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FSPFAS115A

LETTER OF COMMENT NO. 133

Via Email
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Re: Proposed FSP FAS 157-e

Thank you for the opportunity to comment on FASB Staff Position FAS 157-e ("FAS 157-e"). American Capital, Ltd. ("American Capital") is a non-diversified, closed-end investment management company, which has elected to be regulated as a business development company ("BDC") under the Investment Company Act of 1940, as amended (the "Act"). We generally invest in senior debt, mezzanine debt and equity of privately-held middle market companies, alternative asset funds and to a lesser extent structured finance investments (i.e. CMBS, CLO, CDO). As an investment company, American Capital is required to record all of its investments at fair value under FASB Statement No. 157, *Fair Value Measurements* ("SFAS 157"). American Capital uses level 3 inputs in determining the fair value of substantially all of its investments. In general, we support FAS 157-e and believe it assists preparers in clarifying how fair value is determined in inactive markets, including the applicability of distressed transactions.

However, we believe further clarification is needed, in particular:

1. <u>More guidance (including examples) in determining the discount rate and/or liquidity risk premium in the income approach (i.e. discounted cash flow model)</u>. Per FAS 157-e, if a reporting entity concludes that a market is not active and does not have evidence that a quoted price was supported by multiple bidders and sufficient time to market the investment prior to sale, then the reporting entity should consider the quoted price to be associated with a distressed transaction and should use a valuation technique other than one that uses the quoted price, such as an income approach to estimate fair value. The FASB did acknowledge in FAS 157-e that the fair value resulting from the present value technique should not be derived solely from inputs based on the quoted price

associated with a distressed transaction, but rather the inputs should be reflective of an orderly transaction between market participants that would reflect all risks inherent in the asset, including a reasonable risk premium in pricing the asset in a non-distressed transaction. In essence, judgment must be used to construct a discount rate if the observable data reflects factors from a distressed transaction or inactive market.

However, additional guidance should be provided to assist preparers in building up the discount rate to incorporate a "reasonable risk premium" between willing buyers and sellers. If a willing seller's discount rate is a rate of return in an active market (as the example in A32F of FAS 157-e indicates), how is an appropriate liquidity risk premium determined to apply to the rate of return that a willing buyer would accept in an active market when all observable data reflects what a willing buyer will accept in a distressed or inactive market? In an inactive market, utilization of observable inputs without significant adjustment would result in the use of a distressed input. The FASB's Staff Board Meeting Handouts on March 16, 2009 refers to the use of "reasonable profit margin" instead of "reasonable risk premium" to determine the inputs into a present value technique in determining fair value. We believe the terminology "reasonable profit margin" is more definitive in an inactive market than the current FAS 157-e guidance because it could be based upon market participants' cost of capital and profit margin rather than capturing external data from a distressed and inactive market.

Ultimately, more specific guidance is needed in developing a discount rate where substantial judgment is required, particularly if it is not based on observable data. The use of judgment has become one of the most difficult accounting concepts to apply because it is in cross purposes with requirements to provide "auditable" support documentation, particularly in circumstances where there is a lack of observable data. In fact, we believe that one of the reasons FAS 157-3 did not result in significant changes in the determination of fair value is because the need for auditable support ultimately forced companies to use observable data inputs reflecting distressed trades in illiquid markets that were not representative of fair value instead of using management's "judgment". In order to make FAS 157-e practical from an implementation perspective, clear and concise direction that a company can look at its internal pricing models to develop its discount rates rather than external observable data from an inactive market will allow companies and their auditors more flexibility to use the judgment that the FASB and SEC are directing in each of the SFAS 157 pronouncements.

2. Clarification regarding the applicability of the principles of FAS 157-e to other investments and observable inputs. Most of the assets held by the several dozen BDCs are assets that were originated with the intention of being held to maturity and a market to trade these assets does not exist. Presently, FAS 157-e appears to be intended for structured finance investments since the examples within the FSP reference CDOs. Further, in applying Step 2 of the two-step process, "quoted prices" are singled out when determining relevance (i.e. if the "quoted prices" are associated with a distressed transaction). We value other level three assets in which "quoted prices" generally do not exist for the investments and those markets could be considered inactive. However other types of observable inputs, other than "quoted prices," may exist (i.e. bids, indexes, etc.) for these markets. Since SFAS 157 is a principal-based standard, the guidance within FAS 157-e should be applicable to all investments in inactive and distressed markets regardless of whether the investment has "quoted prices" or not. Therefore, we would appreciate clarification that this is intended for broader applicability than just quoted markets.

3. Add a provision to the FAS 157-e or issue an additional FSP giving companies a choice to reconsider their previous SFAS 159 election for existing balance sheet accounts. Entities were required to adopt both SFAS 157 and FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial*

Liabilities ("SFAS 159"), as of the beginning of the reporting entity's first fiscal year that began after November 15, 2007. The adoption of SFAS 157 ultimately resulted in material changes in the valuation methodologies of many entities, particularly BDCs. For many of their loan investments, BDCs are now required under SFAS 157 to value held to maturity debt investments using a hypothetical secondary market as the principal market instead of the mergers and acquisition market that they transact in. However, these interpretations on how to apply SFAS 157 to the investment portfolios of BDCs and private equity funds by the large accounting firms, the Valuation Resource Group and preparers of financial statements were not concluded upon by the SFAS 159 required adoption date of January 1, 2008 for a calendar year reporting company. SFAS 159 and SFAS 157 should be considered together by companies since SFAS 159 allows a company to elect what financial assets and liabilities on the balance sheet are recorded at fair value and SFAS 157 provides guidance on how to determine the fair value. We and other BDCs were not able to make an informed decision on our SFAS 159 election since the SFAS 157 fair value concepts were not completed by our SFAS 159 implementation date. This has resulted in a significant mismatch between fair value and historical cost accounts on our balance sheet and ultimately volatility in our equity capital account that is misleading to the readers of our financial statements. Another one-time opportunity to elect the fair value option under SFAS 159 would be useful in fixing the unintended consequences of the evolution of SFAS 157 guidance after the implementation date of SFAS 159.

Again, we thank you for consideration of recommendations and would be happy to discuss these in person if necessary.

Sincerely,

John Erickson

John Erickson
Chief Financial Officer
American Capital, Ltd.

cc: Mary L. Schapiro
Chairman
Securities and Exchange Commission