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VALUATION AND REPORTING REQUIREMENTS FACED BY VENTURE CAPITALS

by

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As the industry has matured and experienced an enormous growth over the last decade in Europe, venture capital, and private equity in general, constitutes an increasingly significant financing source for numerous young entrepreneurial firms. The companies financed by venture capitalists are often characterized by high growth potentials, perform predominantly high tech related activities, and possess a high level of risk. As a result, a number of aspects regarding the general financing process demand special attention in light of venture capital financing. While existing research has discussed many aspect of the venture capital financing process, less attention is spent on post-investment valuation and reporting issues.

This paper, therefore, specifically focuses on problems relating to the valuation and disclosure regarding of the portfolio of venture companies by venture capitalists. First of all, we document which factors influence the venture capitalist' valuation process using the characteristics of the input factors in this process. Secondly, we discuss in detail the valuation and reporting requirements to which venture capitalists in Belgium are subject. The incompleteness of the accounting and corporate framework regarding valuation and reporting of financial investments and the need for European venture capitalist to have access to more solid and conclusive guidelines has resulted in the issue of EVCA valuation and reporting guidelines. We analyse in detail how and if these guidelines, which are not legally binding, provide an answer to this need. However, our conclusion is that a lot of decisions in the valuation and disclosure activities of venture capitalists remain susceptible to the judgement and discretion of the valuation manager.

Key words: venture capital; valuation; reporting; portfolio.

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Valuation and reporting requirements faced by venture capitalists

1. Introduction

The economic downturn has lead to a lot of criticism regarding the valuation methods used for high tech, high risk, and high growth venture firms, mainly for those traded on public capital markets. The burst of the so-called "internet bubble" brought the market values of these companies back to a fraction of their market value at the end of the last century. Many of these high growth potential, high risk firms are characterized by a large proportion of intangible assets on their balance sheet. A lot of them were or are still mainly financed by venture capitalists. Also other venture investments supported by venture capitalists are neither easily marketable, nor easily valued.

Prior research focused on the use of different valuation methods by venture capitalist when evaluating the investment projects submitted to them (Wright and Robbie (1996), Manigart et al. (1997)). However, at a later stage the venture capitalist will probably use different valuation methods after the investment is made, not only because of the development of the venture itself, but also because more and more reliable information will become available to the venture capitalist (Nagtegaal (1999)). Once the value of these portfolio companies is determined, a decision needs to be taken regarding the reporting of these values in the financial statements of the venture capitalist. In addition to the importance of valuation and reporting for internal purposes, national accounting standards require the compliance with generally accepted accounting principles regarding valuation for external reporting. A crucial characteristic of venture capitalists, motivating our research interest in this topic, lies in the fact that the total assets of venture capitalists consists almost exclusively of the venture investments in portfolio. Consequently, the valuation issue is a vital and fundamental element with respect to the operations of any venture capitalist.

The main goal of our research is to bring the valuation and reporting issues closer in line. Next to identifying the variables that determine the decisions taken regarding the methods and options chosen by venture capitalists in practice, our investigation will concentrate on analysing the valuation and reporting guidelines available to venture capitalist when providing information on their portfolio of (long-term) financial assets. First, we concentrate on the valuation and disclosure requirements following from Belgian accounting and corporate legislation. Secondly, will discuss the main actions undertaken by the European Venture Capital Association (EVCA) in order to deal with the lack of transparency and clarity in the existing regulation. The objectives of this paper can be summarized in three elements. First of all, we want to provide a clear overview of the reporting framework, and the connected valuation issue, a Belgian venture capitalist is subject to. Secondly, we will identify some of the problems and obstacles arising when implementing these statutory requirements. Finally, this analysis will serve as a starting point for an empirical study on the valuation and external reporting behavior of Belgian venture capitalists.

The remainder of this paper is organized as follows. Section 2 concentrates on the link between valuation and reporting issues. After portraying the leading valuation methods and techniques, the factors determining the selection of a valuation method as well as the input variables in the valuation process are explained. Section 3 discusses in detail the accounting and corporate regulation currently in force in Belgium regarding the valuation and disclosure of financial assets. Section 4 pursues this investigation by analysing EVCA's valuation and reporting guidelines. Section 5, finally, presents some important conclusions.

2. Valuation versus reporting, or are both related?

Although traditionally the valuation issue might be considered to pertain mainly to investment analysis and investment appraisal, the value resulting from the valuation process will be used as a basic input for reporting activities, a more accounting related matter. A venture capitalist has numerous valuation methods and techniques at his or her disposal when planning to value the venture proposals or the venture projects in portfolio. Consequently, the most popular methods will be discussed from a venture capitalist's point of view. In addition, we provide an overview of considerations he or she will (have to) take into account when selecting the most appropriate valuation method. Finally, we briefly discuss the major financial instruments venture capitalists use or develop in their financing activities.

2.1 Valuation methods at hand

Given the widespread use that is and can be made of a valuation, a substantial academic literature, with a finance as well as accounting background, deals with valuation issues. This has resulted in the development of numerous valuation methods and valuation techniques, stemming from either a theoretical or a practical origin. Consequently, the valuation literature and research field continues to expand. We, however, will limit our analysis to a description of the most commonly used valuation methods in practice. The underlying objective is to introduce the methods available to valuation managers or practitioners. Our goal is neither to provide a detailed analysis, nor to supply a profound evaluation of each of these methods. The methods we selected can be classified into three main categories, labeled as asset-based, income or earnings-based and market-based valuation methods (Pratt et al. (1996)).

