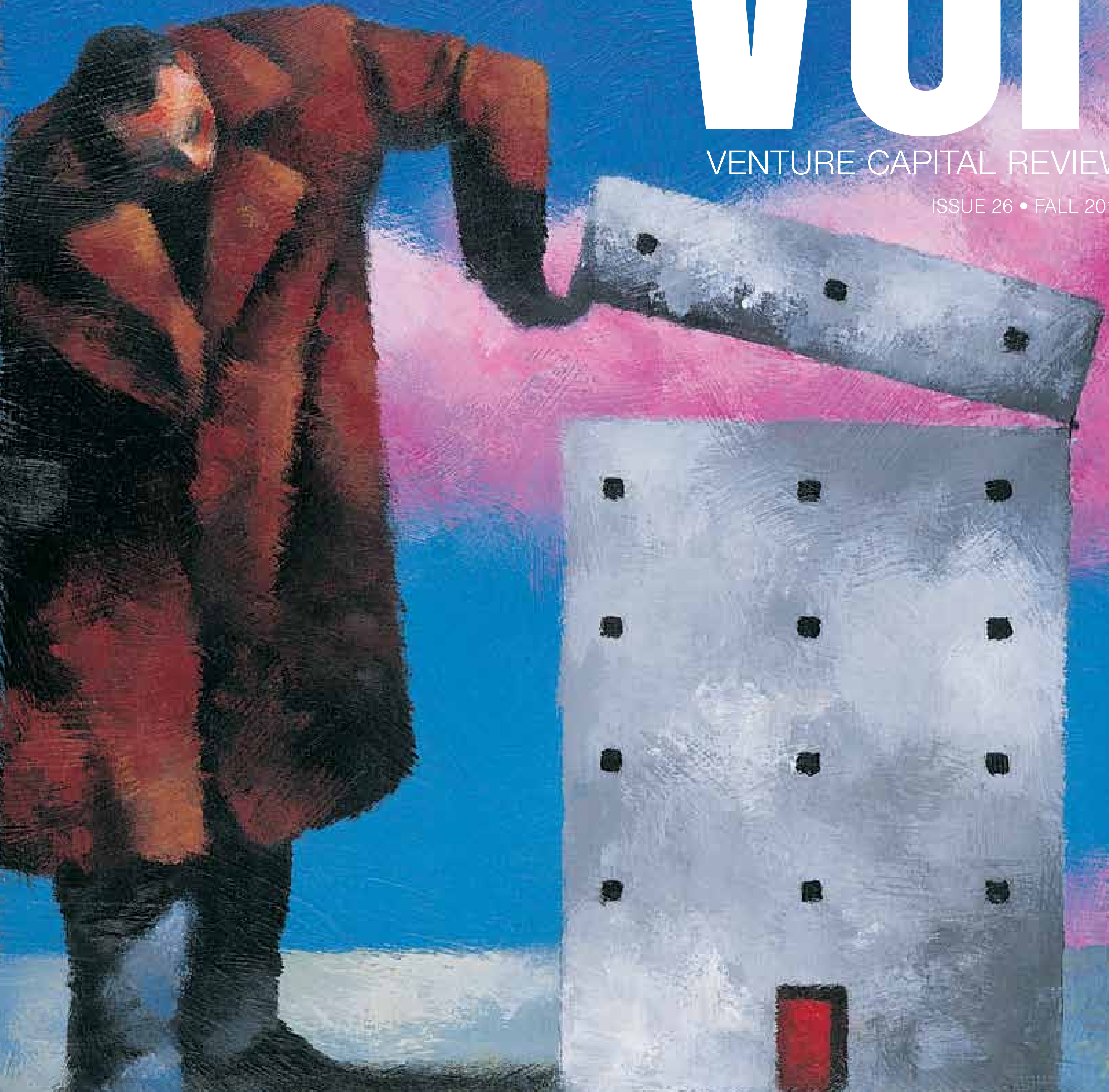
VCR

VENTURE CAPITAL REVIEW

ISSUE 26 • FALL 2010



PRODUCED BY THE NATIONAL VENTURE CAPITAL ASSOCIATION AND ERNST & YOUNG LLP

aranca
Research.Analyze.Communicate

FAS 157 Compliance Troubles: Can IRC 409A Offer Some Succor to Venture Capital Firms?

