



International Accounting Standards Board (IASB)
First Floor
30 Cannon Street
London, EC4M 6XH
United Kingdom

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Comment Letter on Fair Value Measurements Exposure Draft

Dear Board Members,

The International Private Equity and Venture Capital Valuation Board (IPEV Board) appreciates and welcomes the opportunity to respond to the Exposure Draft (ED) on Fair Value Measurements. As we have always stated with our responses in the past, there is great importance for the private equity investment community to be able to obtain and rely on consistently determined fair value estimates. Fair Value Measurements is a subject area where users currently face challenges in understanding true measures of value and are often at a disadvantage as to whether adjustments are required in their analysis of reported information. Our responses are presented with the objective to present further thoughts on the issues surrounding how fair value should be estimated, in particular for illiquid or infrequently traded assets

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 comments to your specific questions:

Definition of fair value and related guidance

Question 1

The exposure draft proposes defining fair value 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’ (an exit price) (see paragraph 1 of the draft IFRS and paragraphs BC15–BC18 of the Basis for Conclusions). This definition is relevant only when fair value is used in IFRSs. Is this definition appropriate? Why or why not? If not, what would be a better definition and why?

Comments

Because of the desirability of convergence with U.S. GAAP, we agree with the ED’s proposal to define fair value as an “exit price.” For the private equity industry, fair value represents a hypothetical transaction for the sale of a private company at a hypothetical price, as observable transaction prices are generally available only twice, once at entry and once at exit, usually several years later.

Generally a fair value measurement represents an estimated hypothetical *exchange price*, where there is a party to whom it is an *entry price*, and a party to whom it is an *exit price*. For private equity, *market participants* could include strategic (corporate) buyers, financial (private equity) buyers, or the public market (initial public offerings). While we agree with the exit market concept because of the benefit of international convergence, we highlight the following potential weaknesses of using an exit market concept:

- There are circumstances in which the value to the current owner is greater than the value in an exit transaction. For example, a company with a large tax operating loss carry forward may be of more value to an existing owner than it would be to a buyer who may lose the benefit of the tax loss carry forward due to change in control provisions of the applicable tax code. Therefore, the value in the exit market is less than the value in use.
- The concept of fair value being an arm's-length transaction, e.g. an orderly transaction, or a transaction price between willing buyers and sellers is under pressure from the "bid" price bias created by using an exit market concept. Almost all private equity assets trade infrequently. Therefore, a single bid price could be deemed an exit price and thereby invalidate the orderly transaction premise.

The exit price concept leads logically to the potential need for recording day one gains and/or losses to the extent the entry price differs from the estimated exit price. We agree with the need to immediately record such unrealized gains and losses, but we highlight the fact that using the exit price will result in such treatment. **Finally, we highlight for the Boards consideration the fact that because of the divergence between IFRS and US GAAP for Investment companies; specifically the requirement under IFRS for Investment Companies to consolidate control positions, IFRS does not meet the needs of the ultimate investor and therefore may not be a relevant basis of accounting for the private equity industry.**

Scope

Question 2

In three contexts, IFRSs use the term 'fair value' in a way that does not reflect the Board's intended measurement objective in those contexts:

(a) In two of those contexts, the exposure draft proposes to replace the term 'fair value' (the measurement of share-based payment transactions in IFRS 2 Share-based Payment and reacquired rights in IFRS 3 Business Combinations) (see paragraph BC29 of the Basis for Conclusions).

(b) The third context is the requirement in paragraph 49 of IAS 39 Financial Instruments: Recognition and Measurement that the fair value of a financial liability with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be paid (see paragraph 2 of the draft IFRS and paragraph BC29 of the Basis for Conclusions). The exposure draft proposes not to replace that use of the term 'fair value', but instead proposes to exclude that requirement from the scope of the IFRS.

Is the proposed approach to these three issues appropriate? Why or why not? Should the Board consider similar approaches in any other contexts? If so, in which context and why?

Comments

IFRS 2 Share-based payment: Share-based payment transactions

We agree with the Board's decision to replace the term fair value with market-based value *IFRS 3 Business Combinations: Reacquired rights*

No comment.