The asset-based valuation methods include all types of accounting valuations of using the firm's financial statements, like historic cost, replacement (substantial) or liquidation value of the assets, book value of equity or net worth. These methods seek to determine the company's value by estimating the value of its assets, which can be found in the balance sheet. They take neither the company's possible future situation, nor any asset not included in the balance sheet into account. Given that these methods are based on accounting numbers, often equal to historic cost or acquisition values, these methods are more traditional and conservative, following amongst others from the observance of the prudence principle. These values are not always very reliable or realistic for young, fast growing companies.

The earnings-based methods, like the dividend discount model and the discounted cash flow models, are determined using the expected future revenues, earnings, cash flow or other indicators. Unlike the balance sheet-based methods, these methods do not rely on the past in order to make predictions about the value of companies, making them very useful for valuing new ventures lacking a track record and historical financial information. A major drawback of these methods, however, concerns the uncertainty associated with the estimation or prediction of the future cash flows. Certainly in an already very uncertain environment as for young companies, this may result in increasing expected errors of the forecasted values (Waldron & Hubbard (1991)). Besides, the dividend yield method will rarely be used since these investment companies hardly ever pay out significant dividends, especially in the early stage. Moreover, venture capitalists's main return is expected to stem from an increased value at exit and not from an intermediate insignificant dividend income stream.

The final category of valuation methods consists of market-based methods, like the fair (market) value, third party transaction method, multiples method, rules-of-thumb methods. This category contains a more heterogeneous set of methods. The multiples method and rules-of-thumb methods calculate a value by multiplying an accounting number for the investment with a corresponding ratio obtained from the market. Consequently, a valuation can mostly be quickly calculated. However, the ratios used are often sector specific and do not always correspond to the industry of the investment. Besides, as for the asset-based methods, they are mostly based on historic information which is not always readily available for young, start-up companies. When using benchmark valuations, like the third party transaction method does, the valuation problem is transferred to the other players in the industry.

Apparently, each of these valuation methods has each its own approach towards taking the past, present and future into account. The more traditional or conservative methods are based on historical values, while the more progressive methods are looking at the future performance and activities. The first category corresponds more or less to the approach the current accounting standards in most Continental European countries advocate. The more prospective methods, on the other hand, can find more support in Anglo-Saxon accounting environments, where the change to a "fair (market) value" based accounting is gaining attention and importance (see Barth and Landsman (1995), websites and publications by the SEC, FASB, IASB).

2.2 Factors influencing the selection of a valuation method

Numerous arguments and opinions can be raised that justify the application of a wide range of valuation methods. A number of considerations we feel are important and which are used to limit our research focus are discussed more in detail. Broadly speaking, we distinguish on the one hand elements related to the underlying objective and context of the valuation process and, on the other hand, elements relating to the parties involved in the valuation process, that is to say the party determining the value, the party being valued, as well as the relation between these two parties.

With respect to the underlying objective of the valuation, reference needs to be made to the purpose of the valuation and the application that will be made of the value determined accordingly. A crucial distinction, therefore, needs to be made between internal valuation purposes and external valuation objectives. Among the most important internal uses that will be made of the valuation we can note the monitoring or control function of the investment's performance, follow up decision taking, and the evaluation of the investment manager. Clearly, the party in need of a valuation can freely determine the value and valuation methodology that will be used and that is best in line with the objective of the value determination. Consequently, we hypothesize that the internal valuation methods will be highly dependent on the person calculating the value. On the other hand, the value following from the valuation process will also be used for external reasons. The most important among these objectives undoubtedly concerns the external reporting to investors and the public, which is dominated by legal requirements. In this case, the valuation methodology chosen and the way in which it is implemented will be highly influenced by corporate and accounting regulation. One of the basic principles advocated by accounting standards worldwide concerns the prudence principle, leading to the use of more conservative and fixed valuation approaches.

We identified a second major distinction, which is related to the difference between valuation for internal and external purposes, based on the timing within the investment cycle. On the one hand, a valuation can be determined at a pre-investment stage, mainly for investment decision taking. The resulting value will serve different functions, like the determination of the investment amount awarded and the allocation of property and control rights. The valuation method selection in this context will be strongly influenced by the restricted access to information and information sources at hand. After all, although the evaluation and information collection procedures may be very elaborated, the information available as well as its reliability remains highly uncertain. On the other hand, however, once an investment is made, different events or moments in time will call for a revision or modification of the initially determined valuation. A concrete illustration of where a new valuation is required is reflected in the legally required annually, or even semi-annually, revision of the book values at the end of the financial period. But a recalculation or complete revaluation might also be indispensable for internal performance appraisal objectives or follow-up decisions. The timing of the latter types of revaluation is not legally fixed, but rather dependent upon the realization of certain targets, benchmarks or contractual covenants. Given the closer relationship that exist between the investment and the investor in a post-investment decision stage, we expect that the investor considering a revaluation will have a closer access to information regarding the investment resulting in more extensive and more reliable data on the investments activities, situation and performance. Perhaps this might lead to a superior value assessment.

A final category of elements influencing the selection of a valuation method groups the characteristics of the parties concerned in the valuation process. More specifically, we assume that factors specific to the investor in need of a valuation, the investment subject of the valuation process, as well as the relationship (i.e. the financing agreement) that exists between both parties will play an important role in the investor's selection process. With respect to the investor, characteristics that should be considered are, for instance, size, experience, independence, and investment preferences. Size, performance, financial situation, market listing or not, development stage, and activity are attributes of the investment that may be taken into consideration when the investor selects a valuation method. Finally, the type of financing, contracting arrangements, investment size and covenants are some of factors reflecting the intensity of the relationship between investor and investment. We assume that these factors will have an influence on the preferred valuation method. For instance, investments financed through equity participation will be valued differently from debt financing.

