



**The Government Accounting Standards Board
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RE: Project No. 26-5E --Exposure Draft Fair Value Measurement and Application

The International Private Equity and Venture Capital Valuation Board (IPEV Board) appreciates and welcomes the opportunity to respond to the Board's Exposure Draft. There is great importance for the private equity investment community, especially governments that invest in private equity, to be able to obtain and rely on consistently determined fair value estimates. Fair Value Measurement is a subject area where preparers, users, auditors and valuers face challenges in both estimating and understanding true measures of value.

The International Private Equity and Venture Capital Valuation Guidelines (IPEV Valuation Guidelines), launched in March 2005 last revised in December 2012 (available at www.privateequityvaluation.com), provide the private equity industry with best practice in consistently estimating the fair value of investments compliant with IFRS and US GAAP. Valuation guidelines are used by the private equity and venture capital industry for valuing private investments and provide a framework for fund managers and investors to monitor the value of existing investments. The IPEV Valuation Guidelines have been endorsed by 42 private equity and venture capital associations around the world, including the Private Equity Growth Capital Council and the National Venture Capital Association in the United States.

Government investors in private equity and venture capital (generally through government sponsored pension plans—hereafter referred to as limited partners (LPs)) need consistently and robustly determined fair value information for a number of reasons which include but are not limited to:

- Fair Value is the basis investors (LPs) use to report periodic (quarterly/yearly) performance to their stakeholders, beneficiaries, boards, etc.
- Fair Value is the best basis for LPs to make “apples to apples” asset allocation decisions.
- Fair Value is an important data point in making interim investment (manager selection) decisions on a comparable basis.

- Fair Value is often necessary as a basis to make incentive compensation decisions at the LP level.
- Limited Partners need consistent, transparent information to exercise their fiduciary duty. Fair Value provides such information on a comparable basis for monitoring interim performance. An arbitrary reporting basis such as cost does not allow comparability.
- Relevant financial reporting standards (GAAP) require LPs to report their investments on a Fair Value basis.

Therefore we applaud the Board's steps to strengthen and clarify fair value reporting standards for government entities.

Our responses to the Exposure Draft are general in nature and are presented with the objective of providing the Board with practical input from the perspective of the global private equity industry. Our views should be considered from the perspective of industry best practice used in the private equity and venture capital, and not necessarily from the perspective of other types of assets, liabilities or financial reporting requirements. Because of the unique nature of the private equity and venture capital industry, in particular regularly valuing illiquid or infrequently traded assets, we can provide the Board with our experience of the challenges inherent in exercising judgment to value such assets consistent with the principles espoused in the Exposure Draft which are substantially congruent with the fair value measurement standards promulgated by both the IASB and FASB.

The IPEV Board supports the use of fair value as the best measure of valuing private equity portfolio companies and investments in private equity funds. The following represent our general comments and comments with respect to selected specific questions which pertain to private equity and venture capital.

General Comments

Subject to our comments elsewhere in this letter, we generally do not perceive any fundamental issues with the concepts and principles articulated in the Exposure Draft (ED). The concepts and principles in the ED are consistent with those in FASB ASC Topic 820 and IFRS 13, with which we have extensive practical experience. Laudably, we find that the ED lays out the guidance in "plain English", which will ease implementation. We also find that the proposed disclosures are less onerous than those in ASC 820, reflecting a more practical approach to addressing user needs without an overload of marginally useful information.

We think that some of the areas that merit further analysis and guidance by GASB arise in connection with, and are most readily illustrated in the context of, governmental entities such as pension plans and their investments:

- **Unit of Account.** The concept of unit of account (par. 8 of ED) is being introduced for the first time in the GASB lexicon via this ED. Unit of account has been one of the most problematic areas in applying ASC Topic 820 and IFRS 13 (as ASC Topic 820 and IFRS 13 are substantially similar, hereafter we will refer only to ASC Topic 820).

We think that the unit of account guidance may not be sufficiently clear. We recommend that it be reinforced that market participant assumptions should be used in the absence of clear unit of account guidance. For example, the issue has presented itself in the context of investment companies, whether a debt investment in an investee company should be valued considering market participant assumptions which often reflect the sale of a controlling position in the equity of the investee by the same investor. The unit of account in this case is effectively the aggregate of the debt and equity investment.

