
Fair Value from an Investor
(Limited Partner) Perspective
Impact of ASC 820 (SFAS 157)

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Presented by:

Keith J. Keller
Managing Director
Duff & Phelps
keith.keller@duffandphelps.com
678-642-4356

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Contents

Section 1	Fair Value
Section 2	Overview of ASU 2009-12 “Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)”
Section 3	AICPA TPA (TIS 2220 Long-Term investments)
Section 4	Implications of the TPA for LPs and GPs
Section 5	Other Audit Issues
Section 6	IPEV Guidelines
Section 7	ILPA Guidelines

Section 1

Fair Value

Fair Value Defined

FASB ASC 820 definition of Fair Value:

“Fair value 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.”

How is Fair Value applied for:

- an LP interest in an alternative investment fund
- an LP interest in a fund of alternative investment funds
- a Fund of Fund interest in a Fund
- a Fund interest in an underlying portfolio company

Management Responsibilities

Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.

(AU 328 paragraph 4)

- Applies to GPs for Fund Financial Statements
- Applies to LPs for LP Financial Statements

Section 2

Overview of ASU 2009-12

ASU No. 2009-12: Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

Timeline

- Accounting Standards Update (“ASU”) 2009-12 (“the Update”) was released on September 30, 2009.
- The update is effective for periods ending after December 15, 2009.

Scope

- The Update provides a practical expedient for determining the fair value of an interest in an alternative investment fund if three conditions are met.

Disclosure

- Significant additional disclosure is required (aggregated by major security type) for all interests in alternative investments reported at fair value, even if NAV is not used to estimate fair value.

Conditions Required to use NAV

Applicable for investments required or permitted to be recorded or disclosed at fair value including interests in Fund-of-Funds, Hedge Funds, Real Estate Funds, Private Equity Funds (Buyout, Venture Capital, Mezzanine Debt) etc., which are not actively traded if the following conditions are met:

- The fund meets the definition of an investment company as contained in the Investment Companies Guide (AICPA Audit and Accounting Guide, Investment Companies) (Topic 946).
- Net Asset Value (“NAV”) has been calculated in accordance with Topic 946 (e.g., NAV is derived based on valuing underlying investments at fair value consistent with Topic 820 (FAS 157)).
- NAV is as of the same date as the investors measurement date (e.g., no reporting lag).

Section 3

AICPA TPA (TIS 2220 Long-Term investments)

Use of NAV: Historical Background

- **Prior to 2007 (before application of SFAS 157):** NAV routinely used by investors to estimate the fair value of an interest in an alternative investment fund.
- **July 2007:** FASB's Valuation Resource Group discusses the question as to whether or not NAV is considered Fair Value in the context of SFAS 157 Fair Value Measurements. FASB Staff responds "Not necessarily" but provides no further guidance
- **2008 – January 2009:** The AICPA formed a taskforce to address the question of NAV and Fair value. A draft issues paper FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments, was released for comment in early 2009.
- **February 2009:** FASB's VRG again discusses the NAV / Fair Value Question.
- **June 2009:** FASB issued its proposed FSP FAS 157-g, "Estimating the Fair Value of Investments in Investment Companies That Have Calculated Net Asset Value per Share in Accordance with the AICPA Audit and Accounting Guide, Investment Companies".
- **Summer 2009-September 2009:** FASB issued its exposure draft on using NAV to value interests in alternative investments, culminating with the issuance of ASU 2009-12 "Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)" in September 2009.
- **December 2009:** The AICPA released TIS (Technical Information Service) Section 2220 Long-Term Investments, to assist reporting entities in implementing the provisions outlined in FASB ASC 820, Fair Value Measurements and Disclosures. More specifically, the TPA (Technical Practice Aid) aims to assist those reporting entities attempting to estimate fair value of their investments by utilizing NAV.
- The Technical Practice Aid answers 10 questions related to estimating and disclosing the fair value if interests in alternative assets. The TPA can be accessed at the following link: TIS Section 2220 – Long-Term Investments

AICPA TIS 2220 Inquiries

- **.18 Applicability of Practical Expedient:** Which investments are permitted, as a practical expedient, to be measured at fair value on the basis of the net asset value (NAV)?
- **.19 Unit of Account:** How should the unit of account be identified for an interest in an alternative investment?
- **.20 Determining Whether NAV is Calculated Consistent with FASB ASC 946, Financial Services – Investment Companies:** How does a reporting entity conclude that the NAV, as most recently reported by the manager of the alternative investment (reported NAV), has been calculated in a manner consistent with the measurement principles of FASB ASC 946, Financial Services – Investment Companies?
- **.21 Determining Whether an Adjustment to NAV is necessary:** How does a reporting entity determine whether an adjustment to the last reported NAV is necessary?
- **.22 Adjusting NAV When It is Not as of the Reporting Entity's Measurement Date:** If the reporting entity concludes that the reported NAV is calculated consistently with FASB ASC 946, but an adjustment is necessary because the NAV is not as of the reporting entity's measurement date, how should the reporting entity estimate the adjustment?

