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CFOs’ plea to FASB

Why the PEGCC’s and NVCA’s recent endorsement of private equity valuation standards is really about an excruciating audit season.

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One of the major untold stories in the alternative investment industry right now is just how dissatisfied chief financial officers have been with auditors’ interpretation of Topic 820, the US accounting standard formerly known as FAS-157 that guides fair value estimates of portfolio companies.

Chief financial officers must use a number of market assumptions to calculate the fair value of an asset. For private equity and venture capital firms this entails relying on “unobservable inputs” that can make valuing illiquid private securities more art than science.

But with limited guidance to go on, auditors seem to be struggling with how fair value measurements should be judged, and are looking for approaches that provide a “by the book” feel in order to avoid scorn from the Public Company Accounting Oversight Board. Additional oversight from the Securities and Exchange Commission (which a large portion of the industry was first subjected to just last year) has intensified pressure for auditors to find a workable approach to fair value audits.

Unfortunately the approach auditors are developing does not jive with industry practice, sources tell *PE Manager*. Preparers of financial statements would like to report what price a hypothetical independent buyer would pay for an asset using market participant assumptions. To fact check their assumptions, auditors are asking GPs to additionally generate complex option pricing models, include complicated graphs in the footnotes detailing when an asset moved within a “fair value hierarchy” of judgment, and more generally “a bunch of variables to plug in to a bunch of formulas that nobody uses for transacting business”, as one CFO puts it. More data and calculations, the thinking goes, allows auditors to show their overseers that GPs were tested, regardless of how useful those tests really were.

There’s a hope that valuation guidelines published by the industry, for the industry, can help mitigate the issue. Industry trade bodies have rallied around valuation standards published by the International Private Equity and Venture Capital Valuation board (IPEV), which could provide auditors a blueprint when testing fair value estimates.

According to market sources, that's part of the reason why the Private Equity Growth Capital Council (PEGCC) and the National Venture Capital Association (NVCA) threw their weight behind IPEV’s guidelines. Historically these trade bodies (which have their roots in lobbying) did not address valuation standards. But with auditors ratcheting up pressure in a way that is taking its toll on members, the PEGCC and NVCA felt compelled to formally endorse IPEV standards.

Some in the industry have brought the problem of fair value audits to the attention of the Financial Accounting Standards Board (FASB), the board responsible for setting US accounting standards.

> **“I don’t think it’s FASB’s fault, but it’s FASB’s responsibility to try and fix things”**

Stephen Holmes, chief operating officer of venture capital firm InterWest Partners and winner of the 2013 PE Manager Leadership Award, warned members of the FASB that the board faced reputational risk because of how Topic 820 is being implemented.

“I don’t think it’s FASB’s fault, but it’s FASB’s responsibility to try and fix things,” he said during a board meeting made public via video.

The good news is that FASB is alive to the issue. A spokesperson for the group said US accounting standard setters are in the process of a “post-implementation review” of Topic 820 which began recently. CFOs will be hoping that review includes clearer instructions for auditors to rely on market participant assumptions when auditing fair value estimates.

Unfortunately based on history, such reviews typically take about a year to complete, meaning next year’s audit season may be just as grueling.