In view of the above, it would also be helpful to relate the *unit of account* to the appropriate *unit of valuation*, and illustrate it. This means that even though a fair value measurement may be required for a particular asset as a unit of account, it may be appropriate to consider this asset in the context of a group as a unit of valuation, if this is how market participants would consider it. This can have a profound impact on the valuation conclusion. While the concept is illustrated in the Asset Group example of ASC 820 (par. 820-10-55-26 through 820-10-55-29), we find that this point is often missed in practice.

- **Transaction Costs.** Paragraph 16 explains the principle that transaction costs are excluded from fair value measurements, consistent ASC Topic 820. We have observed diversity in practice in the application of this principle under ASC 820. For example, if a government pension plan has an investment in a building with a fair value of 100 and brokerage fees to sell the building are 6, is fair value 100 or 94? In the ASC 820 world most preparers end up for various reasons at 94 as they do not want to “realize” less than the fair value estimate. We recommend more clarity and application guidance (illustrations) in order to circumvent a practice issue for government entities.
- **Calibration.** One of the key and most helpful tools in performing fair value measurement is the requirement in ASC Topic 820 for calibration. Unfortunately, this requirement is not very well understood or widely applied. In light of this, we caution that the calibration language in par. 21 of the ED may not be sufficiently strong. We recommend using the words “shall be” rather than “should be” and even providing an illustration of the application of this concept.
- **Control premiums/discounts.** The discussion in par. 29 seems to assume in the absolute that a control premium exists when there is a controlling interest, always making it more valuable than a minority interest. The term “control premium” means different things to different people. Further the concept of a control premium may pre-suppose the existence of a minority discount. As more fully described below, market participants in the private equity and venture capital industry do not typically think of value in the context of control premiums or minority discounts. Fundamentally there is no such thing as a “control premium.” Only 3 percent, or so, of companies are taken over each year. Is it reasonable to apply limited evidence from 3 percent to the whole? If a “control premium” exists, why aren’t all public companies subject to takeover bids as they would be more valuable under a

single owner? If a company is already well run, what is the benefit of control? Therefore, it is critical that concepts be clearly defined and articulated such that the use of the term control premium does not force the use of a minority discount and with resultant valuation measurements that would differ from the perspective of market participants.

For the private equity and venture capital industry market participants pay what they pay. They don't identify a price and then add a premium or deduct a discount. Further, while the price paid for an investment may mathematically be more or less than some other price, that fact does not mean that valuation estimates are arrived at using a premium or discount. In addition, for many situations, the price paid by a "control" investor is the same as that paid by a "minority" investor. Artificially imposing or implying the need for a premium or discount when it does not exist in the real transaction world of private equity and venture capital would be exceedingly unfortunate.

The use of the terms "premium" and "discount" in paragraphs 28 and 29 can be confusing and may lead to divergence in practice. In particular, many government pension plans co-invest with private equity managers. As such, the government pension plan makes a "minority" investment in an equity security where other likeminded investors hold a "control" position. Since the government pension plan generally would pay the same price per share for the minority position as the control shareholder pays for the control position, would the language as currently drafted lead to a practice where there would be a day one loss for the minority investment? We do not believe this would be a correct or logical outcome, though the proposed standard as written could lead to such a result. In the absence of different rights which would cause cash flows not to be proportional, a control and non-control position in a private company would be valued at the same value per share.

- **Marketability.** The concept of marketability and the potential need for a marketability discount is often misunderstood and applied inconsistently. The final standard should be clear that similar to ASC 820 and IFRS 13 the presumption is that the marketing period for any asset began sufficiently in advance of the measurement date such that the hypothetical exit transaction occurs on the measurement date. Therefore, a marketability discount where marketability is defined as the time it would take to effect a transaction; would not be allowed under the standard. However, for assets that are deemed illiquid a market participant would likely pay a price reflecting a discount to a similar liquid investments and as such liquidity does enter into the assessment of fair value, but this does not change the presumption that the asset is sold on the measurement date.
- **Market Participants.** Par. 12 states: "... [market participants] should be considered from the perspective of the government, *thereby allowing for differences between entities with different activities*" [emphasis added]. We think this is not meaningful and confusing. The reason the reference to "allowing differences between entities with different activities" is included in FAS 157/ASC 820 is to properly direct the thought process to identifying the

market and market participants in line with the entity that holds the asset or owes the liability (e.g. wholesaler, retailer, dealer, corporate, etc.), but in this case it is always the government.