AICPA TIS 2220 Inquiries (continued)

- **.23 Adjusting NAV When It Is Not Calculated Consistent with FASB ASC 946:** If the reporting entity concludes that an adjustment is necessary because a reported NAV is not calculated consistently with the measurement principles of FASB ASC 946, how does a reporting entity estimate the adjustment?
- **.24 Disclosures-Ability to Redeem Versus Actual Redemption Request:** In order to classify the investment as level 2, must the investor have submitted a previous redemption request effective as of the measurement date or is it sufficient for an investor to have had the ability to redeem on the measurement date, even though it may not have exercised this ability?
- **.25 Impact of “Near Term” on Classification Within Fair Value Hierarchy:** What is considered “near term” for purposes of determining whether the investment would be classified as level 2 or level 3?
- **.26 Categorization of Investments for Disclosure Purposes:** Should these reporting entities use a different categorization than that appearing in the sample disclosure?
- **.27 Determining Fair Value of Investments When the Practical Expedient is not Used or is not Available:** For entities that do not elect to use NAV as a practical expedient to estimate fair value or are unable to adjust the most recently reported NAV to estimate a NAV that is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity’s measurement date, what inputs or investment features should be considered in estimating fair value?

.18 Applicability of Practical Expedient

Inquiry: Which investments are permitted, as a practical expedient, to be measured at fair value on the basis of the net asset value (NAV)?

- FASB ASC 820-10-35-59 permits reporting entities, as a practical expedient, to estimate the fair value of their investments in certain entities that calculate NAV per share (or its equivalent) by using NAV if the interest is not actively traded.
- Such investments, (alternative investments), include interests in:
 - Hedge Funds,
 - Real Estate Funds,
 - Private Equity Funds (Buyout, Venture Capital, Mezzanine Debt) etc., which are not actively traded if the following conditions are met:
 - Commodity Funds
 - Offshore fund vehicles, and
 - Fund of Funds
- Generally, Investment Companies (including Fund of Funds), Pension Funds, Endowments and certain other investors use the fair value framework to report interests in alternative assets.

ASU 2009-12: Exceptions to use of NAV

- An investment with a readily determinable fair value is not allowed to be valued using NAV.
- A reporting entity is not permitted to estimate the fair value of an investment using NAV if it is probable that the entity will sell the investment (or a portion of the investment) for an amount other than the NAV. A sale is considered probable if all of the following criteria have been met:
 - Management commits to a plan to sell the investment.
 - An active program to locate a buyer and other actions required to complete the plan to sell the investment have been initiated.
 - The investment is available for immediate sale subject only to usual and customary terms.
 - Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or the plan will be withdrawn.

.19 Unit of Account

Inquiry: According to the FASB ASC glossary, the unit of account is “[t]hat which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated).” How should the unit of account be identified for an interest in an alternative investment?

- For interests in alternative investments, the appropriate unit of account is the interest in the investee fund itself, not the underlying investments within the investee fund; this is because the reporting entity owns an undivided interest in the whole of the investee fund portfolio and typically lacks the ability to dispose of individual assets and liabilities in the investee fund portfolio.
- As discussed in FASB ASC 820-10-35-61, if it is probable at the measurement date that a reporting entity will sell a portion of an investment at an amount different from NAV, and the criteria described in FASB ASC 820-10-35-62 are met, the portion that the reporting entity intends to sell is valued in accordance with other provisions of FASB ASC 820, Fair Value Measurements and Disclosures.
- The remaining portion of the interest that is not probable of being sold may be valued by using NAV as a practical expedient in accordance with FASB ASC 820-10-35-59.

.20 Determining whether NAV is calculated consistent with FASB ASC 946

FASB ASC 820-10-35-59 states: A reporting entity is permitted, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.

Inquiry: How does a reporting entity conclude that the NAV, as most recently reported by the manager of the alternative investment (reported NAV), has been calculated in a manner consistent with the measurement principles of FASB ASC 946, Financial Services – Investment Companies?