IAS 39 Financial Instruments: Financial liability with a demand feature

No Comment

The transaction

Question 3

The exposure draft proposes that a fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the most advantageous market to which the entity has access (see paragraphs 8–12 of the draft IFRS and paragraphs BC37–BC41 of the Basis for Conclusions). Is this approach appropriate? Why or why not?

Comments

Principal vs. Most Advantageous Market

While we believe that there may be instances in which the principal market would provide a better indication of fair value (situations in which a greater volume and frequency of transactions take place), we do not object to the concept of using the most advantageous market to estimate the hypothetical transaction price. The Board should highlight in its basis for conclusions that there is no intention to deviate from conclusions reached under US GAAP by using the principal market.

Ability to Access a Specific Market

The ED states:

“In the absence of evidence to the contrary, an entity may assume that the principal market for the asset or liability is the most advantageous market, provided that the **entity can access** the principal market” [emphasis added].

By focusing on the *ability to access* the principal market, the ED may create confusion and divergent practice. There is no corresponding requirement to identify the ability to access the most advantageous market. As noted above, in the private equity industry, there are three primary exit strategies. Some could conclude that the IPO market would be the most advantageous market, yet the IPO market is not open to all companies at all times. Therefore, we recommend that the issue of the *ability to access* a market is better addressed through the fair value hierarchy while taking into account current market conditions. An entity is required to use the highest level of relevant inputs available, and in order to categorize an input as Level 1 an entity is *required* to have access to such market at the measurement date.

Additional arguments against a requirement for the reporting entity’s access to the reference (principal) market include:

- Given current market conditions, language that bases the reference market determination on the ability to access such market may prove problematic (e.g., a market may have no activity at the measurement date, rendering access meaningless).
- The often hypothetical nature of a transaction is challenged by the requirement that the entity have access to the market (e.g., valuation of a portfolio company when no observable M&A or IPO market exists).

Question 4

The exposure draft proposes that an entity should determine fair value using the assumptions that market participants would use in pricing the asset or liability (see paragraphs 13 and 14 of the draft IFRS and paragraphs BC42–BC45 of the Basis for Conclusions). Is the description of market participants adequately described in the context of the definition? Why or why not?

Comments

We agree with the ED's articulation of the market participant view. However, we believe that the following Board position should get greater prominence in the final standard:

“a ‘market’ does not need to be observable to exist, eg there does not need to be an organized exchange for the asset or liability... in such cases an entity should consider the characteristics of market participants who would enter into a transaction for the asset or liability.”

We recommend that the Board consider incorporating this clarification in paragraph 14 of the ED. This would facilitate the fair value measurement process in situations when markets are frozen, or when there are no trades, or where assets trade infrequently as is the case with privately owned companies held by Investment Funds.

Better articulating a market participant would also help address situations involving limited partnership interests in alternative investments or hedge fund interests where principal-to-principal or brokered transaction data may be opaque and may not be *observable* and therefore may not be the best indication of fair value, since, such transactions are infrequent and often involve a distressed seller. These types of investments are designed (a) to be redeemed with the investee or (b) to be exited via distributions from the investee at times allowable under the terms of the investee's governing documents. In grappling with this issue, FASB recently decided that an entity would be permitted to use net asset value (if based on the fair value of underlying investments and as of the same measurement date) as a practical expedient for estimating fair value on an interest-by-interest basis unless certain criteria are met indicating that it is probable that the entity will sell the investment in a secondary market.

Further, on a related issue in the ED (**The transaction**), we observe that too much emphasis may be placed on an “actual transaction” in paragraph 12 of the ED without consideration of whether it is an *orderly transaction*. This may result in overweighting observable prices which under certain circumstances are not determinative of fair value, an issue FSP FAS 157-3 and FAS 157-4 tried to address in U.S. GAAP. By wording this paragraph carefully, similar potential issues in the application of an IFRS on fair value measurement may be mitigated.

