

Alert

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Fair Value Rules Impact Private Equity World

“SFAS 157 identifies a fair value hierarchy to rank the reliability of inputs used in a valuation approach.”

Since the issuance of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, last September, corporations have begun to prepare for implementation. Additionally, SFAS 157 has led to an increased awareness of the concept of fair value by the private equity industry.

The Private Equity Industry Guidelines Group (PEIGG) is in the process of revising its current valuation guidelines to ensure that they are compliant with SFAS 157. The PEIGG developed valuation guidelines in 2004 in response to the lack of consistency in valuation methodologies used to value investments in portfolio companies.

In accordance with SFAS 157, portfolio companies are required to be reported at fair value, which is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

This definition, which focuses on exit values, e.g. the value when an asset is sold, rather than entrance values, is new to the private equity industry. SFAS 157 has raised other concerns for the PE industry, mainly in the following areas:

- * Valuation approaches
- * Fair value hierarchy
- * Discounts
- * Transaction costs
- * Disclosures

VALUATION APPROACHES

A mark-to-market approach is generally used to value investments. In situations where a mark-to-market approach would not be appropriate, SFAS 157 requires that valuation techniques consistent with the market approach, income approach and/or cost approach should be used to estimate fair value.

Typically, venture investments are valued using last round financing. However, PEIGG guidelines point out that after a period of time, cost or the latest round of financing becomes less reliable as an approximation of fair value. Managers are required to assess whether a circumstance has occurred which would require an adjustment to the value of an investment. One example would be if market or economic conditions have changed significantly since the time of the original investment. Other examples are provided in the PEIGG guidelines.

FAIR VALUE HIERARCHY

SFAS 157 identifies a fair value hierarchy to rank the reliability of inputs used in a valuation approach. The first – and highest – level refers to quoted prices for identical securities in an active

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market. When those prices are not available, the second – or middle – level will base fair value estimates on observable inputs that a market participant would use. If observable inputs are not available, the third – and lowest – level will require the use of unobservable inputs.

However, the objective of fair value remains the same and thus even unobservable inputs will need to incorporate the assumptions a market participant would use in developing an exit price. The reporting entity’s own data may be used to develop unobservable inputs, provided that information which shows that market participants would use different assumptions is not readily available with undue cost and effort.

DISCOUNTS

SFAS 157 requires that fair value of a financial instrument that trades in active market is measured using the quoted price of the instrument (within level 1 of the fair value hierarchy). The Board states that the price should not be adjusted by the size of the position relative to trading volume (blockage factor). This is a change from previous practice; under the grandfather provisions of the AICPA Audit and Accounting Guide Audits of Investment Companies, blockage, or liquidity, discounts, were allowed.

TRANSACTION COSTS

According to SFAS 157, fair market value should not be adjusted for transaction costs, such as commissions or due diligence costs. The statement requires that transaction costs be expensed.

DISCLOSURES

The FASB calls for expanded disclosure requirements under SFAS 157. The new disclosures are meant to increase transparency for financial statement users with regards to 1) fair value measurements at the reporting date, 2) the inputs and assumptions used to arrive at fair value, and 3) the effect of fair value measurements on earnings. Under SFAS 157, the level used to rank the reliability of inputs in a valuation approach would need to be disclosed, along with the assumptions used. The FASB encourages entities to combine fair value disclosures under SFAS 157 with fair value information disclosed under other accounting pronouncements, such as SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*, if feasible. For more information, contact your Valuation Research representative or Tony Law at (414) 221-6217. **VR**

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