Concluding, we can claim that every time a valuation method needs to be selected, several very distinct considerations will be taken into account, each having an impact on the method that is preferred in the end. When applying this analysis to the focus of our research, we obtain the following conclusions. The valuation issue we are concentrating on is tied to the external reporting behavior of the venture capitalist. Consequently, the subjective element is presumed to be less dominant. Secondly, we focus on the valuation and reporting activities of a venture capitalist in the framework of his or her monitoring or control activities, that is to say the post-investment follow-up stage. At this stage, the venture capitalist undoubtedly has access to more, more relevant and more detailed information, allowing the use of valuation methods in a more accurate manner. Given the potential variation in the third category of factors, less clear deductions can be made in advance with respect to their impact. Nevertheless, the preference of certain methods presumably might be linked to these types of variables as well.

2.3 Defining financial assets

One of the elements revealed to have a considerable influence on the valuation selection method process, is the relationship that exists between the venture capitalist and the venture investment. Although this relationship is also determined by informal, intangible aspects, like the intensity of contact, communication, and assistance between the parties involved, an important part can be related to the formal aspects of this relationship. A crucial aspect concerns the type or form of financing, which is reflected in the financing agreement or financing contract between the two parties. The financing contract, in turn, determines the types of financial assets that are involved in the venture capital financing.

When providing financial resources to venture enterprises, venture capitalists can generally opt for the traditional financing forms, that is equity financing, debt financing, or a combination thereof. In order to deal with expected agency problems, venture capitals have developed sophisticated contracting practices, some of which are unique to the venture capital industry. In particular, the purchase of convertible securities by the venture capitalist is by far the predominant form of investment. U.S. based research has demonstrated that convertible preferred equity is the optimal form of venture capital finance (Sahlman (1990), Gompers (1997), Kaplan & Strömberg (2000)). In contrast to the evidence from U.S. venture capitalists financing U.S. venture projects, recent evidence indicates that a variety of forms of finance (e.g. common equity, warrants, straight preferred equity, convertible debt, straight debt and combinations of these instruments) are used among venture capitalists in other countries (see, e.g. Cumming (2000) for evidence from Canada, Bascha and Walz (2001b) for evidence from Germany). Venture capital financing, thus, can involve three main groups of financial assets, namely equity securities, debt securities and derivative instruments contingent on the other financial assets. Based on this conclusion, we can state that the types of financing agreements open to Belgian venture capitalists when investing in venture projects is boundless. Nevertheless, we expect that the majority of financing agreements will fit in well in the traditional classification established in the accounting and corporate legislation.

3. Valuation and reporting requirements for a Belgian venture capitalist's investment portfolio

The main focus of this paper concerns the valuation of a venture capitalist's financial (fixed) assets in view of the external reporting requirements. These financial assets originate from the normal (long-term) investment activities carried out by venture capitalists. Consequently, short-term speculative transactions and all kinds of specialised financial activities, like bond or security lending, sale and repurchase agreements, debt factoring, bill discounting, and securitisation of assets, clearly do not belong to these normal financing activities and will, therefore, not be analysed.

Given the objective of the paper, we will first of all concentrate on the accounting requirements regarding financial assets present in Belgian accounting standards. Not only will the general rules be discussed, but also where necessary or important we will specify the regulation more thoroughly from the perspective of the venture capital industry. The following elements will be treated: the scope of application, valuation requirements, and reporting demands. It is important to note that in this discussion, our attention will mainly be focused on the accounting regulation. Nevertheless, the requirements stated by other supervising bodies are discussed in detail. We conclude with an overview of problems that can be identified following from the application of these accounting and legal requirements.

3.1 Scope of the regulation

Most companies for which the liability of their shareholders or partners is limited to the subscribed capital, have to file their annual accounts with the Balanscentrale of the Belgian National Bank. In general, these annual accounts have to be drawn up according to one of the two presentations described in Book II of the royal decree of

30 January 2001 executing the Code of companies. Large[1] companies are obliged to use the full presentation, while the others can opt for the abbreviated presentation. The main differences concern the specification of certain balance sheet items, like financial fixed assets and short-term assets, and the use of a very distinct income statement. Finally, the notes to the accounts are strongly condensed in the abbreviated version. For a rather small group of companies (2%)[2] a specific presentation exists for the disclosure of their annual accounts, which is for the most part governed by specific laws. The companies concerned include financial institutions, holding companies, pension funds, insurance companies, hospitals, and others.

Based on a profound analysis of the accounting regulation and company law, it is clear that a majority of Belgian venture capitalists have to be considered ordinary enterprises with limited liability (NV, BVBA or CV). Accordingly, they are subject to the ordinary accounting regulation as described in the R.D. of 30 January 2001. Nevertheless, an important number of Belgian venture capital providers are identified as holding companies[3], like for instance the GIMV. Not only do these holding companies have to comply with some specific accounting requirements, they also are subject to the prudential supervision of the Banking and Finance Commission (CBF). Since almost all of these companies are listed on a Belgian stock exchange and given the introduction of detailed information requirements for all listed companies, the regulations on holding companies have lost some of their importance. For the annual and consolidated accounts, holding companies are subject to a specific royal decree. Fortunately, this specific regulation refers largely to common accounting law for a large number of provisions. Regarding the valuation and reporting of financial assets in their annual accounts, holding companies have to apply the ordinary accounting

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[1] A company is regarded as "large" when:
- the yearly average of its workforce is at least 100 *OR*
- two of the following limits are exceeded: (1) yearly average of workforce: 50;
  (2) turnover (excl. VAT): € 6.250.000,00;
  (3) total assets: € 3.125.000,00.

These limits have to be calculated on a consolidated basis. This means that the figures for the filing company are combined with those of its subsidiaries.