- A reporting entity's management is responsible for the valuation assertions in its own financial statements (slide 9).
- Determining that reported NAV is calculated consistently with FASB ASC 946 (e.g. that the underlying investments are fair value based (consistent with FASB ASC 820)) requires a reporting entity to independently evaluate the fair value measurement process utilized by the fund manager to calculate NAV.

.20 Determining whether NAV is calculated consistent with FASB ASC 946 (continued)

- Such an evaluation is a matter of professional judgment and includes determining that the investee fund manager has an effective process and related internal controls in place to estimate the fair value of its investments that are included in the calculation of NAV.
- The reporting entity's controls used to evaluate the process of the fund manager may include the following:
 1. Initial due diligence (procedures performed before the initial investment).
 2. Ongoing monitoring (procedures performed after the initial investment).
 3. Financial reporting controls (procedures related to the accounting for, and reporting of, the investment) (See also AICPA practice aid [Alternative Investments—Audit Considerations](#)).
- Before concluding that the reported NAV is calculated in a manner consistent with FASB ASC 946 (e.g. is fair value based), the reporting entity evaluates the evidence gathered via the initial due diligence and ongoing monitoring of the investee fund.

.20 Determining whether NAV is calculated consistent with FASB ASC 946 (continued)

- The reporting entity also may consider the following key factors relating the valuation received from the investee fund manager:
- The investee fund's fair value estimation processes and control environment, and any changes to those processes or the control environment
- The investee fund's policies and procedures for estimating fair value of underlying investments, and any changes to those policies or procedures
- The use of independent third party valuation experts to augment and validate the investee fund's procedures for estimating fair value
- The portion of the underlying securities held by the investee fund that are traded on active markets
- The professional reputation and standing of the investee fund's auditor (this is not intended to suggest that the auditor is an element of the investee fund's internal control system, but as a general risk factor in evaluating the integrity of the data obtained from the investee fund manager)
- Qualifications, if any, of the auditor's report on the investee fund's financial statements
- Whether there is a history of significant adjustments to the NAV reported by the investee fund manager as a result of the annual financial statement audit or otherwise
- Findings in the investee fund's advisor or administrator's SAS 70 report, if any
- Whether NAV has been appropriately adjusted for items such as carried interest and clawbacks (more fully described in paragraph .29 of Technical Question and Answer [TIS] section 6910, "Investment Companies" [AICPA, Technical Practice Aids])
- Comparison of historical realizations to last reported fair value

.21 Determining Whether an Adjustment to NAV is necessary

Inquiry: How does a reporting entity determine whether an adjustment to the last reported NAV is necessary?

- FASB ASC Paragraph 820-10-35-60 allows the reporting entity to estimate fair value using reported NAV when the following requirements have been fulfilled:
 - (i) NAV has been calculated consistently with FASB ASC 946 and
 - (ii) NAV has been calculated as of the reporting entity's measurement date.
- Examples of when an adjustment to the last reported NAV may be necessary include, but are not limited to:
 - NAV is not as of the reporting entity's measurement date; or
 - NAV is not calculated in a manner consistent with the measurement principles of FASB ASC 946 (which requires, among other things, measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820);
 - Or both.
- The existence of either of these factors may lead the reporting entity to conclude that an adjustment to the last reported NAV may be necessary. Practically, it is difficult to assess whether an adjustment is necessary unless an estimate of the adjustment is calculated.

.22 Adjusting NAV When It is Not as of the Reporting Entity's Measurement Date

Inquiry: If the reporting entity concludes that the reported NAV is calculated consistently with FASB ASC 946, but an adjustment is necessary because the NAV is not as of the reporting entity's measurement date, how should the reporting entity estimate the adjustment?

- FASB ASC 820-10-35-60 states that “The objective of any adjustment is to estimate a net asset value per share for the investment that is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date.”
- If the last reported NAV is calculated consistently with FASB ASC 946 but is not as of the reporting entity's measurement date, the reporting entity may request the investee fund manager to provide a supplemental NAV calculation consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, or it may be necessary to adjust or roll forward/roll back the reported NAV for factors that might cause it to differ from the NAV at the measurement date.

