

FASB Statement 157: Fair Value Measurement Topics for Private Equity Firms Webcast

The session begins at 12:30 pm eastern

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Welcome

Harris Smith

Regional Managing Partner

Los Angeles



Addressing your questions

Time permitting, we will address questions in Q & A at the end of the program. Please type in your questions at any time.

The image shows two screenshots of a software interface. The left screenshot displays a presentation slide titled "Welcome" with speakers Eddie Adkins and Rick Wagner. The "Q&A" button in the bottom right is highlighted with an orange box. A yellow arrow points to the right screenshot, which shows the Q&A interface. A "Q&A" label in an orange box is positioned above the arrow. The right screenshot features a table with columns for "username", "questions", "answer", "time", and "Answered".

| username | questions | answer | time | Answered |
|-----------|------------------------|----------|--------------------|----------|
| tomcassel | Welcome to today's C | Bulletin | Tue Mar 7 13:53:02 | 0 |
| tomcassel | Welcome to today's C | Bulletin | Tue Mar 7 13:55:15 | 0 |
| tomcassel | Welcome to today's C | Bulletin | Tue Mar 7 13:59:05 | 0 |
| Cassell | if you have a question | | Tue Mar 7 14:29:56 | 0 |

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Our presenters

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Fair value measurement topics for private equity firms

Objectives

- Identify some of the issues clients will face implementing FASB Statement 157

Agenda

- Brief overview of FASB Statement 157
- Common questions

Overview of key concepts

- **Exit price** vs. entry price
- **Orderly transaction** assumes pre-measurement date exposure to market
- **Market participants** vs. "willing parties"
- Emphasizes **market-based** measurement, not an **entity specific** measurement
- Price in **principal (or most advantageous) market** from seller's perspective

Let's begin...

What is the primary purpose of the fair value hierarchy?

I believe it is to prioritize the use of observable inputs over unobservable inputs in fair value measurements

Don't get caught up in thinking that the hierarchy only relates to disclosures

Common questions

[1] 2 3 4 5 6 7 8 9 10 11 12 13

Where do you start?



Common questions

[1] 2 3 4 5 6 7 8 9 10 11 12 13

Where do you start?

- Identify assets and liabilities measured at fair value
- Identify assets and liabilities disclosed at fair value
- Determine principal (or most advantageous) market
- Prioritize use of market based inputs
- Determine hierarchy of inputs
- Classify within the hierarchy

Common questions

1 [2] 3 4 5 6 7 8 9 10 11 12 13

If an outside valuation specialist provides fair value measurement what needs to be done?



Common questions

1 [2] 3 4 5 6 7 8 9 10 11 12 13

If an outside valuation specialist provides fair value measurement what needs to be done?

- Company is responsible for amounts and disclosures in their financial statements
- Company needs to determine processes and controls over valuation
- PCAOB Staff Audit Practice Alert 2

Common questions

1 2 **[3]** 4 5 6 7 8 9 10 11 12 13

What investment securities would be Level 1?



Common questions

1 2 **[3]** 4 5 6 7 8 9 10 11 12 13

What investment securities would be Level 1?

- Identical security traded on an active market
 - Exchange traded securities
 - Stocks, bonds, futures or options traded on an exchange
 - Actively traded bonds
- Active market has sufficient frequency and volume of transactions to provide pricing

Common questions

1 2 3 [4] 5 6 7 8 9 10 11 12 13

What are some examples of investment securities that would be Level 2?



Common questions

1 2 3 [4] 5 6 7 8 9 10 11 12 13

What are some examples of investment securities that would be Level 2?

- Restricted stock of a public company
- Debt securities traded on an active market, but matrix pricing is used
- Debt securities traded on a market that is not active (few transactions and/or prices not current)
- Similar debt securities traded on a market that is not active
- Many derivatives – many inputs would be Level 1

Common questions (cont)

1 2 3 [4] 5 6 7 8 9 10 11 12 13

What type of restriction on the sale of a security might affect the fair value?

- A restriction that is specific to the security would result in an adjustment
 - **Example:** A security that is restricted under Rule 144
- A restriction that is specific to the holder would not result in an adjustment
 - **Example:** Common stock of a public company that is subject to an underwriter's lock-up agreement

Common questions (cont)

1 2 3 [4] 5 6 7 8 9 10 11 12 13

What might be the effect of such restrictions on the fair value hierarchy?

- Restricted stock of a public company likely Level 2
 - **Example:** Common stock of a public company that is restricted under Rule 144
- Restricted stock of a public company subject to Level 1
 - **Example:** Common stock of a public company that is subject to an underwriter's lock-up agreement

Common questions (cont)

1 2 3 [4] 5 6 7 8 9 10 11 12 13

What are some examples of investment securities that would be Level 2?

- Similar investment securities are traded on a market that is not active
 - Subjective judgment as to similarity of security and level of activity of similar security could render Level 3

Common questions

1 2 3 4 **[5]** 6 7 8 9 10 11 12 13

What are some examples of investment securities that would be Level 3?



Common questions

1 2 3 4 **[5]** 6 7 8 9 10 11 12 13

What are some examples of investment securities that would be Level 3?

- Somewhat similar investment securities are traded on a market that is not active
 - Amount of adjustment because only somewhat similar would render Level 3
 - Amount of adjustment because the market is inactive would render Level 3
- No similar investment securities are traded

Common questions

1 2 3 4 5 **[6]** 7 8 9 10 11 12 13

What about an investment in a portfolio company?