Application to assets: highest and best use and valuation premise

Question 5

The exposure draft proposes that:

- (a) The fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset or by selling it to another market participant who will use the asset in its highest and best use (see paragraphs 17–19 of the draft IFRS and paragraph BC60 of the Basis for Conclusions).
- (b) The highest and best use of an asset establishes the valuation premise, which may be either ‘in use’ or ‘in exchange’ (see paragraphs 22 and 23 of the draft IFRS and paragraphs BC56 and BC57 of the Basis for Conclusions).
- (c) The notions of highest and best use and valuation premise are not used for financial assets and are not relevant for liabilities (see paragraph 24 of the draft IFRS and paragraphs BC51 and BC52 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

Comments

- (a) We suggest making the following, or a similar, edit to paragraph 17 of the ED, to convey the principle more clearly:

“The fair value of an asset should consider a market participant’s ability to generate economic benefit by using the asset in its highest and best use or by selling it to another market participant who will use the asset in its highest and best use” [insertion noted].

- (b) We agree that the highest and best use of an asset establishes the valuation premise as it determines both the manner or use and the “package”, or asset group in which the asset will be used.

Comments on the Articulation of the In-Use Premise and In-Exchange Premise

We disagree with the ED’s articulation in paragraph 23 that the **in-use valuation premise** assumes that the asset is **sold individually**, i.e., not as part of a group of assets or a business. In particular, we believe that the “individual” premise could be grossly misunderstood. Specifically, when the asset is an ownership interest in a private company, it should be clear that the percentage ownership of the entire company is being valued, not each individual share representing an ownership interest. A corresponding problem is the prohibition to look at an ownership interest as a block. Private equity investors buy and sell portions of private companies. They rarely purchase individual shares of publically traded companies. Therefore the unit of account should be the ownership interest in the private company, not an individual share of a private company.

- (c) Highest and Best Use and Premise and *Financial Assets and Liabilities*

No comment

We again highlight that the issue of “blockage” should be viewed as a valuation premise. In the ED, the Board proposes to exclude blockage factors from all levels of the fair value hierarchy for financial instruments by emphasizing that IAS 39 specifies the unit of account represented by the exit transaction as the *individual instrument*. As noted above, we believe that the individual instrument could be misconstrued to mean individual shares rather than the specific ownership interest of a private company. Therefore, we strongly encourage the board to either clarify IAS 39 for purposes of valuing private companies, or modify the Fair Value proposal to be in harmony with US GAAP by being silent with regards to blockage and level II and III inputs.

Question 6

When an entity uses an asset together with other assets in a way that differs from the highest and best use of the asset, the exposure draft proposes that the entity should separate the fair value of the asset group into two components: (a) the value of the assets assuming their current use and (b) the amount by which that value differs from the fair value of the assets (ie their incremental value). The entity should recognise the incremental value together with the asset to which it relates (see paragraphs 20 and 21 of the draft IFRS and paragraphs BC54 and BC55 of the Basis for Conclusions). Is the proposed guidance sufficient and appropriate? If not, why?

Comments

No comment

Application to liabilities: general principles

Question 7

The exposure draft proposes that:

- (a) A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (see paragraph 25 of the draft IFRS and paragraphs BC67 and BC68 of the Basis for Conclusions).
- (b) If there is an active market for transactions between parties who hold a financial instrument as an asset, the observed price in that market represents the fair value of the issuer's liability. An entity adjusts the observed price for the asset for features that are present in the asset but not present in the liability or vice versa (see paragraph 27 of the draft IFRS and paragraph BC72 of the Basis for Conclusions).
- (c) If there is no corresponding asset for a liability (eg for a decommissioning liability assumed in a business combination), an entity estimates the price that market participants would demand to assume the liability using present value techniques or other valuation techniques. One of the main inputs to those techniques is an estimate of the cash flows that the entity would incur in fulfilling the obligation, adjusted for any differences between those cash flows and the cash flows that other market participants would incur (see paragraph 28 of the draft IFRS).

Are these proposals appropriate? Why or why not? Are you aware of any circumstances in which the fair value of a liability held by one party is not represented by the fair value of the financial instrument held as an asset by another party?

