classified as liabilities on the balance sheets of investee companies (e.g., VCF portfolio companies).

From our perspective these proposals have been counterproductive. Both the portfolio company issuer and the VCF investors intend that these preferred securities will convert to common stock upon a successful exit transaction like an IPO or an acquisition. Of course, in most cases, portfolio companies do not reach this point of success. Instead, they liquidate with few assets, rendering preferences on dividends or assets largely valueless. Therefore, as users of portfolio company financial statements, VCFs see these investments as equity investments whose preferences provide contingent, but minimal downside protection. They do not see these preferences as having much monetary value, nor do they see such values as ascertainable with any degree of reliability. They certainly do not see these features as creating a creditor-debtor relationship. In this light, accounting requirements to classify these securities, or any feature of them as liabilities belies the VCF holder's understanding of the equity nature of the investment.

Consequently, our consistent position regarding various efforts to more precisely classify preferred securities to take into account their "debt-like" features is that the complexity inherent in such accounting is unnecessary and wastes the capital invested in portfolio companies. The same is true regarding the valuation exercise that might arise from efforts to bifurcate such securities. The basis for NVCA's position was explained more fully in our 2008 letter responding to the FASB's Preliminary Views document on this subject.[3] While the concerns expressed in that letter pertain to the "Basic Ownership" and "Ownership-Settlement" Approaches, the factual situation for venture capital fund financial statement users remains the same.

[3] Letter to Robert Herz, Chairman, FASB from Mark G. Heesen, President, NVCA, dated May 30, 2008. Available at http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175818444371&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=153923&blobheadervalue1=filename%3D52120.pdf&blobcol=urldata&blobtable=MungoBlobs .

As we have noted in other comment letters, a classification of the preferred securities as anything other than equity mischaracterizes the nature of the VCF investment. It can also have negative practical consequences on early-stage entrepreneurial companies because it can impede their ability to complete ordinary business arrangements. The infusion of capital that a portfolio company receives from a venture capital fund is usually the bulk of the company's equity capital. It's ability to, for example, obtain a bank loan or to lease space could be seriously reduced if any portion of the venture investment was classified as liability on the balance sheet.

A potential borrower's balance sheet that mischaracterizes the nature of the borrower's relationship with its investors is an example where complexity hurts both the preparer and the user of the financial statements. In the loan example, it is important to acknowledge that not all lenders are well versed in the intricacies of debt/equity accounting, which, as the ITC notes, arise from a "path-dependent set of complex standards that were sometimes difficult to interpret and apply."[4] It is critical that lenders can easily understand financial statements.

As noted earlier, it seems to us that current GAAP is overly complex because of its focus on separating equity with "debt-like" features from "true equity." For lenders (or landlords), we believe that GAAP would be easier to apply consistently if only those instruments that give the security holder the right to compel the delivery of cash were classified as debt. Anything that cannot legally be a claim that comes ahead of a lender's claim are not true debt. If that were the conceptual basis for distinguishing equity from liabilities, a lender could see clearly the security interests that could present a legal claim that comes ahead of a lender's claim. To that extent, simplification consistent with a conceptual framework that is simple to articulate would be welcome.

We also note that the chart on page 2 of the ITC shows that "users" do not view distinguishing liabilities from equity as among the "Areas of Financial Reporting in Need of Improvement." As users of portfolio company financial statements, we believe that this view is based on recent FASB efforts which have or would have increased the complexity of these standards. Should the FASB consider changes in this area with an eye toward simplifying GAAP and making balance sheets more useful for users, we believe progress is possible. The "true debt" approach may well lead to a more coherent and more common sense conceptual approach to these questions.

[4] ITC, paragraph 3.8.

Topic 718 Applicable to Private Companies

Venture capital funds' portfolio companies almost always issue stock options to their employees. It is an integral part of the entrepreneurial business model. As investors who hope to share the upside of the portfolio company's success, we are thoroughly familiar with the economics of employee stock options.

While there are various approaches for evaluating the potential impact of employee stock options, like many other users, VCFs generally disregard the bulk of the disclosures required by Topic 718. They are, however, aware of the expense that portfolio companies bear in developing and reporting the information GAAP requires for employee share-based payments. Therefore, we see significant potential benefit for preparers and users of private company financials from reducing measurement complexity and the amount and the complexity of information that Topic 718 requires for private companies.

Conclusion

NVCA shares the FASB's goal of providing useful financial information while reducing complexity and ensuring that the benefits of financial information are commensurate with the cost of obtaining it. We hope that our comments are helpful in addressing the challenges inherent in the many issues the FASB faces and we stand ready to assist in any way we can. 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,

Bobby Franklin

Bobby Franklin
President and CEO