By Bharat Ramnani, Swetabh Pareek and Srinivas Macha

KEY POINTS

- Since its introduction, the utility of FAS 157 has been vociferously debated and the opinions are polarized. Not surprisingly, several VCs have denounced it in various public forums.
- Challenges posed by FAS 157 require VCs to devote significant resources in terms of time, energy and money to be compliant. And the perception is, it does not add any value.
- With most VCs currently performing FAS 157 valuations of their portfolio companies internally, such exercises may expose them to greater risk of scrutiny and potential compliance issues in future.
- Such internal FAS 157 valuations may lack proper documentation of analysis and assumptions.
- Can 'fair market value' premise valuation performed by portfolio companies offer some relief to VC firms to better comply with 'fair value' premise FAS 157 valuation?

Ever since FASB Statement No. 157 (FAS 157, now codified as ASC 820) was introduced in 2006, public forums have become veritable battlegrounds and sharply polarized the opinion on its utility. While the defenders have been guarded with their opinions, the detractors have been denouncing it increasingly vehemently to the point of calling it "stupid," and in some cases, "a significant contributing factor" for the recent financial meltdown. Behind the rhetoric, however, it is fair to say that FAS 157 has been received with skepticism with some merit. Entities that need to comply with the FAS 157 norm, including venture capital firms, have been a worried lot. Not without reason, for the impact of induction of this Statement on VC firms has been enormous.
For instance:

- Complexity involved in being compliant with FAS 157 is perceived to be greater in comparison with the current methods of valuation.
- The increased complexity directly meant need for much greater efforts in terms of time, energy and money.
- The challenges posed by FAS 157 are comparatively stiffer for VC firms, as their investments are typically made in the innovative technology start-ups.
- FAS 157 prescribes quarterly reporting, as the VCs are required to report to their LPs every quarter.
- Moreover, the clarity on how to comply with the Statement was not adequate, due to the ambiguity in application of new concepts introduced.

Prior to FAS 157, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. The FAS 157 Statement has added objectivity and clarity to the then-prevalent versions of definition of fair value by providing guidance on grey areas and introducing new concepts.

But, What is FAS 157?

FAS 157 provides comprehensive guidance for determining the fair value of almost any asset or liability, especially in illiquid investments. In many ways, it has heralded a paradigm change by shifting the focus from historical cost to fair value in financial reporting. It aims to help mainly investors and the public at large in making informed and correct decisions.

As a basis for considering market participant assumptions in fair value measurements, FAS 157 establishes a fair value hierarchy that distinguishes between observable inputs and unobservable inputs. Entities are to use inputs for measuring fair value according to the three-level hierarchy, using the highest level possible if such inputs are available, and if not, going to the next lower level. The three levels for measuring fair value are:

- Level 1 Inputs: are quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 Inputs: are other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.
- Level 3 Inputs: are unobservable inputs for the asset or liability.

Unobservable inputs are to be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. However, unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

Prior to FAS 157, there were different definitions of fair value and limited guidance for applying those definitions in GAAP. Moreover, the guidance was spread across various accounting pronouncements that required fair value measurements. Also, the differences in the guidance created inconsistencies that added to the complexity in applying GAAP. FAS 157 has added objectivity and clarity to the then-prevalent versions of definition of fair value by providing guidance on gray areas and introducing new concepts.

Present Challenges for VC Firms

VC firms seem to be especially concerned about the clarity in application of FAS 157 norms. While the auditors expect change in the valuations of portfolio companies every year, the VC firms are not amused. They are long used to carrying their investments "at cost" in their portfolio companies until the latter are either funded by a third party, funded internally or marked down due to poor performance. Their investment portfolios are primarily comprised of equity holdings in unlisted entities, start-ups and other illiquid assets. Secondly, the application of underlying concepts of fair value definition to such investments is difficult due to unavailability of observable inputs i.e., market-based prices.

Therefore, the introduction of FAS 157 posed significantly greater challenges for VC fund managers, as:

- In order to comply with the new Statement, the VC firms are now required to appraise their investments using unobservable data, which requires significant expertise in valuation techniques and rigorous due diligence.
- Audit partners observe utmost care and due diligence while auditing these investments as there is a significant impact of these assets on a VC firm's financial statements.

Overall, these challenges lead VC firms to devote a greater amount of resources to being compliant with the new Statement.

How do firms generally perform this exercise currently?

We observe that VC firms treat the FAS 157 exercise as a necessary evil that adds little or no value to their core business activity. If anything, it only enhances work and usurps precious partner time in compiling statements that otherwise should be spent on deal evaluation. That is because most VC firms perform the FAS 157 exercise using internal resources. In addition, working papers or documentation generally comprises Excel-based valuation analysis supported by last round of funding (post money) or relative valuation.