.22 Adjusting NAV When It is Not as of the Reporting Entity's Measurement Date (continued)

- The following factors might necessitate an adjustment to reported NAV when it is not calculated as of the reporting entity's measurement date:
 - The reporting entity has made additional investments since the calculation date of the reported NAV and prior to the reporting entity's measurement date,
 - The reporting entity has received distributions or partial redemption since the calculation date of the reported NAV,
 - The reporting entity has become aware of changes in the value of underlying investments since the calculation date of the reported NAV,
 - Market changes/economic conditions have changed to affect the value of the investee's portfolio after the calculation date of the reported NAV,
 - Changes have occurred in the composition of the underlying investment portfolio of the investee fund after the NAV calculation date.

.22 Adjusting NAV When It is Not as of the Reporting Entity's Measurement Date (continued)

The roll forward NAV might be calculated as follows:

Last Reported NAV (calculated consistently with FASB ASC 946)	\$	X,XXX
Add capital contributions/subscriptions		C,CCC
Subtract distributions/redemptions/withdrawals		(D,DDD)
Adjust for changes in valuations ^(a)		<u>V,VVV</u>
Roll forward NAV (as of the reporting entity's measurement date)	\$	R,RRR

(a) Market changes refer to market fluctuations between the date of the reported NAV and the reporting entity's measurement date. Examples of other economic conditions for which it may be necessary to adjust a reported NAV include, but are not limited to, a portfolio company being acquired, going public, or declaring bankruptcy between the date of the reported NAV and the reporting entity's measurement date, or changes in the value of underlying investments caused by company performance or market conditions, or both.

.23 Adjusting NAV When It Is Not Calculated Consistent with FASB ASC 946

Inquiry: If the reporting entity concludes that an adjustment is necessary because a reported NAV is not calculated consistently with the measurement principles of FASB ASC 946, how does a reporting entity estimate the adjustment?

- Although it is not possible to state all the reasons why a reported NAV may not be consistent with the measurement principles of FASB ASC 946, the reporting entity would need to consider and understand the following:
 - The reasons why NAV has not been based upon fair value.
 - Whether a fair value based NAV can be obtained from the investee manager.
 - Whether the specific data needed to adjust the reported NAV can be obtained and properly utilized to estimate a fair value based NAV. Examples of circumstances in which the reporting entity may be able to obtain data to estimate an adjustment include:
 - » Reported NAV is on a cash basis.
 - » Reported NAV utilizes blockage discounts taken on securities valued using level 1 inputs, which is not consistent with FASB ASC 820.
 - » Reported NAV has not been adjusted for the impact of unrealized carried interest or incentive fees.

.24 Disclosures – Ability to Redeem Versus Actual Redemption Request

FASB ASC 820-10-35-58(c) states: “If a reporting entity cannot redeem its investment with the investee at net asset value per share (or its equivalent) at the measurement date but the investment may be redeemable with the investee at a future date (for example, investments subject to a lockup or gate or investments whose redemption period does not coincide with the measurement date), the reporting entity shall consider the length of time until the investment will become redeemable in determining whether the fair value measurement of the investment shall be categorized as a Level 2 or a Level 3 fair value measurement. For example, if the reporting entity does not know when it will have the ability to redeem the investment or it does not have the ability to redeem the investment in the near term at net asset value per share (or its equivalent), the fair value measurement of the investment shall be categorized as a Level 3 fair value measurement.”

Inquiry: In most cases, redemptions from alternative investment funds that redeem at NAV are only permitted with advance notice, ranging from 30 to 120 days. In order to classify the investment as Level 2, must the investor have submitted a previous redemption request effective as of the measurement date or is it sufficient for an investor to have had the ability to redeem on the measurement date, even though it may not have exercised this ability?

- Determining the appropriate level within the fair value hierarchy is a matter of professional judgment. Even if a redemption notice has not been submitted at the measurement date, as long as the reporting entity has the ability to redeem in the near term at NAV, the investment may be classified as level 2.

.25 Impact of “Near Term” on Classification within Fair Value Hierarchy

Inquiry: What is considered “near term” for purposes of determining whether the investment would be classified as Level 2 or Level 3?

- Classification within fair value hierarchy requires judgment, considering attributes specific to the investment:
 - If an investor has the ability to redeem its investment at NAV on the measurement date (a redemption period of 90 days or less is generally considered near term), the investment should be categorized as Level 2 fair value measure (e.g., most Hedge Funds without restrictions).
 - If an investor will never have the ability to redeem its investment at NAV, the investment must be categorized as Level 3 (e.g., most Private Equity and Real Estate funds).
 - A redemption period of 90 days or less generally would be considered near term, because any potential discount relative to the time value of money to the next redemption date would be unlikely to be considered significant.