Since it is the government that holds the asset or owes the liability that is subject to fair value measurement, considering differences between entities with different activities is a moot point. The exit transaction will always be between a government entity and a market participant (which could be a government or a non-government entity). Paragraph 15c appropriately explains this dynamic by stating "...the government should identify...market participants with whom the government would enter into a transaction in that market." Therefore, we recommend amending par. 12 by striking the reference to "thereby allowing for differences between entities with different activities".

- **Principal Market.** The standard refers to the "government's principal market" (in several places) when measuring at fair value the subject asset or liability. We believe that the reference should be to "the principal market for the asset or liability" (consistent with ASC 820) as the objective is to find the deepest and most liquid market for the asset (or liability). Then separately it would be discussed that the government needs to have access to that market (as in par. 12), and that it typically the market in which the government would normally transact is presumed to be the principal market (as in par. 10). In other words, the principle should be stated clearly by reference to the subject asset or liability, while still having the additional guidance in par. 10 and 12.
- **Items Excluded from Fair Value Measurement.** Paragraph 69 lists items excluded from the fair value measurement requirements in the ED. However, we note that some of these items could be held by pension plans, in which case the question arises as to whether they should be in fact measured at fair value. As noted in our introductory comments, we believe that all investment assets held in a government pension plan should be reported at fair value.
- **Use of NAV.** ED Paragraphs 73/74: We do not believe that it is sufficiently clear that a government entity should not (cannot) blindly accept NAV as a fair value estimate for an interest in a limited partnership. Steps which should be undertaken by LPs to validate or vet that NAV is based on the fair value of underlying investments and is as of the same measurement date are articulated in the IPEV Valuation Guidelines and in AICPA technical practice aids.

Further, it may not be fully understood by reading the ED that a direct or co-investment in the equity or debt of a private company would require the government entity to undertake valuation procedures which support the fair value assertions in their financial statements. A government entity should not blindly accept fair value derived by an investment manager for co-investments. Again, the IPEV Valuation guidelines provide industry best practice on how a government entity would value such direct investments in private companies.

- **Disclosures.** We fully support GASB’s practical approach which limits disclosures that are of little use.
- **Glossary.** We noted that the definition of “option pricing model” is included in the glossary and in paragraph 26. The inclusion of “option pricing model” gives readers the implication that such models should be applied in estimating fair value. It should be made clear that such models would only be appropriate if they reflect market participant assumptions. In the private equity and venture capital space, few, if any, market participants use option pricing models to determine the value of an investment in the equity or debt of a private company and therefore it would be inappropriate to imply that such models must or could be used to estimate fair value when they do not reflect market participant assumptions.

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We appreciate the opportunity to provide the Board with our feedback. We would be pleased to discuss any questions you may have with you. Please direct specific questions to David Larsen, 415-693-5330 or david.larsen@duffandphelps.com.

Very truly yours,

/s/ Emile Van Der Burg

The International Private Equity and Venture Capital Valuation Board

Emile Van Der Burg
Chairman of the IPEV Board

The International Private Equity and Venture Capital Valuation Guidelines

The International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) were launched in March 2005 and were last revised in December 2013 to reflect the need for greater comparability across the industry and for consistency with IFRS and US GAAP accounting principles. Valuation guidelines are used by the private equity and venture capital industry for valuing private equity investments and provide a framework for fund managers and investors to monitor the value of existing investments. The IPEV Guidelines are based on the overall principle of 'fair value' in order to be consistent with IFRS and US GAAP.

The International Private Equity and Venture Capital Valuation Board (IPEV Board) reports and is accountable to a general assembly composed of all the endorsing associations to manage the evolution of the guidelines going forward. The IPEV Guidelines have been endorsed globally by 42 national and regional trade associations, including the Private Equity Growth Capital Council and the National Venture Capital Association in the United States.

For more information: <http://www.privateequityvaluation.com>.