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Fair value accounting and private equity: the challenges and steps firms can take to measure fair value

If the first few months of 2012 are any indication, the private equity industry may soon begin to re-prioritize the means by which it measures its investments and performance reporting.

Recently, private equity firms have come under increased scrutiny by the Securities and Exchange Commission in connection with potential overstatements in the values of their portfolios.[1] Private equity portfolio companies are often not part of an observable market (i.e., they do not have market trading prices). In order to arrive at a value of these potentially illiquid investments, firms must often employ best estimates that are based on models and internal information.

A NEW, GLOBAL STANDARD FOR MEASURING FAIR VALUE

Until the introduction of FAS 157 (now ASC 820) in 2006, there were different definitions of fair value and limited guidance for applying the standards in compliance with GAAP. FAS 157 required companies to take current market pricing and conditions into account when valuing assets. Since that time, fair value accounting has become especially important – and subject to examination by the SEC. The SEC has voiced concerns about the valuations of assets in the past, notably during the financial crisis when markets became unstable, placing stress on certain assets and triggering liquidity problems. As a result, determining observable prices for these assets as required under FAS 157 grew challenging and, in some cases, resulted in valuations that proved to be unattainable. This ushered in a cycle of write-downs as companies found rationalizing their valuations next to impossible.

[1] "Private Equity Industry Attracts S.E.C. Scrutiny," The New York Times, February 12, 2012.

Now, the SEC appears to have taken the position that the same judgments that resulted in these problems can also be applicable to private equity firms and their portfolio companies, which are usually not traded on public markets.

The recent scrutiny of private equity firms appears to indicate that the environment of heightened regulatory activity and public animus that was present during the financial crisis continues to persist today. Two key areas that may lend themselves to the potential for perceived misstatements of the value of private equity portfolio companies are the ways in which firms attract capital from investors and how portfolio managers are compensated – both of which are tied to valuations.

ELIMINATING THE RED FLAGS

Investor confidence is more important than ever in attracting capital in the wake of the financial crisis and various investment scandals. There are substantial reputational risks to private equity firms associated with failing to provide accurate valuations. An overly optimistic earnings forecast or unrealistic growth rate could raise red flags for a firm's valuation. In turn, those red flags may result in a regulatory inquiry or litigation. In order to minimize this risk, it's important for the private equity firm's management to have the right expertise available to conduct appropriate valuations. If the firm does not have these capabilities internally, enlisting the help of independent valuation experts can provide assurance and a higher level of comfort to its limited partners.

FAIR VALUE ACCOUNTING: AN OVERVIEW OF RULEMAKING

A driving force behind the use of fair value measurements has been a move to harmonize U.S. GAAP and international financial reporting standards (IFRS), a set of accounting guidelines developed by the International Accounting Standards Board (IASB), an independent organization, whose objective is to provide a global framework for how public companies prepare and disclose their financial statements.

In an effort to create a single, consistent meaning of fair value, amended rules were enacted in May 2011 by the Financial Accounting Standards Board (FASB) and the IASB. These rules require companies to provide new disclosures as to the methods they use to value securities whose market values aren't observable. By requiring detailed disclosures of estimates and assumptions used in models, regulators sought to increase the transparency, and by extension, the perceived accuracy of fair value measurements.

ASC 820 provides guidance for determining the fair value of assets and liabilities. Under it, fair value is defined as "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."[2] ASC 820 establishes a three-tiered structure that prioritizes those inputs that should be used to measure fair value, with Level 1 inputs given the highest level of acceptance and those that are based on an entity's own assumptions (Level 3) given the lowest, as follows:

- **Level 1 inputs:** Quoted prices for the identical assets traded in active markets.
- **Level 2 inputs:** Quoted prices for comparable assets or liabilities that can be observed directly or indirectly in active markets.
- **Level 3 inputs:** Assets that do not have an external market. They are derived by using data that is not observable and are used with valuation models that require assumptions.

NOT A BLACK AND WHITE WORLD

In general, portfolio companies may be categorized as Level 2 or Level 3 inputs. Prior to the implementation

[2] FAS 157, Financial Accounting Standards Board, Original Pronouncements As Amended, September, 2006

of fair value requirements, firms valued these investments based on their cost. GAAP requirements now call for these investments to be valued based on observable prices. However, when there is no observable market price, GAAP requires fair value to be based on the best information available in the circumstances.