.26 Categorization of Investments for Disclosure Purposes

Inquiry: The sample disclosure provided in FASB ASC 820-10-55-64A appears to apply to an institutional investor with a diversified portfolio of hedge, private equity, and real estate funds. Certain entities, however, specialize in one particular investment category or have a significant investment in one such category, such as private equity or venture capital. Should these reporting entities use a different categorization than that appearing in the sample disclosure?

- FASB ASC 820-10-55-64A indicates that “the major categories presented.....are provided as examples only and are not intended to be treated as a template. The major categories disclosed should be tailored to the nature and risks of the reporting entity’s investments.”
- The disclosure should be tailored to address the concentrations of risk that are specifically attributable to the investments. For example, a private equity fund of funds should not simply categorize its investments as “private equity” as this categorization is not specific enough to address the nature and risks of the investee funds.
- More specific categorization, perhaps relating to industry, geography, vintage, year or strategy (venture, buyout, mezzanine, etc) may be more appropriate and more use to the reader. Such categorization is a matter of judgment.

.27 Determining Fair Value of Investments When the Practical Expedient is not Used or is not Available

Inquiry: For entities that do not elect to use NAV as a practical expedient to estimate fair value or are unable to adjust the most recently reported NAV to estimate a NAV that is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, what inputs or investment features should be considered in estimating fair value?

- If the reporting entity chooses not to estimate fair value using NAV or cannot estimate fair value Using NAV, then fair value could be estimated using an alternative method such as:
 1. Estimating and modeling all future cash flows and discounting at an appropriate rate.
 2. Estimating the fair value of an interest in a Fund based on transparent observable secondary market transaction data applying the concepts of Topic 820.
 3. Identifying a similar fund or funds and using it as a proxy for the value of the fund being valued. (Highly unlikely that sufficient correlation would exist, but conceptually possible).

.27 Determining Fair Value of Investments When the Practical Expedient is not Used or is not Available (continued)

- Consideration should be given to:
 - Investments with redeemable interests
 - Investments with non redeemable interests
- Further the following should be evaluated in making the fair value assessment:
 - Investment Inputs such as NAV, overall market conditions, transactions in brokered markets, features of the alternative investment, discounted future cash flows and factors used to determine whether there has been a decrease in the volume and level of activity for the asset when compared with normal market activity for the asset.
 - Investment Features such as initial due diligence features (i.e. lock-up period and redemption fees, notice periods, holdbacks, suspension of redemptions, lack of redemption options, fund sponsor approval to transfer, use of “side pockets”) and ongoing monitoring features (i.e. imposition of a gate, redemptions from an investee fund, notification of redemption, significant changes in key terms of the investee fund, closure of fund to new subscriptions, ability of fund to identify and make acceptable investments, allegations of fraud against the investee fund manager, change in financial strength or key personnel of investment manager).

Section 4

Implications of AICPA TIS 2220, Long-term Investments

Implications of TIS 2220, Long-Term Investments

- The guidance provided in the AICPA Technical Guidance clarifies that an investor reporting under ASU 2009-12 cannot blindly accept NAV reported by the Fund without independently evaluating the fair value measurement process utilized by the investee fund manager.
- GPs that utilize a more rigorous fair value estimating process, and who report timely, may limit the amount of independent work that the LP finds it necessary to perform.
- Therefore, ASU 2009-12 and the TPA, indirectly, may result in LPs being more likely to invest with GPs who report NAV based on rigorous, timely, fair value estimates.
- LPs unfamiliar with ASU 2009-12 and the AICPA TPA may have difficulties with their auditors as a result of not demonstrating rigor in their policies, processes and procedures for estimating fair value.
- Greater pressure on LPs from their auditors, will likely result in more adhoc requests for data and information from GPs.

