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The Private Equity Council (PEC) is a Washington, D.C. based advocacy, communications and research organization established to develop, analyze and distribute information about the private equity industry and its contributions to the national and global economy. The PEC appreciates the opportunity to provide comments to the Financial Accounting Standards Board (FASB) in response to the proposed Accounting Standards Update, Topic 820, “Improving Disclosures about Fair Value Measurements” (hereafter “ASU”). This letter incorporates the views of fifteen private equity firms with whom we have met to help formulate our response.

Executive Summary

Our comments on the proposed ASU are limited to the proposed sensitivity disclosures for Level 3 fair value measurements. Level 3 valuations are inherently judgmental and accordingly we agree that for each valuation a reasonable range of acceptable valuation outcomes exists. Despite existing disclosure regarding the use of estimates, current accounting may inadvertently imply a level of precision around a single point estimate that does not exist in practice. Therefore, the concept of sensitivity disclosure, at least in concept, is appealing. However, we note that no requirement currently exists to provide sensitivity disclosure for many other important estimates that companies routinely make. Accordingly, we believe that valuation estimates should be treated in the same manner.

While conceptually appealing, we are concerned about the practical implications of ASU 820 to private equity funds. Our practical concerns stem from: (i) the number of unique investments in most funds; (ii) the use of multiple valuation methodologies for each investment; (iii) a multitude of significant unobservable inputs to those fair value measurements; and (iv) the complexity of the investment deal structures and the inability to aggregate in a meaningful way under the proposed guidance. Finally, we do not believe that this proposal will increase the usefulness of financial statements to the investors in private equity funds.

Sensitivity Disclosure is Not Practical for Private Equity

Private equity funds generally invest in private transactions which are Level 3 valuations. It is not uncommon for such funds to make on average 20 to 30 investments and certain specialty funds (such as real estate, mezzanine or debt funds) may invest in substantially more transactions. The uniqueness of each investment may render aggregation difficult and or less meaningful.

Statement of Financial Accounting Standards No. 157, “Fair Value Measurements” suggests that certain Level 3 investments be valued using more than one methodology where possible (e.g., a market approach based upon public company comparables, a market approach based upon precedent transactions and an income approach based upon a discounted cash flow). Some entities calculate a valuation range for each methodology and then use analysis and judgment to reconcile the multiple outputs to conclude upon a single point estimate. The use of multiple valuation approaches, albeit arguably a best practice, renders the determination of just one or two significant inputs from among the many other reasonably possible unobservable inputs that could significantly impact the fair value measurement both difficult and potentially misleading.

The selection and description of inputs under valuation methodologies becomes complex and the relevant factors vary substantially by investment. Consider the following areas of judgment that are frequently used in the valuation of Level 3 private equity investments:

- The appropriateness of the comparables selected
- What valuation metric is used— profit after tax, EBIT, EBITDA, revenues or net equity
- Use of trailing or forward multiples
- Relevance of pending transactions/financings and how to discount for the risk of not closing
- The relevance of dealer quotes and or investment banker valuations during marketing of an IPO
- Appropriateness of control premiums, minority discounts, and lack of marketability discounts
- Factors related to deal structures including protective rights and preferences and how to value those rights
- Multiple sets of cash flows (investment case, management’s forecast, bank plan)—judgment as to which set to use is a key input
- Multitude of assumptions underlying projected cash flows including growth factors
- How the discount rate is determined in a DCF and the multiple judgmental inputs in a Weighted Average Cost of Capital calculation as well the assumptions used in determining the terminal value in a DCF model
- Progress toward achievement of key developmental milestones
- Evaluations of uncertainties affecting the operations of the investment, taxes and or enforceability of contractual provisions

- Valuation implications stemming from liquidity and/or covenant issues

These factors are just a few of the inputs that may materially impact each valuation. Each of these inputs individually, or in combination with some or all of the other inputs, could be considered significant unobservable inputs. Accordingly, selecting just one or two valuation inputs for sensitivity disclosure will not only be a difficult selection but will omit the many other factors that may significantly impact valuation. To provide sensitivity disclosure for all of the material inputs, individually or in combination, would clearly not be practical.