Valuing assets and transactions based on an observable market can be especially challenging when these entities do not trade on a regular basis. For companies that do not have an observable market, there may be a wide discrepancy between the price that a company calculates and what a third-party valuation expert believes to be the fair value of a portfolio company. In order to determine the fair value of these assets, private equity firms must rely on models that are composed of multiple data sets and numerous assumptions. These assumptions require judgment and as a result, can produce a wide range of valuations if any of the inputs are altered.

These models may also be susceptible to manipulation or perceived manipulation. A private equity firm may base a valuation on a model that assumes a particular growth rate or earnings estimate that is used to arrive at a discounted cash flow. Yet even a slight adjustment to these numbers could cause its value to drop by hundreds of millions of dollars.

The market and competitive situation, and resultant financial information, used to develop a valuation can change rapidly. Although GAAP calls for fair value to be based on the best available information when markets are unobservable, many uncertainties related to economic conditions or potential transactions exist. As a result, valuations that are calculated at different time periods may vary significantly from one another.

DEVELOPING A REASONABLE APPROACH

Since the financial crisis, many valuations of assets and liabilities – whether they be collateralized loans or portfolio companies – have become much more difficult to justify given revised standards, market dynamics and increased investor and regulatory scrutiny. In private equity, fair value accounting is viewed by regulators as an effective means of providing investors with a greater level of transparency into the performance of portfolio companies.

Determining fair value requires private equity firms to demonstrate that they have put a rigorous effort behind the fair value estimate they arrive at by accounting for significant uncertainties. The quality of this estimate is highly dependent on a firm's ability to support its assumptions. Such valuations require reasonable assumptions that are realistic; that is, they must be correlated to markets, competitive dynamics and other factors. It is critical that firms have well-defined processes in place to ensure that the models used in their valuations are reasonable and reflect underlying market conditions. Firms should identify and be able to support any assumptions that they make. They should give considerable thought to those assumptions made for the performance of underlying investments over the long term and should account for a portfolio company's historical and projected financial results. To the extent they exist, private equity firms should search for comparable companies to determine an appropriate valuation multiple. Regardless of the method a firm utilizes to calculate fair value, it is important to explain and justify the reasoning behind it thoroughly. Today, this is critical in minimizing the risk of potential red flags that may invite regulatory inquires and in providing a greater level of confidence to the firm's investors.

Valuations can raise questions and be subject to scrutiny by regulators or other potentially adverse parties. Because they tend to be based on firms' own models, they may create perceived conflicts of interest. Also, data provided as part of a valuation may be based on assumptions that aren't reasonable. In some cases private equity managers may be faced with litigation. For example, an investor may claim that a manager's valuations were based on the wrong assumptions. As a result, it's important that the models and assumptions that are used to calculate valuations be not only transparent but also defensible. To do so, and to avoid such questions, firms can obtain valuations from third-party experts.

RESPONDING TO AN SEC INQUIRY

In the current environment, the SEC recognizes that fair value is highly judgmental. Level 2 and Level 3 assets carry with them a significant amount of subjectivity. As a result, regulators have been concerned that valuations of assets that fall in these categories have a greater likelihood of abuse. In some instances, the SEC may want to make sure that the firm accurately represents the financial performance of its portfolio companies. If so, private equity firms may be required to produce independent valuations that support the fair values included in their financial reporting.

On these occasions, it is important for a private equity firm to be able to articulate the substance and form of those assumptions that went into its valuation. Among the questions that a firm should consider:

- Is there a reasonable basis for a fair value estimate given to a particular company?
- Is the value consistent with the market?
- Is the value consistent with any comparables that may exist?
- How will valuations be impacted by changes in the models and assumptions that are used?

CONCLUSION

There's a new level of scrutiny associated with the ways in which private equity firms value their portfolio companies. Because these investments are not easily observable and pose challenges for investors, the SEC may continue to focus its efforts on ensuring that firms provide accurate valuation information.

Certainly, private equity firms can best address their valuation concerns by doing so proactively. To do so, they should assess the process used to develop assumptions before a problem occurs. However, if faced with risk associated with misstated financial information, it is critical that firms be rigorous in their approach to modeling, documentation, and those methodologies used in their valuations. **A**

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