[2] www.bnb.be

[3] A holding company within the meaning of the royal decree n° 64 of 10 November 1967 can be defined as a Belgian company which holds equity interests totalling at least 500 million Belgian francs (about € 12,5 million) or at least half of its funds, which owns one or more subsidiaries, and whose shares or those of its subsidiaries are spread among the public of Belgian investors.

standards. As a result, we can limit our analysis of the valuation and reporting requirements applicable in Belgium to the common standards.

3.2 Valuation standards for financial assets in Belgium

The central valuation method in Belgian GAAP states that each asset has to be valued at its acquisition cost or acquisition value, being the price agreed upon by the parties related to the deal or the price paid to acquire the asset. Participating interests and shares classified under long-term financial assets as well as current investments are generally recorded at (historic) cost. Receivables and cash are recorded at their nominal amount. It is permitted to charge ancillary costs relating to the acquisition of long-term financial assets and current investments directly in the income statement.

Under Belgian GAAP, investments in subsidiaries and associates in the parent company's separate financial statements are carried at acquisition cost. Uncalled amounts on participating interests and shares have to be disclosed in the notes. Enterprises may revalue participating interests and shares recorded under financial fixed assets when it is considered that the value of these assets, as determined by reference to their usefulness to the enterprise, clearly and permanently exceeds their book value. When such assets are necessary to the enterprise to carry out its business or part of it, as a going concern, the revaluation may be limited to the extent that the surplus arising on revaluation can be justified by reference to the profitability of the enterprise or the subdivision concerned. A justification of the surplus arising on the revaluation of these assets needs to be included in the notes to the annual accounts of the period in which the revaluation was first recorded. Surpluses arising on revaluation are recorded directly on the liabilities side of the balance sheet under a specific caption. They are maintained there until the related assets have been disposed of. Any revaluation surplus previously recorded is taken to the income statement when the assets concerned are realised. Any recorded revaluation must be reversed partly or fully if they are no longer justified.

Participating interests and shares classified under long-term financial assets must be written down in case of a permanent impairment or reduction in value justified by the financial position, profitability or future prospects of the company in which the participating interests or shares are held. The impairment needs to be permanent. Any recorded write-downs must be reversed if they are no longer justified according to the evaluation at the end of the accounting period.

Long-term receivables are valued at their nominal value. It is permitted to charge ancillary costs relating to the acquisition of long-term financial assets directly to the income statement instead of including them in the acquisition cost. Revaluation of these assets is not allowed. Amounts receivable, including fixed income securities, recorded as financial assets must be written down when receipt on the due date of all or part of the nominal amount is uncertain or doubtful. Any recorded write-downs must be reversed (partially) if they are no longer justified according to the evaluation at the end of the accounting period.

Short-term equity investments are also recorded at acquisition cost, including the auxiliary costs or not. A revaluation is not allowed. When at the end of the accounting period the market (realisation) value is lower than the acquisition cost, a write-down is compulsory. If later on the value increased again, one is obliged to reverse the write-down. Additional write-downs are required to take into account the future evolution of the realisation or market value or the risk inherent to the nature of the company's activities.

Fixed income securities are recorded based on their acquisition cost value. The difference between the acquisition cost and redemption value of fixed income securities should be included in the income statement pro rata temporis as an adjustment to interest income during the remaining maturity of the securities, and added or deducted from the acquisition costs of the securities. When at the end of the accounting period the market (realisation) value is lower than the acquisition cost, a write-down is compulsory. The impairment is not required to be permanent as in the case of long-term financial assets. If later on the value increased again, one is obliged to reverse the write-down. Additional write-downs are required to take into account the future evolution of the realisation or market value or the risk inherent to the nature of the company's activities.

As mentioned before, Belgian GAAP is characterised by an absence of an overall guidance regarding accounting for financial derivative instruments. The standards generally tend to account for compound instruments as single instruments, thereby reflecting the legal form of the underlying instrument. Consequently, the rights and obligations resulting from derivatives are only accounted for "off balance sheet". This accounting strategy is that which we hypothesize venture capitalists are tended to follow since the financial derivatives related to the financing arrangement are predominantly very illiquid, extremely specific and often dependent upon the realisation of certain benchmarks. It is clear that it is extremely difficult to value such financial assets, which are often hard to separate from the underlying financial assets. Besides, the value of these contingent claims is mostly relative minor compared to the value of the underlying instrument.

3.3 Disclosure requirements regarding financial assets in Belgium

3.3.1 Reporting requirements following the Belgian accounting regulation

Regarding the reporting of the investments made by a venture capitalist, Belgian GAAP requires to record the financing agreement under two separate headings of the balance sheet, namely under the so-called long-term financial fixed assets or short-term investments, depending on the nature and intensity of the financing agreement. The figures included in the balance sheet only need to reflect an overall value by category of the financial assets. More detailed information needs to be provided and included in the notes to the accounts.

The class of long-term "financial fixed assets" covers property and control rights held in other enterprises with the intention to establish a lasting and specific relationship with (and influence on) these enterprises, as well as long-term receivables with respect to these enterprises. An additional sub-classification divides both types of assets (shares and loans) into three groups depending on the intention and intensity of the financing arrangement. The first class consists of affiliated enterprises or, in other words, enterprises with which a participating interest exists and which are controlled directly or indirectly by the enterprise, which control the enterprise or with which the enterprise forms a consortium. The second class groups enterprises with which a participating interest exists groups enterprises which are not affiliated enterprises, but in which the company holds directly or indirectly a participating interest or which hold directly or indirectly a participating interest in the company. A participating interest implies the possession of property and control rights in another enterprise with the intention of creating a long-term and specific relationship with this enterprise and which allows exercising an influence on the management of this company. In practice, a participating interest is considered to exist when one holds directly or indirectly a 10% equity stake in other enterprise. The final class is composed of enterprises that do not belong to the two former classes. Nevertheless, the shareholding in these companies is meant to improve the company's own operations through the creation of long-term and specific relationship with these enterprises.