Common questions

1 2 3 4 5 **[6]** 7 8 9 10 11 12 13

What about an investment in a portfolio company?

- Determine principal market to sell the investment
- Consider whether a secondary market exists

Common questions (cont)

1 2 3 4 5 **[6]** 7 8 9 10 11 12 13

What about an investment in a portfolio company?

- If no market is identified consider the inputs that a hypothetical market participant would use to price the investment
 - **Market approach** – multiple of earnings or EBITDA
 - **Income approach** – discounted cash flows, option-pricing model

Common questions

1 2 3 4 5 6 **[7]** 8 9 10 11 12 13

If there has been a recent transaction involving a portfolio company (such as a subsequent round of financing or a sale by another investor), how would that be factored into valuation?

How would that be factored into the level within the hierarchy for disclosure?



Common questions

1 2 3 4 5 6 **[7]** 8 9 10 11 12 13

If there has been a recent transaction involving a portfolio company (such as a subsequent round of financing or a sale by another investor) how would that be factored into valuation?

Depending on how recent the transaction it might be given more weight given to a market approach valuation than transactions involving other entities.

Common questions (cont)

1 2 3 4 5 6 **[7]** 8 9 10 11 12 13

If there has been a transaction involving a portfolio company (such as a subsequent round of financing or a sale by another investor) how would that be factored into the level within the hierarchy for disclosure?

- The transaction price would generally not be observable
- However, if it were observable, any adjustments to transaction price (a) due to different rights and obligations in the reference securities sold compared to the subject securities held or (b) due to staleness of the transaction would be Level 3 inputs
- A Level 3 input or combination of Level 3 inputs that is significant to the overall valuation would result in the investment being Level 3

Common questions

1 2 3 4 5 6 7 **[8]** 9 10 11 12 13

If an entity holds a controlling interest in an actively traded public company, is a control premium appropriate or must the fair value be based solely on the product of the quoted price times the quantity held?



Common questions

1 2 3 4 5 6 7 **[8]** 9 10 11 12 13

If an entity holds a controlling interest in an actively traded public company, is a control premium appropriate or must the fair value be based solely on the product of the quoted price times the quantity held?

One view is that paragraph 27 of FAS 157 requires the use of the quoted price times the quantity.

Another view is that if the unit of valuation is a controlling interest the highest and best use might indicate that the principal market is a transaction with a strategic buyer that would potentially pay a premium for the benefits associated with controlling the entity.

Common questions

1 2 3 4 5 6 7 8 **[9]** 10 11 12 13

Should transaction costs incurred in the purchase of an investment now be expensed based on FAS 157?



Common questions

1 2 3 4 5 6 7 8 **[9]** 10 11 12 13

Should transaction costs incurred in the purchase of an investment now be expensed based on FAS 157?

We do not believe that transaction costs should be expensed. Paragraph 2.41 of the Investment Company Audit Guide indicates that transaction costs are an element of the cost of the investment.

However, these costs do not represent an element of fair value and thus would generally result in an unrealized loss when marking to fair value on day one.

Common questions

1 2 3 4 5 6 7 8 9 **[10]** 11 12 13

Is an investment in a real estate partnership eligible for the deferral of FAS 157 for nonfinancial items?



Common questions

1 2 3 4 5 6 7 8 9 **[10]** 11 12 13

Is an investment in a real estate partnership eligible for the deferral of FAS 157 for nonfinancial items?

No, an investment in a partnership or other entity that owns real estate would not be eligible for the deferral in FSP FAS 157-2.

Common questions

1 2 3 4 5 6 7 8 9 10 [11] 12 13

What about limited partner investments in funds?



Common questions

1 2 3 4 5 6 7 8 9 10 [11] 12 13

What about limited partner investments in funds?

- Determine principal market to sell the investment
- Consider whether a secondary market exists
- If no market is identified consider the inputs that a hypothetical market participant would use to price the limited partner investment
 - Are restrictions an attribute of the security or the holder?
 - Consider transfer restrictions and redemption provisions

Common questions

1 2 3 4 5 6 7 8 9 10 11 **[12]** 13

What about a limited partner investment in a private equity fund?



Common questions

1 2 3 4 5 6 7 8 9 10 11 **[12]** 13

What about a limited partner investment in a private equity fund?

- Is there a secondary market, even if not at all active?
- Information about transactions in a secondary market would be considered
- What can be said about transactions in secondary markets?
 - Are transaction prices at NAV, at a discount to NAV, or at a premium to NAV?
 - What factors about the limited partnership investment influence the amount of premium or discount from NAV?

Common questions

1 2 3 4 5 6 7 8 9 10 11 12 [13]

What about a limited partner investment in a hedge fund?



Common questions

1 2 3 4 5 6 7 8 9 10 11 12 [13]

What about a limited partner investment in a hedge fund?

- Is there a secondary market, even if not at all active?
 - Information about transactions in a secondary market would be considered
- If no market is identified consider the inputs that a hypothetical market participant would use to price the limited partner investment
 - Are redemptions subject to a lock-up period? Is it an attribute of the security or the holder?
 - Are redemptions and subscriptions at NAV? How frequent?

Any final questions?

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Thank you

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