Hard to value assets will inevitably add to the complexity. A venture fund, for example, may invest in early stage, pre-revenue companies. The reasonably possible range of valuation outcomes for each company could be quite broad. Frequently, such portfolios will be made up of a few investments that become highly successful while the balance of the portfolio may struggle to generate any return at all.

Certain portfolios may be valued based upon third party pricing services. In some cases, these are Level 3 assets. The data to make the sensitivity disclosures in such cases is generally unavailable. To obtain the underlying data from the pricing services would likely be onerous and result in significant incremental cost.

What is “Reasonably Possible”?

We are also concerned that undue effort and cost will be incurred in evaluating what is a “reasonably possible” alternative input. As drafted, management’s determination of the inputs remains subject to estimation and judgment. Application across investments, industries or between different management teams will likely be inconsistent. Additionally, auditors will likely incur substantial time trying to test what is a “reasonably possible” alternative input. Additional guidance as to what is “reasonably possible” would help with the implementation of this aspect of the proposed ASU.

Does Sensitivity Disclosure Apply to Carried Interest?

The investment managers of private equity funds typically earn a carried interest should the realized capital appreciation exceed defined hurdle rates. Many funds will disclose the amount of accrued carried interest and/or accrued clawback (how much carry would be paid to the manager or returned by the manager if the fund were liquidated at the reporting date at the fair values indicated) and account for it within the statement of equity as an allocation of income between the partners with the fund. Sensitivity disclosure that stops short of accrued carry may be misleading to users of the financials. However, calculating accrued carry for a single aggregation may be equally misleading and calculating accrued carry for all of the possible permutations would be overly burdensome and likely confusing as well.

Application to the Investment Manager

Similarly, it seems unclear whether such sensitivity disclosure is required in the financial statements of the investment manager. In the situation when the manager does not consolidate the underlying funds, any accrued carry is theoretically not carried at fair value (i.e. SFAS 159 cannot be applied to the manager's accounting for carried interest). As such no sensitivity disclosure would be required. This is similar to the exception provided to investors that rely upon NAV as a practical expedient for fair value. However, in the case where the manager is required to consolidate sponsored funds, then sensitivity disclosure would be required. Such disclosure could be misleading without at least qualitative disclosure as to how it impacts the manager's income (typically carried interest).

Sensitivity Disclosure Does Not Increase Usefulness to Investors in Private Equity

Investors in private equity funds want transparency as to how private equity funds value their investments. Detailed disclosure as to valuation methodology is necessary and investors obtain this information through direct communication with the fund manager. Investors perform diligence to ensure that the fund manager has appropriately complied with SFAS 157 so that they can rely upon the fund's NAV as a practical expedient for fair value in their own accounting. It is unclear how sensitivity disclosure is beneficial to private equity investors since they must already perform diligence as to the manager's valuation approach and they are exempt from this ASU requiring sensitivity disclosure as they may rely upon NAV as a practical expedient to fair value, assuming certain other criteria are met.

Private equity funds are distinct from hedge funds and certain other alternative investments in that private equity funds are closed end funds without redemption rights. While current fair value is meaningful, it does not set a redemption price nor does the fund manager earn an incentive fee from the current fair value. In the end, investment realizations determine how much the investors and the manager each earn. The real question for investors in private equity is what the investment will be worth when sold and what is the manager doing to achieve the best result for the fund. Sensitivity disclosure does not address any of the core issues for the manager or the investors.

Effective Date

The implementation of the proposed ASU will require a substantial amount of effort for private equity funds. If the proposed ASU becomes effective, we ask that the FASB consider extending the effective date to no sooner than interim and annual periods ending after December 15, 2010.

Conclusion

We are concerned that the level of disclosure required by the proposed ASU would be difficult to appropriately comply with and undoubtedly costly. We ask that the FASB

reconsider the need for such quantitative sensitivity disclosures as it relates to private equity funds.

Please feel free to contact me at 202-465-7700 if you would like further clarification or additional information.

Very truly yours,

A handwritten signature in black ink, appearing to read "Douglas Lowenstein". The signature is fluid and cursive, with a large initial "D" and a long, sweeping underline.

Douglas Lowenstein,
President and CEO