Section 5

Other Audit Issues

Other Audit Issues

2006 AICPA TPA: Alternative Investments – Audit Considerations

- Addresses challenges associated with auditing investments for which a readily determinable fair value does not exist (i.e. an investment is not publicly traded or quoted market prices are not readily available)
- These investments include private investment funds that meet the definition of an investment company under the provisions of the AICPA Audit and Accounting Guide, Investment Companies (i.e. hedge funds, private equity funds, real estate funds, fund of funds, etc). These types of investment funds are referred to as “alternative investments”.
- Topics addressed in the TPA include:
 - **Existence Assertion** – Whether alternative investments & recorded transactions exist at a given date
 - **Valuation Assertion** – Whether alternative investments are reflected in the investor entity’s financial statements at appropriate amounts
 - » Investor Management’s Responsibility – Understanding the process used by management in developing its fair value estimates
 - » Auditor’s Approach – Assessing the risk of material misstatement of the financial statements
 - » Obtaining an Understanding of Internal Controls
 - » Fair Value Method of Accounting – Obtaining audit evidence related to management’s estimate of fair value of the investment, especially if dealing with a complex/illiquid investment
 - » Cost Method of Accounting – Auditing the valuation assertion of alternative investments that are accounted for using the cost method
 - » Equity Method of Accounting – Obtaining audit evidence in support of the investee’s financial results
 - **Management Representations**
 - **Disclosure of certain significant risks and uncertainties**

Other Audit Issues (continued)

- **Defining Enterprise Value**

- Market Approach – Uses observable prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities
- Income Approach – Converts cash flow or earnings to a single present amount (discounted). Value indicated by current market expectations about future amounts
- Do you use both approaches?

- **Allocating Enterprise Value**

- Waterfall Approach
- Is fair value at a discount or premium to par?
- Black-Scholes Model for options, warrants, convertible debt

Section 6

IPEV Guidelines

IPEV Guidelines Help GPs and LPs Achieve ILPA Principles and Comply with Accounting Requirements

- The IPEV Guidelines provide a framework for valuation best practices that fund managers may utilize when reporting the fair value of investments held by their fund.
- The IPEV Guidelines cover:
 - The Concept of Fair Value
 - Principles of Valuation
 - Valuation Methodologies and the Selection of Appropriate Methods
 - The Valuation of Fund Interests
 - LP Valuation if non-US GAAP basis of accounting
- EVCA/IPEV/ILPA/PEIGG Reporting Guidelines
(to be determined)

Overview

The IPEV Guidelines consist of two main sections:

- **Section I: Determining Fair Value**

- Detailed discussion of the overall concept and definition of fair value as well as additional discussion related to the different valuation methodologies associated with determining fair value.
- This section is comprised of four main parts: (i) The Concept of Fair Value, (ii) Principles of Valuation, (iii) Valuation Methodologies and (iv) Valuing Fund Interests.

- **Section II: Application Guidance**

- This section further elaborates the methodologies discussed in Section I by applying those methodologies and principles to specific cases.

Section I: Determining Fair Value

I. Concept of Fair Value

- Objective: To estimate the Fair Value at which Market Participants would agree to transact at the Reporting Date.
- The guidelines further discuss the primary basis for determining Fair Value related to Quoted and Unquoted Instruments.

II. Principles of Valuation

- Objective: To determine the appropriate valuation methodologies for estimating Fair Value in the absence of an active market and determining a Fair Value comparable to what parties in an arm's-length transaction would make at the Reporting Date.
- Fair Value is estimated by the Valuer by (i) adjusting Enterprise Value for surplus assets, excess liabilities and other contingencies to arrive at an Adjusted Enterprise Value; (ii) Deducting the amount that would be paid in a liquidation scenario and accounting for investments that may dilute the Fund's investment to arrive at the Attributable Enterprise Value; (iii) Allocating the Attributable Enterprise Value between the Company's financial instruments (based on ranking) and (iv) Allocating these amounts according to the Fund's holding in each instrument, representing their Fair Value.
- The guidelines further discuss the uncertainties involved in estimating Fair Value and the correct way to allocate Attributable Enterprise Value between a Company's financial instruments.

Section I: Determining Fair Value (continued)

III. Valuation Methodologies

- Objective: To delve deeper into specific valuation methodologies than can be utilized to estimate the Fair Value of unquoted instruments.
- Commonly used methodologies include (i) price of recent investment, (ii) multiples, (iii) net assets, (iv) discounted cash flows or earnings of the underlying business, (v) discounted cash flows from the investment, (vi) industry valuation benchmarks and (vii) available market prices.
- The guidelines further discuss each of the above methodologies and provide direction on (i) how to derive Fair Value when using each methodology, (ii) which methodology should be utilized and (iii) advantages and disadvantages related to each of the above valuation methodologies.