While it may make business sense to perform these analyses internally, it poses greater risk in cases of scrutiny by the authorities, including auditors, at a later date. Unless such analyses are supported by clearly and comprehensively documented inputs, assumptions and internal ratifications, it could mean potential trouble.

A Missed Opportunity?

Until now, most VC firms have failed to leverage on a potential opportunity that could significantly benefit the whole VC community while dealing with FAS 157 compliance-related issues.

Just about a year before the introduction of FAS 157 by the FASB, the IRS also introduced IRC 409A, where the private companies were required to grant stock at a strike price equal or above its fair market value to avoid penalties. This required the VC-backed privately held companies to determine the fair market value of the common stock. IRC 409A valuations were required to be performed by a qualified person in-house or a third-party appraiser, and such exercises resulted in a detailed report that had to withstand intense auditor scrutiny and potentially, regulatory review. Many portfolio companies opted to get their IRC 409A valuations through a third-party appraiser not only because it saved them time and money, but more important, because it transferred the risk of facing auditors to such appraisers. As a result, independent appraisers ensured that they did a rigorous job of appraising, being very careful with their assumptions and value derivations.

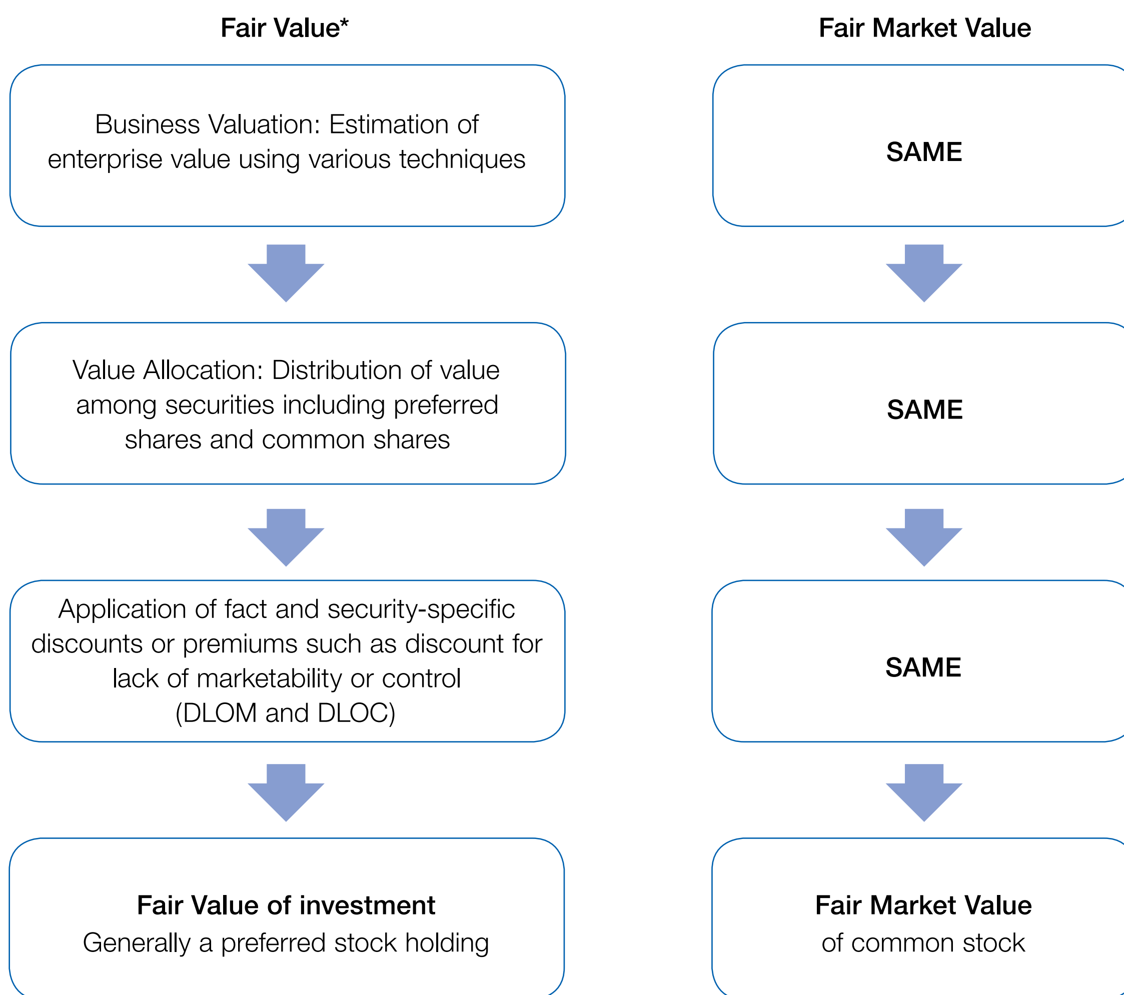
If the VC firms look at these IRC 409A reports closely, then they will realize just how much information in those reports could be useful for their performance monitoring and, indeed, FAS 157 compliance reporting purposes. But, before that, let us put to rest the debate on “Fair Value” and “Fair Market Value” and how different they really are.