Within the "short-term financial assets", two classes are of concern when discussing a venture capitalist's primary financing activities. The class of shares (quoted or not) classified here contains shareholdings in other enterprises acquired without the intention of exercising influence in these enterprises. In other terms, these shares are acquired or subscribed with the intention to resell or to be disposed of within twelve months. The second relevant class covers the fixed income securities. When a venture capitalists grants financing to a venture using only debt instruments without participating in the equity of the investment, the debt instruments are classified as short-term financial assets in the balance sheet. In this case, there can still be a long-term understanding between the two parties involved, but the venture capitalist will not be able to exercise any control in these enterprises.

Belgian accounting standards do not provide a specific heading on the balance sheet for the class of derivative instruments. Only when options are concerned that can be separated from the underlying securities, the Commission for Accounting Standards (CBN) issued clear guidelines stating that these options should be recorded under short-term financial assets. However, given the specificity of this kind of financial instruments when used in venture capital financing agreements, these rules do not proof to be useful for venture capital reporting purposes. Therefore, we conclude that the rights and obligations (calculated and expressed in figures or not) originating from these instruments have to be mentioned in the notes to the annual accounts.

Income relating to long-term financial assets and current assets, as well as write-downs, write-backs and capital gains realised on short-term financial assets is recorded as financial income, while write-downs and write-backs and capital gains realised on long-term financial assets is registered as extraordinary income. Unrealised value increases are not recognized in the income statement.

The legally required notes to the accounts are meant to provide additional as well as more detailed information. Accordingly, the notes should include a summary of the valuation standards applied and a notice and justification of any change in these. When as a result of a lack of objective criteria, the valuation of anticipated risks, possible losses and reduction in the value is uncertain, this should be mentioned in the notes. Important rights and obligations have to be mentioned in the notes. Consequently, information on the derivative instruments related to the long-term financial assets (participating interests and shares, receivables, fixed income securities), like warrants, conversion rights, can be provided in the notes. A justification of the surplus arising on the revaluation of participating interests and shares classified under the financial fixed assets should be presented. In exceptional cases it is possible not to include a shareholding under the financial fixed assets. The exceptional reasons motivating this exclusion need to be mentioned in the notes.

The more detailed and specific information with respect to the financial assets in particular, will be presented using diverse sub-statements called "states". The "state of financial fixed assets" contains more information for the group of long-term financial assets. Information is provided each of the three categories of enterprises with which the enterprise maintains a close and long relationship (i.e. affiliated enterprises, enterprises with which a participating relationship exists, and other enterprises). Concerning the *equity positions* held, a reconciliation of the gross book value, the revaluation surplus and the accumulated write-down at the beginning and end of the period is required. Uncalled amounts on participating interests and shares for each category at the beginning and end of the period are included as well. In addition, the net book value at the end of the period is calculated. With respect to the *receivables* linked to each category of related enterprises, a reconciliation of the net book value at the beginning and end of the period is included, taking into account the write-downs.

A second state titled the "state of participating interests and shares held in other enterprises" presents more detailed information on each company in which the enterprise holds at least directly or indirectly a 10% share. The information that has to be provided for each enterprise includes the identification, number of shares and percentage held, net equity and final result (net income) following from the latest available statutory accounts. A third and related state lists all enterprises for which the responsibility of the investor is unlimited. Information allowing a clear identification of these enterprises needs to be provided. The forth state, "state of short-term instruments" divides the global amounts of the balance sheet over the sub-categories of assets within the short-term financial assets, meaning shares (for which in addition uncalled amounts are conveyed), fixed income securities, and term deposits.

A final state provides a complete overview of the relationships that exists with respectively associated enterprises and enterprises with which a long-standing participation interest exists. Global figures are required with respect to the position of the long-term assets (shares and (subordinated and other) receivables), the short-term financial assets (shares and debt), guarantees, other significant financial obligations, the financial results, and the realised value gain or loss.

3.3.2 Additional reporting requirements introduced by other regulating or supervisory bodies

Next to reporting requirements following from accounting standards, there are other organisations that can establish their proper disclosure requirements. Regarding external reporting, we only identified additional disclosure requirements for those venture capitalists that did apply or plan to apply to public capital markets. When a venture capitalist is listed or plans to be listed on a Belgian stock exchange, two additional levels of supervision will emerge, namely the Banking and Finance Commission and the market authority of that stock exchange, Euronext Brussels (primary and new market) or Nasdaq Europe. In view of our analysis, we investigated in detail the disclosure requirements issued by the Banking and Finance Commission, by Euronext Brussels and Nasdaq Europe, given that a number of Belgian venture capitalists are listed on either stock exchange. In this investigation we especially concentrated on those disclosure requirements that deal with the valuation and reporting of financial assets.

A first category of disclosure requirements these bodies have issued consists of information demands for applicants seeking a listing. In practice, this filing for admission comes down to the preparation of a prospectus that must be approved prior to admission. Nevertheless, the CBF or the market authority may require any additional information it believes necessary for making a profound judgment. A prospectus is required for each issue on a public market, in case of a take-over bid or a change of control in a listed firm. Formally the prospectus should contain the audited annual accounts for the preceding three financial years, possibly supplemented with interim accounts. As discussed above, these accounts contain information on the aggregate value of the financial assets and are recorded using the valuation and reporting standards discussed earlier.

Other general reporting requirements following from the preparation of a prospectus require a description of the investment policy (main investments made in other undertakings over the previous three financial years), more detailed information regarding assets and liabilities of the issuer, and especially regarding each significant shareholding of the issuer. Among the data required for these equity participations, the value at which the financial instruments are held in the issuer's accounts is the most relevant with respect to our research focus.

