



IPEV Valuation Board's comments on the IASB's Discussion Paper "Fair Value Measurements" published in November 2006

30 April 2007

The IPEV Valuation Board welcomes the opportunity given by the International Accounting Standards Board to comment its discussion paper on Fair Value Measurements. More information regarding the IPEV Valuation Board is available in the annex provided at the end of this document.

The fair value of a financial instrument, quoted or unquoted, is a conceptual representation of a transaction price. The theory underlying the determination of fair value should be consistent as a reference that can be used by valuers who are confronted with specific markets whose characteristics might differ from the theory. Therefore, the theory should not try to represent specific situations that might result in, for example, the entry price being different from the exit price. This approach underlies the IPEV Valuation Board's answers to the questions asked in the IASB's document

Q1 In your view, would a single source of guidance for all fair value measurements in IFRS's both reduce complexity and improve consistency in measuring fair value? Why and Why not

The IPEV Valuation Board is a strong supporter of convergence between IFRS's and US GAAP.

Having a single source of guidance for all fair value measurements in IFRS's would probably reduce complexity and improve consistency in measuring fair value. However, in order to achieve its objective, such a document should not aim at being exhaustive in its guidance in order not to create more confusion for accounts preparers, users and auditors.

Consequently, the document should adopt a consistent theoretical approach and should not try to solve issues that are specific to certain markets, assets or asset classes and then apply those solutions to all other situations. The IPEV Valuation Board fears that doing so will create principles and guidelines that are too theoretical and difficult to apply to specific situations.



Q2 Is there fair value measurement guidance in IFRS's that you believe is preferable to the provisions of SFAS 157? If so, please explain

Reverting to the answer to question 1, IAS 39 AG74 specifies that; 'If there is a valuation technique commonly used by market participants to price the instrument and that technique has been demonstrated to provide reliable estimates of prices obtained in actual market transactions, the entity uses that technique.'

This provision is very similar to an approach currently under discussion by the UK Financial Services Authority that aims at a wider use of Industry Guidance to achieve their regulatory objectives within a principles-based framework¹. The IPEV Valuation Board highly recommends that the provision mentioned above remains in the document that will be the single source of guidance on fair value.

Q3 Do you agree that fair value should be defined as an exit price from the perspective of a market participant that holds the asset or owes the liability? Why or why not?

Under the assumption that the market is characterized by a pure and perfect competition, entry and exit price will not differ.

Specifying that the fair value should be defined as an exit price might partially answer questions arising from the non-fulfilment of the underlying conditions that characterize a pure and perfect competition.

But for certain private equity assets, a fair value definition focusing on the concept of exit price might deter preparers and auditors from analyzing the relevant underlying parameters. As a matter of example, for companies in the early stage of their development and that have not received further rounds of financing following the initial investment by the venture capitalist, the best estimate of fair value is based on the entry price paid by the venture capitalist to become shareholder.

During a reasonable period of time after the latest investment, and if no adverse consequences would result in a deterioration of the expected flows of economic benefit from the investee company, the entry price represents a fair value determined by the market defined as the supply and demand of capital relating to technology, or other commercial, projects. The inadequacy of the term exit price (entrepreneurs do not exit the project when receiving venture capital funding and at this stage of

¹ See: <http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/110.shtml>
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development of the investee company a venture capitalist would find difficult to exit its shares) might confuse accounts preparers and auditors.

In such real cases, the definition currently used in IFRS's creates less confusion by stating that fair value is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction. It is then up to accounts preparers, potentially helped by appropriate guidelines, to translate the principle of fair valuing into the market they operate.

Q4 Do you believe an entry price also reflects current market-based expectations of flows of economic benefit into or out of the entity? Why or why not? Additionally, do you agree with the view that, excluding transaction costs, entry and exit price will differ only when they occur in different markets? Please provide a basis for your views.

In a market characterized by pure and perfect competition, entry and exit price will always be identical. The transaction price represents the point where marginal expected flows of economic benefit by buyers and sellers are equal. In that context, expected flows of economic benefit by buyers are either higher or equal to the transaction price. On the contrary, expected flows of economic benefit by sellers are either lower or equal to the transaction price. Entry and exit price can be different when conditions underlying the pure and perfect competition are not met.

Q5 Would it be advisable to eliminate the term 'fair value' and replace it with terms, such as 'current exit price' or 'current entry price', that more closely reflect the measurement objective for each situation? Please provide a basis for your views.

As mentioned above, from a conceptual standpoint, current entry price and current exit price are always identical. It seems difficult to develop accounting standards encompassing all observed situations where the underlying conditions of pure and perfect competition are not satisfied without creating confusion. It seems preferable to adopt a consistent theoretical framework based on the use of the term fair value. It is then up to accounts preparers to assess the impact of having to operate in market(s) in which the competition cannot be qualified as pure and perfect.



Q6 Does the exit price measurement objective in SFAS 157 differ from fair value measurements in IFRS's as applied in practice? If so, which fair value measurements in IFRS's differ from the measurement objective in SFAS 157? In those circumstances, is the measurement objective as applied in practice an entry price? If not, what is the measurement objective applied in practice? Please provide a basis for your views.

See answer to question 3

Q7 Do you agree with how the market participant view is articulated in SFAS 157? Why or why not?

The IPEV Valuation Board agrees with the view when it is in accordance with the references in IFRS's of 'knowledgeable, willing parties in an arm's length transaction'. However, the IPEV Valuation Board is concerned with the use of the notions of 'principal' and 'advantageous' markets (see below answer to question 13).