Comments

No comment

Application to liabilities: non-performance risk and restrictions

Question 8

The exposure draft proposes that:

- (a) The fair value of a liability reflects non-performance risk, i.e. the risk that an entity will not fulfill the obligation (see paragraphs 29 and 30 of the draft IFRS and paragraphs BC73 and BC74 of the Basis for Conclusions).
- (b) The fair value of a liability is not affected by a restriction on an entity's ability to transfer the liability (see paragraph 31 of the draft IFRS and paragraph BC75 of the Basis for Conclusions).

Are these proposals appropriate? Why or why not?

No Comments

Fair value at initial recognition

Question 9

The exposure draft lists four cases in which the fair value of an asset or liability at initial recognition might differ from the transaction price. An entity would recognise any resulting gain or loss unless the relevant IFRS for the asset or liability requires otherwise. For example, as already required by IAS 39, on initial recognition of a financial instrument, an entity would recognise the difference

between the transaction price and the fair value as a gain or loss only if that fair value is evidenced by observable market prices or, when using a valuation technique, solely by observable market data (see paragraphs 36 and 37 of the draft IFRS, paragraphs D27 and D32 of Appendix D and paragraphs BC76–BC79 of the Basis for Conclusions). Is this proposal appropriate? In which situation(s) would it not be appropriate and why?

Comment

We acknowledge that conceptually, entry and exit prices are different. It is appropriate to give recognition to the difference between the two, when it exists (in practice, entry and exit prices may often be the same). We do not believe that the proposed Fair Value guidance should conclude on the treatment of initial gains or losses, if any. Where fair value is required, resultant gains or losses should be recognized for any changes in fair value estimates, even if they occur on “day one”.

Valuation techniques

Question 10

The exposure draft proposes guidance on valuation techniques, including specific guidance on markets that are no longer active (see paragraphs 38–55 of the draft IFRS, paragraphs B5–B18 of Appendix B, paragraphs BC80–BC97 of the Basis for Conclusions and paragraphs IE10–IE21 and IE28–IE38 of the draft illustrative examples). Is this proposed guidance appropriate and sufficient? Why or why not?

Comments

We believe this guidance is generally sufficient;

Disclosures

Question 11

The exposure draft proposes disclosure requirements to enable users of financial statements to assess the methods and inputs used to develop fair value measurements and, for fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period (see paragraphs 56–61 of the draft IFRS and paragraphs BC98–BC106 of the Basis for Conclusions). Are these proposals appropriate? Why or why not?

Comments

We understand that the Board wishes to provide users with information on the sensitivity of fair value measurements to changes in the main valuation inputs (paragraph 57 (g) of the ED). However, we believe that basing the sensitivity on *reasonably possible* alternative assumptions that would change fair value significantly, as proposed, is too broad, especially for private equity and venture capital. Most private equity managers use multiple techniques with multiple inputs in estimating fair value. The broad language could be interpreted as requiring multiple scenarios for each individual investment. Such a requirement is not useful to readers of Fund financial statements and is operationally impractical.

Alternatively, the Board may consider requiring disclosure of aggregate ranges of fair value estimates. Disclosing a range has the advantage of providing worst and base case results, however it does not take into account the portfolio effect of investing in a Fund.

Convergence with US GAAP

Question 12

The exposure draft differs from Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (SFAS 157) in some respects (see paragraph BC110 of the Basis for Conclusions). The Board believes that these differences result in improvements over SFAS 157. Do you agree that the approach that the exposure draft proposes for those issues is more appropriate than the approach in SFAS 157? Why or why not? Are there other differences that have not been identified and could result in significant differences in practice?

Comments

As noted above, we believe that fair value estimates made consistent with the exposure draft could differ materially from estimates made using US GAAP (topic 820, SFAS 157). In particular this is because of the requirement to value an individual instrument and the inability to value level II and III assets as a block.

Other comments

Question 13

Do you have any other comments on the proposals in the exposure draft?

Comments

None

Very truly yours,

The International Private Equity and Venture Capital Valuation Board

Prof. Herman Daems

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 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 by 36 national and regional trade associations.

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