Since it is generally interesting for the public to be informed via the prospectus of how the shares of the issuing company are valued, the CBF generally requests that an analysis of the price range or the offer price be included in the prospectus. The price range or the offer price is then analysed on the basis of current valuation methods, care being taken that the information is comprehensible for private investors[4].

The second category contains important continuing obligations imposed upon companies already admitted to the market and include periodic as well as occasional information disclosure demands[5]. The most important documents that listed venture capitalists must file are quarterly reports (when listed on the New Market or on Nasdaq Europe), semi-annual and annual reports. Listed companies must publish an annual report, including audited financial statements on their activities and results, and a semi-annual report, as well as a quarterly reports if their financial instruments are listed on the New Market or Nasdaq. The information that needs to be included in

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[4] Circular on the Operation of the Primary Market, 19/06/2000, CBF, pp 8-9.
[5] The requirements regarding periodic and occasional info are treated in royal decree of July 3, 1996.

these reports is set forth in the rule books of the respective stock exchanges. In general, the disclosure demands corresponds to the ordinary financial statement established and published according to Belgian accounting standards. In addition, information regarding any material event or decision, like the acquisition or disposition of assets, bankruptcy of a subsidiary or affiliate, needs to be included in these interim reports.

In addition to providing certain reports at fixed points in time, listed companies are also required to disclose all price sensitive information to the public and, prior to such disclosure, notify and provide details to the market authority. There does not exist an exhaustive list of events, changes, decisions and information, but what is meant are material changes or developments relating to the company's organisation, operations or major shareholdings. For instance, in the event a share capital transaction occurs, a disclosure is required of the price paid or received and how it is being satisfied, and of the value of the items transferred.

3.4 Obstacles resulting from the Belgian valuation and reporting requirements

Following our analysis, we can deduct a number of important conclusions regarding the valuation and reporting requirements introduced by Belgian accounting and corporate legislation. These requirements have lead to a situation where there still exist a number of problems and obstacles for the person responsible for determining a valuation, as well as for the investor making use of the valuation reported.

First of all, the predominance of the historic cost reflects the conservatism in the Belgian accounting system, which justifies this attitude using the prudence principle. For young, fast growing venture investment projects the historic cost value, however, does not reflect their upward potential and may become outdated quite fast. Although an upward revaluation is allowed in limited circumstances, it is left entirely to the judgment and appreciation of the valuation manager to decide if these circumstances are present or the conditions are met. Moreover, the same manager has no guidance regarding the determination of a new value. A similar reasoning holds for write-downs in case of value reductions.

Another important drawback of the Belgian valuation and reporting system deals with the external reporting issue. Our description of the requirements following from the accounting standards clearly demonstrates that only aggregate value figures of the entire investment portfolio have to be disclosed in the financial statements, which make up the bulk of the external reporting activities of the majority of the Belgian venture capitalists. Only when a venture capitalist is making use of the public capital markets he has to publish in certain circumstances the value figures for the individual venture investments in his or her portfolio. Consequently, the value that can be attached to these legally required disclosed data is highly questionable from the point of view of investors and researchers interested in the valuation of individual venture projects.

4. Valuation and reporting guidelines issued by EVCA

The incompleteness of the accounting and corporate framework regarding valuation and reporting of financial investments in many jurisdictions and the need of venture capitalist to have access to more solid and conclusive guidelines has gained the attention of several specialised organisations, like, for instance, the European Venture Capital Association (EVCA), the British Venture Capital Association (BVCA), and the Association for Investment Management and Research (AIMR). One of the objectives of the European private equity sector, represented by EVCA[6], is to provide greater transparency to its investors. As the industry has matured, there has generally been perceived to be a need for greater consistency of valuation and disclosure standards by both managers of and investors in venture capital and private equity funds. EVCA sees several reasons supporting a movement to greater transparency. For instance, existing investors might be given the opportunity to better monitor and evaluate the performance of their investments in venture capital funds, and this could at the same time permit to attract new investors. Also accountants, auditors and those responsible for the valuation and reporting policy would welcome a set of recommended industry practices.

[6] The European Venture Capital Association (EVCA) was formed in 1983 at the joint initiative of the industry and of Directorate-General Enterprise of the European Commission. Its membership has grown to over 380 European venture capital operators from more than 30 countries. Its mission is to globally promote and to facilitate European venture capital and private equity. EVCA provides information services for members and creates networking opportunities (www.evca.com).

Undoubtedly, the actions and initiatives undertaken by EVCA and which resulted in the release of valuation and reporting guidelines, which were issued in 1993 but reviewed in March 2001, are the most important and, in general, have received the most support in the venture capital industry. Consequently, we will concentrate on examining the specific requirements regarding the valuation and subsequent disclosure of investment projects present in the EVCA guidelines. More specifically, we first of all discuss the scope of application of these guidelines, before going into detail of the valuation and reporting methodology proposed by EVCA. Some concluding remarks present a critical evaluation of these guidelines.

4.1 Scope of the guidelines

EVCA has issued pan-European guidelines for the reporting and valuation of private equity portfolios and a code of conduct which all EVCA members should follow. These valuation and reporting guidelines are strongly mutually related and should be used jointly. It should be emphasised, however, that the EVCA guidelines do not impose an (legal) obligation on managers of VC funds, but rather seek to set a benchmark against which European VCs (and particularly EVCA members) may wish to relate their reporting. While EVCA guidelines attempt to give a framework and guidance to the valuation process, they do not attempt to restrict it. Where they set out strict or fixed criteria, they do so because this could improve consistency and clarity (EVCA (2001)). The EVCA guidelines seek to define a common method of valuation and reporting for the private equity market and, thus, for the venture capital industry. The guidelines thereby emphasize the disclosure and transparency of information in order to provide investors with as much confidence as possible in the valuations.