The definition of Fair Value focuses on the price that would be received to sell an asset or paid to transfer the liability. This means a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. In the case of VC firms, the marketability of the investments in early stage start-ups is low until the technological and financial viability of the technology, product or the value proposition is proven. Similarly, the concept of principal or most advantageous market also loses its meaning due to the illiquid nature of the investments. In the end, the fair value is based upon the reporting entity's own assumptions due to the unavailability of observable data. These assumptions are more or less similar to the assumptions used for valuation under IRC 409A.

On the other hand, IRS Revenue Ruling 59-60 defines Fair Market Value (FMV) as:

- The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.
- Courts frequently rule with the assumption that a hypothetical buyer and seller are able, as well as willing, to trade and are well-informed about the property and the market for such property.

The process of determination of Fair Value or FMV is a multistep exercise as illustrated below:



* for typical VC investment in a privately held start-up company

But, what if VCs look at leveraging IRC 409A reports while compiling their FAS 157 compliance reports? In addition to greater efficiency and cost savings, VC firms can reap additional benefits by leveraging on the IRC 409A analysis performed by an independent appraiser.

Are they similar?

In essence, and with objectivity, few new concepts or differences can be noted between FV and FMV, including concept of exit price, most advantageous market and fair value hierarchy. However, when analyzed in light of nature of assets under contention, i.e., investments in illiquid privately held start-ups, the perceived differences become insignificant in terms of any material differences in the conclusions.

Why Blend IRC 409A Reports into FAS 157 Reporting?

On the face of it, this proposition might come across as odd, as the motivations behind IRC 409A and FAS 157 appraisals differ slightly at least in the spirit if not in the letter. IRC 409A appraisals are commissioned by individual companies to establish FMV for a variety of purposes, including granting employee stock options. Therefore, the propensity of a CFO in such cases is to get a conservative valuation. On the other hand, VC firms would like to see enhanced valuations irrespective of the fact that they would like to use investment cost or latest funding round as a basis. While there is little data to support this, the buzz on internet forums indicates that the general perception is that there is a significant variation in valuation for the same portfolio company for the same period.

But, what if VCs look at leveraging IRC 409A reports while compiling their FAS 157 compliance reports? For one, they would benefit from rigorous analysis, specific assumptions, intense interaction between company management and the appraiser, and a comprehensive and certified report at the end of it all that can withstand auditor and regulatory scrutiny. Such an invaluable exercise currently plays little role when VC firms analyze and evaluate their portfolios. However, if VC firms do use such reports, then we reckon the time and effort could be reduced drastically. Moreover, such FAS 157 analysis is more defensible, as the underlying information has already been vetted rigorously.

