

## FAS 157: An Accounting Rule By Any Other Name Still Draws Ire

By Laura Kreutzer and Sabrina Willmer

10/1/2009

DATELINE NOT UPDATED -- The already impenetrable jungle of FAS 157 is about to get even denser.

Saying it is responding to feedback, the Financial Accounting Standards Board is proposing some changes to the rule governing fair value that would directly affect private equity firms. It has also renamed the rule, which is now going by the name Topic 820.

FASB is suggesting that firms should provide additional analysis of Level 3 assets in their portfolio. Topic 820 divides assets into three classes: Level 1, based on market prices; Level 2, based on market prices of similar entities; and Level 3, which must be determined without any real market guides, and which are common in PE portfolios.

The proposal, if enacted, would essentially require firms to disclose a range of values for their Level 3 assets, by requesting determinations of how valuations would increase or decrease if one or more inputs was changed to a "reasonably possible" alternative.

Industry practitioners say this doesn't make any sense.

"If you look at firms that use best practices, they approach valuations based on multiple methods, such as a [merger and acquisition], possible IPO or a recapitalization with another sponsor," said David Larsen, managing director at financial advisory firm Duff & Phelps Corp. "They will look at it from multiple perspectives to come up with a point estimate. They've already incorporated reasonable alternatives. The question now is, do they have to disclose those alternatives and open themselves up to second guessing?"

If so, firms worry they could be exposed to conflicting requests from auditors and limited partners, or even lawsuits. Consider a case in which a buyout firm comes up with a valuation of \$100 million for a portfolio company, but says that under other possible circumstances it could be worth \$50 million to \$150 million. "It opens a Pandora's box of questions," Larsen said. "The auditor could say, 'Well, why didn't you pick \$50 million?' and the LP could start asking, 'Why didn't you pick \$75 million or \$150 million?'"

"It would be a better rule if it just required disclosure of a significant unobservable input that is outsized to anything else," said Kevin O'Mara, a partner at law firm Jones Day.

Firms also are worried about additional costs of the new requirements, as well as the risk of disclosing more proprietary information than they already do. But in the end, their biggest problem with the proposed rules is that FASB may simply be asking the impossible.

William Hupp, chief financial officer of Adams Street Partners, argued that while a sensitivity analysis might work fine for stocks and bonds -- Level 1 or 2 assets -- each and every portfolio company of a PE firm that is a Level 3 asset will have unique, difficult-to-quantify inputs, like the value of a product that a start-up is developing, making it hard to come up with any sort of

meaningful disclosure of valuation ranges. "I don't think this is going to be operational," Hupp added.

Stephen Holmes, chief financial officer at venture capital firm InterWest Partners LLC, agreed. "In the world of early-stage investing, there's a huge range of what's reasonably possible and there's no way to audit that, because you come up with meaningless ranges," Holmes said. "My first read of [the proposal] causes the hair on my head to stand up."

FASB is accepting comments on the proposals. The deadline is Oct. 12.

## The New-Look FAS 157

The Financial Accounting Standards Board is proposing a number of changes to FAS 157, now known as Topic 820. A summary:

### Level 3 Inputs

For fair value measurements using significant unobservable inputs, if considering "reasonably possible alternative inputs" would increase or decrease fair value significantly, that must be disclosed.

### Level 3 Value Measurements

Information about purchases, sales, issuances and settlements would be required on a gross basis, rather than as one net number.

### Transfers To Level 1 And 2

If there are any transfers of assets into or out of Levels 1 and 2, the amount and reasons would need to be disclosed.