4.2 EVCA's Valuation guidelines

When formulating its valuation guidelines, EVCA set off defining a number of principles predominating the valuation process. As a result, the valuation should be prudent and applied consistently and professionally. Besides, the method, data and process used in coming to the valuation should be clearly disclosed. Other considerations that need to be taken into account when valuing investments more concretely imply that the valuation basis should be consistent from year to year and any change in method used should be clearly documented. When calculating a value for an investment, dilution effects and effects of translating investments denoted in foreign currency should be taken into account. According to EVCA, valuations should be produced at least twice year and audited once. Finally, it is also recommended that an independent, third party, reviews the valuations calculated according to these valuation guidelines. Therefore, EVCA foresees in its reporting guidelines a separate set of elements that should be provided to allow this independent, but to the venture capitalist related body to assess the valuation process in a profound manner.

Concretely, EVCA valuation guidelines can be summarized as follows. First of all, there is a clear distinction between quoted and unquoted investments. Regarding the valuation of unquoted investments, the application of two valuation methodologies, the conservative value and the fair market value, is recommended.
The *conservative value methodology* posits that all unquoted investments should be valued at the historic cost, corresponding to the acquisition cost or cost at investment. Nevertheless, two exceptions are recognized. Firstly, when a new financing round or partial sale, involving a material investment by a third party at arm's length has taken place, the valuation should be based on the transaction price. The second exception imposes a write down by multiples of 25% when there has been a material and permanent reduction in the investment's value below the historic cost. Potential events resulting in such a material and permanent value decrease include the breach of a covenant, failure to service debt, and a substantial change in market conditions.

The *fair market value approach* supports a valuation equal to the estimated amount for which the investment or asset could be exchanged on the valuation date between a willing buyer and a willing seller in an arm's length transaction. The most appropriate indication of such a fair market value is likely to be an independent third party transaction within the valuation period. However, usually such a third party transaction is not present, leading to the use of alternatives. For investments with revenues and either profits or positive cash flows, the fair market value may be determined by reference to the multiples derived from the largest relevant sample size of comparable companies for which a valuation is available. These companies should be comparable with respect to the use of accounting standards, business focus, size and profitability. If, however, appropriate comparable companies are not available, the valuation manager can either use relevant and applicable sub-sector multiples, or apply the actual entry multiples paid for the investment to the investment's last trading figures. The multiples suggested in the guidelines for valuation purposes include the price/earnings ratio (P/E), price/cash flow ratio (P/CF), enterprise value[7]/earnings before interest and taxes (and depreciation and amortization) (EV/EBIT(DA)). All valuations based on the comparable multiples method should be discounted to take account of the illiquidity of the investment. The discount level used should be fixed and applied consistently to all unquoted investment valuations. It is recommended that a discount of at least 25% is used. Any variation in the application of the discount rate should be disclosed and clearly explained. Besides, an upward revaluation of an investment in the initial post investment period (12 months) is unusual. For investments with or without revenues, but without either profits or positive cash flows, the conservative value should be used.

Quoted investments should be valued on the basis of their quoted mid-market price on the last day of trading in the valuation period. However, a number of discounts should be applied to this market price to take account of liquidation limitations. For all quoted investments that are not subject to a restriction on their disposal, the recommended discount level is between 10% and 20%. If, however, the number of shares held is small relative to the quarterly trading volumes (i.e. less than 10%), then the discount may be reduced or removed altogether. For quoted investments that are subject to a restriction or lock-up, a minimum discount of 25% should be applied, increasing if the lock-up is significant. Finally, when the venture capitalist has a large shareholding compared to the quarterly trading volumes (i.e. greater than 30%), an additional discount of 5% to 10% should be applied.

4.3 Reporting requirements following from EVCA guidelines

Next to these valuation rules, EVCA proposed a number of guidelines concerning information which the venture capitalist should supply its investors with regarding the investment portfolio and the individual investments in this portfolio. The overall aim underlying the issuance by EVCA of a set of standard guidelines for reporting to investors is that the use of the guidelines becomes common practice and, as result, will improve the quality and consistency of reporting to investors, as well as promote

[7] Enterprise value is a measure of a company's value, calculated by: market value of the equity plus debt minus cash and cash equivalents.

private equity as an attractive investment opportunity. The guidelines are not to be seen as minimum requirements, nor is compliance required for membership of EVCA.

EVCA recognizes the importance of the so-called statutory accounts, which can be considered as the set of legal reporting requirements. The statutory accounts are regulated by the corporate and accounting legislation of the jurisdiction in which the venture capital organisation is incorporated, as well as the investment agreement or the founding document of the venture capital organisation. EVCA does not want to override the legal requirements to which the venture capitalists are subject. Nevertheless, in its guidelines the organisation utters some criticism on the typical format of the existing statutory accounts, which accordingly to EVCA is not particularly well suited to the business of the private equity industry. Therefore, EVCA recommends that, in addition to the legal requirements, the venture capital organisations must provide additional information to their investors, which require further information in order to evaluate the performance of their investments and to satisfy their own reporting requirements.