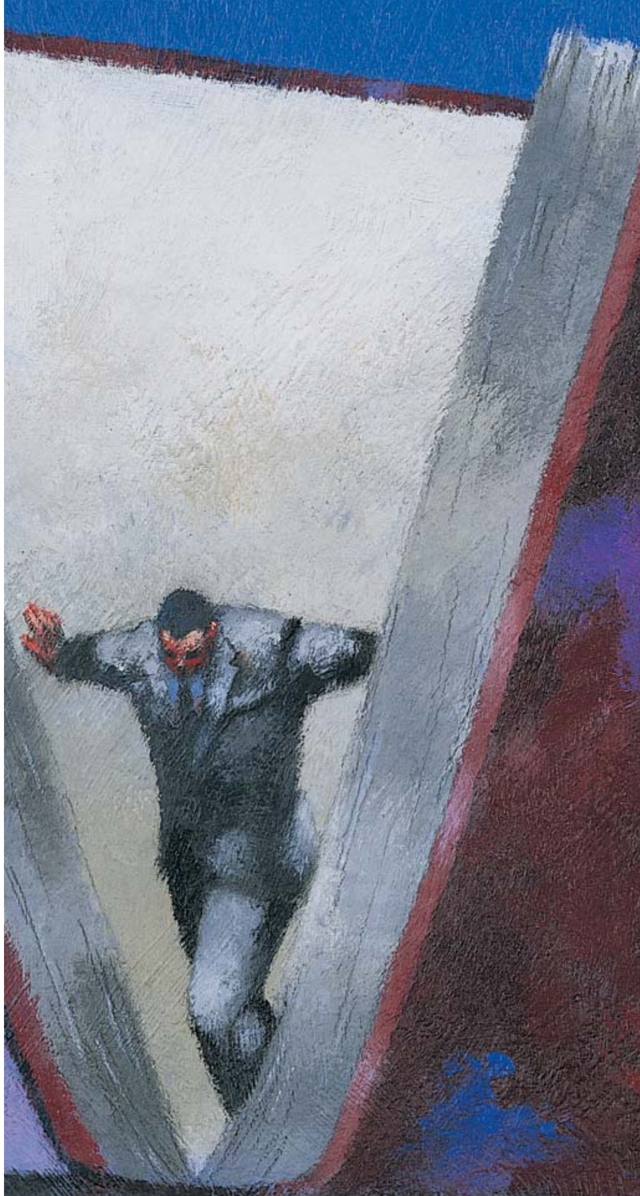
The Way Forward

As most of the efforts and analysis in determination of FMV and Fair Value are similar, VC firms could try to create an internal mechanism to achieve greater efficiency and save cost by avoiding the redundancy of efforts involved. This will require:

- Improved interaction with the portfolio companies and engaged appraisers
- A higher level of involvement in the IRC 409A appraisal process

In addition to greater efficiency and cost savings, VC firms can reap additional benefits by leveraging the IRC 409A analysis performed by an independent appraiser:

- **Better compliance:** The valuation performed by an independent appraiser for IRC 409A purposes are generally robust analysis in compliance with generally accepted valuation techniques and professional standards such as USPAP and are well supported by detailed appraisal reports.
- **Greater transparency and performance monitoring:** The objective of the IRC 409A valuations is to determine the FMV of the common stock. The management of the company has an inherent bias toward lower value within the valuation range, as this valuation is used to grant stock options to senior management. Similarly, FAS 157 analysis performed in-house by VC firms has a tendency toward higher valuation due to the built-in bias. An appraisal performed by an independent appraiser adds integrity and tends to bridge or reconcile the valuations and minimize variations.



- **Safeguard from potential non-compliance due to inconsistency:** Though the objectives of these valuations are different, i.e., tax compliance versus financial reporting, the majority of the data used and methodologies employed remain the same. The issue of inconsistencies between the conclusions of these exercises is gaining prominence, as it has been raised by not only appraisers but also the audit fraternity, as well in the recent past at various public platforms. The convergence of these two valuations will help VC firms to reconcile the legitimate and significant inconsistencies.

The fact remains that FAS 157 is here to stay. If the portfolio companies are already spending investor money and significant management time and getting a defensible valuation, then it makes sense for VC firms to look at such reports more seriously. Otherwise, the option of venting spleen in public always remains. But we believe that will add little value.

For additional information, please contact Lisa Davis at lisa.davis@aranca.com.

About the Authors

Bharat Ramnani/Co-Author: *Bharat is an Associate Vice President at Aranca, responsible for Valuations and Advisory Services practice. Having overseen over 350 valuation opinions, Bharat specializes in valuation of business, intangible assets for tax compliance and financial reporting purposes, and manages Private Equity clients for providing transaction and corporate advisory services. He is a qualified Chartered Accountant with over eight years of experience in Corporate Finance.*

Swetabh Pareek/Co-Author: *Swetabh is a Manager with Aranca's Valuation Services practice, where he manages a large team of analysts providing independent valuation services to venture capital companies across technology, life sciences and other sectors. He has more than six years of experience in valuations, investment banking and project evaluation. Swetabh is a CPA and a qualified Chartered Accountant.*

Srinivas Macha/Editor: *With over 17 years of diverse experience as a business and technology journalist, magazine editor, researcher, senior analyst and as an operations head, Srinivas has worn many caps in his career. At Aranca, he leads corporate communications, branding and media relations, knowledge management and IT initiatives. Srinivas has a Masters in Economics and has a keen interest in global business matters.*

ERNST & YOUNG
Quality In Everything We Do

NVCA
National Venture Capital Association