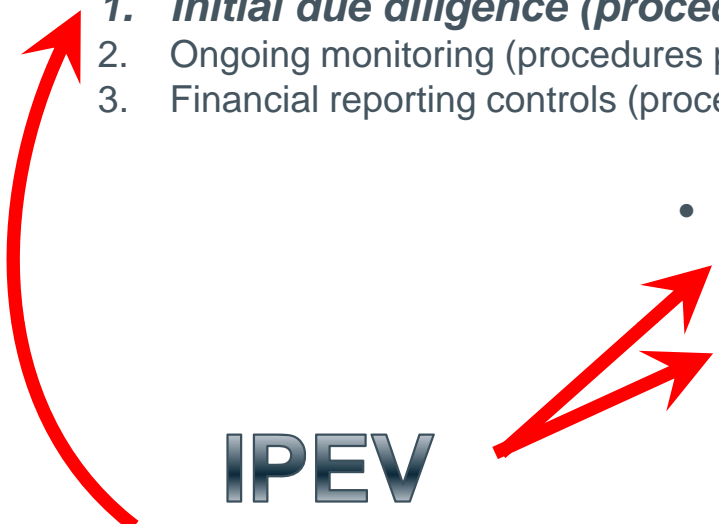
IV. Valuing Fund Interests

- Objective: To provide guidance on determining the reported fund Net Asset Value to determine the Fair Value of an interest in a fund.
- The guidelines further discuss factors that would result in an adjusted Net Asset Value as well as the role of secondary transactions in determining Fair Value.