In its reporting guidelines EVCA introduced two potential reporting standards, differing as to the extent and level of detail, applicable by venture capitalists in their information provision activities towards investors. Although not explicitly mentioned in the guidelines, our analysis reveals that the EVCA recommendations elaborate on the legal disclosure requirements. The *first level (Level One)*, in fact, represents a type of minimum disclosure level. For certain topics the *second level (Level Two)* stipulates the publication of additional elements supplementing and/or clarifying the first level. On the basis of distinct topics, EVCA reporting guidelines provide an overview of the required disclosure for Level One and, in case additional information is indispensable, for Level Two. *Level One*, for instance, states that reporting needs to be produced at least semi-annually, investments should be revalued semi-annually and the method and basis of valuation, in accordance with EVCA valuation guidelines, should be clearly stated. *Level Two*, in turn, advocates quarterly reporting and quarterly revaluing of investments.

With respect to the value reporting of the individual investments and the total portfolio, the guidelines include the following propositions and recommendations.

At *Level One*, a clear statement of the overall position of the VC fund should be given, including prior period comparative figures of: total commitments; total write-downs (as well as when); total committed or reserved for follow-on investments; total invested (and in what); total value of remaining assets in portfolio. Besides, general and specific information on the portfolio companies and the investments are required, including the valuation at the time of investment and the valuation of each investment (in accordance with EVCA valuation guidelines).

With respect to the overall position, *Level Two*, in addition, requires a value progression chart, showing the change in value of the fund over its life, broken down into investments at cost, realised gains and losses, unrealised gains and losses, and compared to total commitments. Regarding individual investments, Level Two demands, amongst others, an assessment of the company's status compared to the expectation at investments and a comparison year by year of the evolution of the valuation of the investment.

It should be noted that in the valuation guidelines, EVCA suggests to publish more information regarding the valuation process, more specifically on the data, method and procedure used in coming to a valuation. Two levels of disclosure are proposed, a basic level to be included in the reporting to all investors, and an advanced level for reporting to an independent third party reviewing the valuations. Consequently, the basic level can be considered a form of external communication, while the advanced level is oriented internally. Within the basic level, a distinction is made following the distinct levels of external reporting defined in the reporting guidelines. Important elements that need to be disclosed under *Level One* reporting, include a statement indicating which valuation is being applied and the reasons underlying that choice, whether EVCA valuation guidelines are being applied, the cost and date of initial investment and subsequent financings, date and amount of the latest round of financing and valuation of the VC's investment, as well as to whether an independent third party was involved, and the change in valuation over the previous two valuation exercises. *Level Two* reporting requires the publication of additional data useful for valuation purposes, like key financials. The advanced level foresees the provision of additional information allowing a more profound evaluation of the valuation process.

4.4 Problems resulting from the EVCA guidelines

Although the valuation proposed by EVCA still is a rather conservative approach, certainly for the very young, unprofitable start-up venture investments, it foresees a more market-oriented approach for the profitable, cash generating companies leading to more realistic valuations. Nevertheless, the valuation of unquoted investments remains a very difficult activity open to different interpretations and subject to the interest, attitude and interpretation of the valuation manager. We, specifically, notice judgment problems when implementing the different methods suggested, for instance with respect to the determination of the multiples, comparables, the prediction of future revenues, cash flows, et cetera. Besides, there is no clear justification of the size of the proposed discounts to correct for illiquidity. Finally, give the lack of legal accountability, the venture capitalist can decide to apply or ignore these guidelines.

With respect to the reporting demands following EVCA's guidelines, it should be stressed that EVCA advocates a very elaborated disclosure constraint. This in fact is a very favourable for investors and the public, but of course not always necessarily for the individual venture capitalist. Using the information the venture capitalist is obliged to make public according to EVCA, the external use of the information should be able to make a profound assessment of the position of the venture capitalist's portfolio. Nevertheless, the values disclosed remain one of the most crucial aspects in the reporting activity. An important conclusion, we can, therefore, derive from our investigation is that valuations must be carried out in a consistent, independent and objective way, exempt from any manipulation Our detailed and critical analysis of the existing guidelines EVCA, proves that this goal of defining a common and uniform valuation methodology is not fully attained

5. Summary – Conclusions

The legal requirements following from Belgian accounting regulation regarding financial assets identify two distinct valuation situations. The first situation is driven by the acquisition or investment decision and amounts to a recognition of the asset concerned in the accounts based on the acquisition value or the nominal value. Regarding the second situation less guidance is presented. More importantly, however at a later stage, different events, developments or decisions may have lead to an important change in the value of the investment project concerned. A revaluation or write-down might be necessary. The way to deal with such situations is left open to the judgment and appreciation of the investor in need of a valuation. This paper illustrates the large amount of financial reporting discretion left to managers regarding the valuation and resulting reporting decisions with respect to their portfolio of venture investments. Valuation discretion mainly arises due to the absence of exogenously determined market prices for the non-quoted securities.

More specifically, with respect to the Belgian accounting regulation dealing with valuation and reporting issues, we can conclude that the requirements are rather conservative and stress the prudence principle. The more market-oriented fair value approach is thereby neglected. Consequently, the book value is dominated by the historic cost, which is the value at which the asset was initially recorded in the accounts. Nevertheless, legislation allows revaluation, but it is left to the judgment and discretion of the valuation manager to decide on how and when to account for this. The information to be disclosed is rather limited in size and mainly contains aggregated value figures.

EVCA's guidelines attempt to provide an orderly framework for venture capitalist when deciding on the valuation of their investment portfolio. Nonetheless, our discussion shows that even these guidelines leave a lot of room for discussion and interpretation when implementing them in practice. It should be noted that the EVCA guidelines contain some very interesting links and references to the concept of "fair value", which is receiving an increasing amount of attention and interest by accounting standard setters and academic researchers. Although EVCA's guidelines provide more guidance on certain issues and require a large amount of disclosure, a venture capitalist needs to obey the legal statutory requirements and can limit its valuation and external reporting behavior accordingly. Finally, these obligations do not prohibit a venture capitalist to disclose voluntarily more information in a different format, to another public and at another point of time.

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