

Invest. Grow. Innovate.

September 3, 2010

Technical Director
File Reference No. 1830-100
FASB
401 Merritt 7
PO Box 5116, Norwalk CT 06856-5116

Re: File Reference 1830-100

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, "Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" (hereafter ASU).

#### **Measurement Uncertainty Disclosure**

We agree with the Board's intent to exclude unquoted equity from the proposed measurement uncertainty disclosure. As stated in question 7 for respondents, "the Board has decided in its project on the accounting for financial instruments that a measurement uncertainty analysis disclosure would not be required for investments in unquoted equity instruments." In the proposed update to financial instruments (Topic 825) respondents were told to "assume an effective date of no earlier than January 1, 2013." Given potential delays, the proposed amendments might not take effect until 2014. It is quite possible that the new fair value disclosure requirements will take effect some time in 2011. Absent explicit guidance in the ASU that unquoted equity is excluded from the disclosure requirements, some observers may be of the opinion that a measurement uncertainty analysis is necessary until the Topic 825 amendments take effect.

To avoid any misunderstanding on this point, we ask that the Board include clear and unambiguous language of its intention to exclude unquoted equity from the proposed measurement uncertainty disclosure. We ask that the Board also make clear that this exclusion applies to the indirect unquoted equity holdings of investors who rely on investee reported net asset value (NAV) as a practical expedient for fair value pursuant to ASU 2009-12. As the Board recognizes, the valuation methodologies used to

950 F Street, NW Suite 550 Washington, DC 20004 estimate the fair value of a private company do not lend themselves to meaningful uncertainty disclosures because of the multiplicity of unobservable inputs with a material impact on fair value. Providing a measurement uncertainty disclosure for a large portfolio of such investments is even more problematic, as the uniqueness of each investment and multitude of distinct risks renders the aggregation of measurement sensitivities more difficult and less meaningful.

We also refer you to the comment letter submitted by the PEC on October 9, 2009, in response to the proposed Accounting Standards Update, Topic 820; "Improving Disclosures about Fair Value Measurements" (file reference 1710-100 – Comment Letter No. 35). Overall, our position is unchanged in that we believe that disclosure of measurement uncertainties for Level 3 instruments is not practical for private equity funds and further that such disclosures would not increase the usefulness of financial statements to investors in private equity funds. A copy of the comment letter is attached for your reference.

We ask that the Board consider the practical implications surrounding measurement uncertainty disclosure for unquoted debt instruments and other Level 3 instruments. Often pricing for unquoted loans and bonds is provided from third party pricing services, broker quotes and internal models. When this information is not internally derived, the information necessary to provide meaningful sensitivity disclosure is frequently unavailable. When valuations are internally derived from models, many of the same issues that apply to unquoted equity instruments apply to unquoted debt instruments and other Level 3 instruments. Once again, we refer the Board to our comment letter dated October 9, 2009 on ASU 820

#### **Control Premiums and Combined Interests in Private Companies**

Private equity funds generally invest in private transactions which are valued using Level 3 inputs. In these transactions, the private equity fund often secures a controlling equity stake where market participants would generally consider a control premium appropriate when pricing the asset. We understand that the Board intends to allow a control premium or a noncontrolling interest discount to continue to be taken into account for Level 2 and Level 3 valuations. Our concern is that the ASU, as drafted, contains language that may be misunderstood to circumscribe a reporting entity's ability to account for control premiums. The requirement that control premiums be "consistent with the unit of account for that asset" may be interpreted to prohibit control premiums based on a reading of the "unit of account" guidance in Topic 946 which remains the individual financial instrument (a single share, for instance). This confusion could be exacerbated by the proposed amendments to the "highest and best use" concept, including the elimination of "in-use" valuation premise.

This also has important implications for the fair value of debt securities when owned in conjunction with a controlling equity stake in the same company. In current practice, the fair value of the debt from the perspective of market participants is likely to be its par value in control situations because the debt holders generally have the right to put the

debt at par upon a change in equity control which generally ensures that the debt would be redeemed at par when the investment is realized.

For example, assume an entity has an enterprise value of \$1,100 on a controlling basis and an enterprise value of \$900 under a non-control basis. Assume that it has debt with a par value of \$500 and the provisions of the debt include a change in control provision. Also assume that the debt would be valued at \$400 based upon pricing in a secondary market. Current practice would value the controlling equity position at \$600 and the debt at \$500 (equaling the \$1,100 controlling enterprise value). Under the exposure draft, the debt would likely be valued at \$400 and the equity at \$500 (totaling \$900 non-control basis enterprise value). We are concerned that this interpretation could result in:

- Undervaluing equity by excluding control premiums; even resulting in day one losses upon public to private transactions
- Overstating the equity value by causing debt to be valued without consideration for its put provisions upon a change in control

To avoid any misinterpretation, we ask that the Board clarify that the ASU permits valuation of a combined interest in a private company in situations where market participants would use the combined interest as the unit of measurement for pricing the asset or liability. This would be consistent with the Board's intent as explained in the Basis for Conclusions Numbers 33-44. By its nature, a fair value measurement "takes into account the characteristics of the asset or liability that market participants would take into account." In the case of a controlling interest in a private company, these characteristics are inextricably linked to the unit of measurement because of the expectation that the investment will be realized in a single transaction.

#### Conclusion

The PEC believes that disclosures of measurement uncertainties for Level 3 instruments is not practical nor does it increase the usefulness of financial statements to the investors in private equity funds. Should the FASB proceed with this disclosure requirement, the PEC requests that the ASU be clarified in two key areas to ensure the language is entirely consistent with the Board's stated intentions. In addition, the PEC believes that on unit of account guidance should be clarified for private equity investments to ensure that fair value measurements take into account the characteristics of the asset or liability that market participants would consider, including control premiums.

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

Very truly yours,

Douglas Lowenstein, President and CEO

Douglas Lamber



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October 9, 2009

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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).

# <u>Sensitivity Disclosure Does Not Increase Usefulness to Investors in Private Equity</u>

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,

Douglas Lowenstein, President and CEO