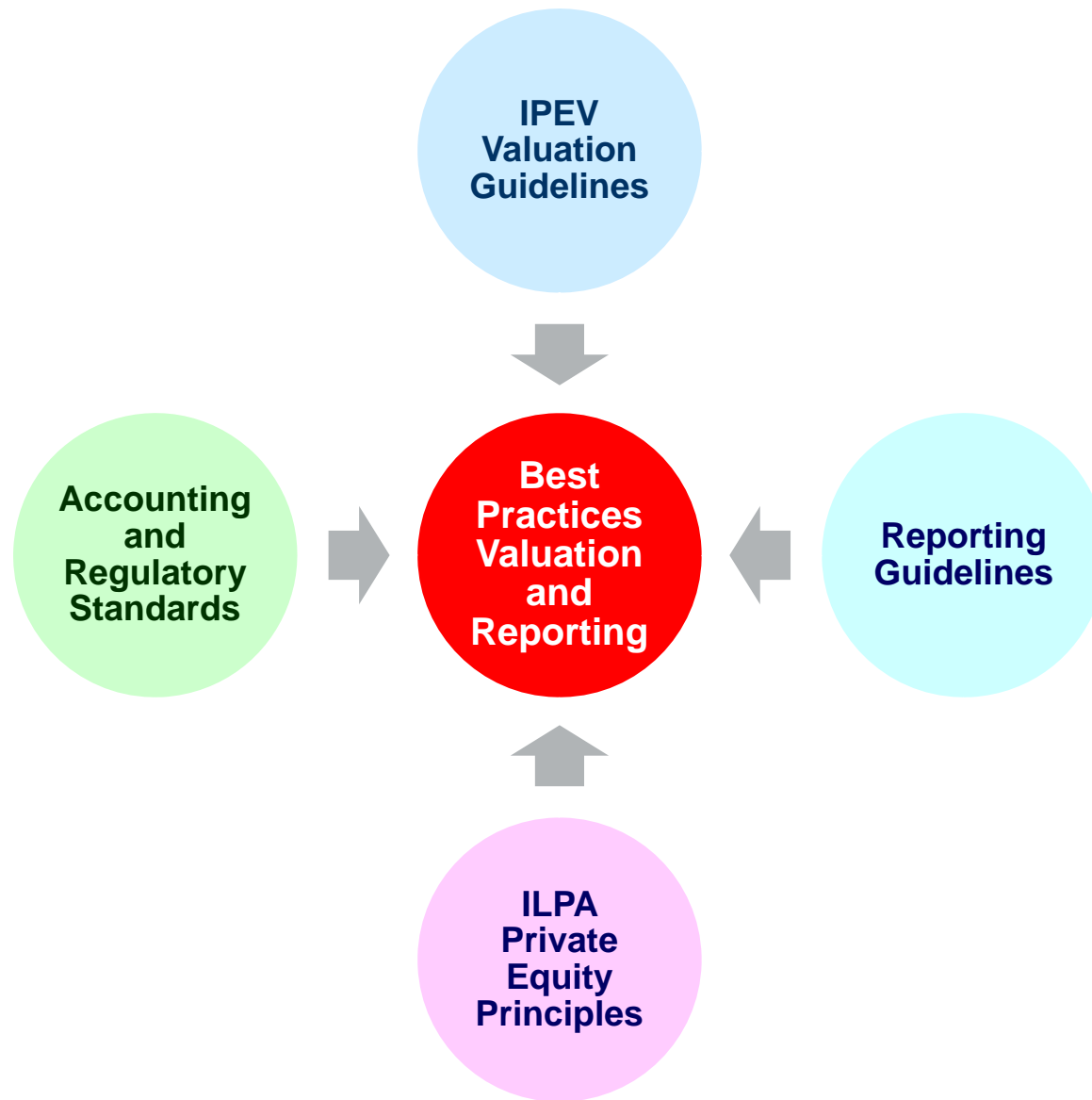
Section II: Application Guidance

- Objective: This section aims to provide guidance on the application of the principles and methodologies described in Section I to specific cases.
- Specific considerations discussed within Section II include (i) Insider Funding Rounds, (ii) Distressed Markets, (iii) Deducting Higher Ranking Instruments, (iv) Bridge Financing, (v) Mezzanine Loans, (vi) Rolled up Loan Interest, (vii) Indicative Offers and (viii) Impacts from Structuring .

How do LPs Determine that NAV is Usable?

- Considerations for qualifying Fund Managers' reported NAV include:
 1. *Initial due diligence (procedures performed before the initial investment).*
 2. Ongoing monitoring (procedures performed after the initial investment).
 3. Financial reporting controls (procedures related to the accounting for, and reporting of, the investment).
 - Additionally, consideration should be given to:
 - *The fund's fair value estimation **processes and control environment**, and any periodic changes*
 - *The fund's **policies and procedures** for estimating fair value*
 - Use of **independent third party** valuation experts to augment and validate the investee fund's procedures for estimating fair value
 - Portion of the underlying securities that are actively traded
 - Professional **reputation** and standing of the investee fund's auditor (this is not intended to suggest that the auditor is an element of the investee fund's internal control system, but may reflect a general risk factor in evaluating the integrity of data obtained from the fund)
 - Qualifications, if any, of the **auditor's report** in the fund's financial statements
 - Whether there is a **history** of significant adjustments to the NAV reported by the fund manager as a result of the annual financial statement audit or otherwise
 - Findings in the investee fund's advisor or administrator's SAS 70 report, if any
- 
- IPEV
Guidelines
Provide
Consistency**

Why Do I Care About the IPEV Guidelines?



Section 7

ILPA Guidelines

Overview

- The ILPA (Institutional Limited Partners Association) guidelines consist of three sections: (i) Best Practices in Private Equity Partnerships, (ii) Appendix A Private Equity Preferred Terms and (iii) Appendix B Limited Partner Advisory Committee. The goal of the principles is to restore and strengthen the basic alignment of interests in the private equity industry as well as strengthen the asset class as an institutional investment strategy.
- The principles outline “best practices” in private equity partnerships; ie: the alignment of interests, governance and transparency.

Institutional Limited Partners Association (“ILPA”) Private Equity Principles

ILPA established these principles to “restore and strengthen the basic ‘alignment of interests’ value proposition in private equity”. The guidelines cover three primary areas of best practice for private equity partnerships.

- **Alignment of Interests**
- **Governance**
 - Limited Partner Advisory Committee meeting processes and procedures should be adopted and standardized across the industry to allow this sub-body of the limited partners to effectively serve its role.
- **Transparency**
 - Detailed valuation and financial information related to the portfolio companies should be made available on a quarterly basis
 - Investors in private equity funds should have greater transparency as requested with respect to relevant information pertaining to the general partner

Key Provisions

- **Waterfall Structure:** The LP's capital contribution plus preferred return should be paid first, before any distributions are made to the GP's carried interest. Carry on recapitalizations should be paid only when the full amount of LP capital is returned on the recapitalized investment.
- **Calculation of Carried Interest:** Carried interest should be calculated on net profits, not gross profits. Furthermore, carried interest should not be paid on current income and should be calculated only on an after-tax basis.
- **Claw back:** Claw back liabilities should be determined and reported periodically and should be paid within 2 years.
- **Management Fee Structure:** Management fees should be based on reasonable operating expenses and reasonable salaries, so that fees are not excessive. Management fees should reduce upon formation of follow-on fund and at the end of the investment period. The management fee should be used to pay all normal operating costs of the GP, including interactions with the LPs. The LPs should have the power to review the partnership expenses annually and placement agent fees should be paid by the GP.
- The Principles also include suggested changes to the fiduciary duty requirements of the GP. For example, provisions of fund documents that disclaim or reduce fiduciary duties should be eliminated.