Q8 Do you agree that the market participant view in SFAS 157 is consistent with the concepts of 'knowledgeable, willing parties' and 'arm's length transaction' as defined in IFRS's? If not, how do you believe they differ?

See answer to question 7

Q9 Do you agree that the fair value of a liability should be based on the price that would be paid to transfer the liability to a market participant? Why or why not?

See question 10



Q10 Does the transfer measurement objective for liabilities in SFAS 157 differ from fair value measurements required by IFRS as applied in practice? If so, in practice which fair value measurement under IFRS's differ from the transfer measurement objective in SFAS 157 and how do they differ?

As a remark, more than as an answer to the question, the IPEV Valuation Board would like to stress that in private equity most of the financial instruments are in substance equity instruments whose value depends on the shareholder's equity value. Consequently, in private equity, the settlement amount of debt instruments, ranking higher in degree of seniority of the private equity financial instruments, is deducted from the enterprise value of the investee company as a step towards the determination of the fair value of the private equity investment.

Q11 In your view, is it appropriate to use a measurement that include inputs that are not observable in a market as fair value at initial recognition, even if this measurement differs from the transaction price? Alternatively, in your view, in the absence of a fair value measurement based solely on observable market inputs, should the transaction price be presumed to be fair value at initial recognition, thereby potentially resulting in the deferral of day-one gains and losses? Please give reasons for you views.

In private equity such a situation is regularly observed in the context of secondary transactions. A secondary transaction occurs when investments held by investors in private equity funds are sold to secondary players. Secondary players pay existing investors in a fund to acquire their stakes. Remaining investors in the fund can for the same reporting period estimate a fair value that is different from the price agreed upon between exiting investors and secondary players. It is not rare that the transaction price of a secondary transaction does not represent a fair value of the stakes in the fund as exiting investors are forced to sell.

The IPEV Valuation Board considers that due to the use of the fair value hierarchy, the benefit for users of financial statements of deferring day-one gains and losses is not clear.



Q12 Do you believe that the provisions of SFAS 157, considered in conjunction with the unit of account guidance in IAS 39, would result in a portfolio-based valuation of identifiable risks of instruments considered in aggregate, or an in-exchange exit price for the individual instruments? Please give reasons for your views.

No comment

Q13 Do you agree that a fair value measurement should be based on the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability? Why or why not?

In the context of private equity, the notions of principal market and most advantageous market for the asset or liability have to be considered carefully. While it is specified in IFRS's that the market to be used as reference has to be immediately accessible to the entity, it seems that SFAS 157 focuses on the characteristics of the asset or liability to be traded on a specific market. However, private equity markets are characterized by different entry barriers, heterogeneous assets and imperfect information. Therefore, adopting a pure conceptual approach based on the notion of accessible market maximising the returns of willing buyers and sellers would give a more pertinent framework. Moreover, there is no theoretical background that legitimates the use of the principal market as reference.

Q14 Do you agree that a fair value measurement should consider attributes specific to the asset or liability that market participants would consider in pricing the asset or liability? If not, why?

Yes

Q15 Do you agree that transaction costs that would be incurred in a transaction to sell an asset or transfer a liability are an attribute of the transaction and not of the asset or liability? If not, why?

Yes



Q16 Do you agree that the risk of non-performance, including credit risk, should be considered in measuring the fair value of a liability? If not, why?

See answer to question 10

Q17 Is it clear that the 'in-use valuation premise' used to measure the fair value of an asset in SFAS 157 is different from 'value in use' in IAS 36? Why or why not?

No comment

Q18 Do you agree with the hierarchy in SFAS 157? If not, why?

Although the fair value hierarchy aims at prioritising valuation techniques, it might also impact users' perception of the quality of fair value estimates. It seems to the IPEV Valuation Board that the quality of fair value estimates does not systematically depend on the use of observable market inputs. Therefore, there is a risk that the current phrasing will result in preparatory arbitrage between using inputs ensuring a level-2 fair value and the use of level-3 inputs, regardless of the quality of fair value estimates.

Q19 Are the differences between the levels of the hierarchy clear? If not, what additional information would be helpful in clarifying the differences between the levels?

See answer to question 18

Q20 Do you agree with the provision of SFAS 157 that a blockage adjustment should be prohibited for financial instruments when there is a price for the financial instruments in an active market (Level 1)? In addition, do you agree that this provision should apply as a principle to all levels of the hierarchy? Please provide a basis for your view?

The IPEV Valuation Board considers that a specific financial instrument can be quoted on an active market while simultaneously this same financial instrument might not be actively traded. Under such circumstances, the assumption that being quoted on an active market results in a pricing of individual instruments reflecting already the impact of a blockage might not be verified, which would justify the application of a discount.



Because level-2 and level-3 fair value estimates will generally be based on valuation techniques other than the product of the number of units of the instrument held and its quoted price, it is preferable not to forbid the use of blockage factor discounts to all levels of the fair value hierarchy.

Q21 Do you agree that fair value measurements should be determined using the price within the bid-ask price spread that is most representative of fair value in the circumstances, as prescribed by paragraph 31 of SFAS 157? Alternatively, do you believe that the guidance contained in IFRSs, which generally requires assets to be valued at the bid price and liabilities at the ask price, is more appropriate? Please explain the basis for your view?

For their quoted instruments, private equity houses generally use the bid price as it constitutes the best estimate of the fair value than any other price comprised within the bid-ask price spread.

Q22 Should a pricing convention (such as mid-market pricing or bid price for assets and ask price for liabilities) be allowed even when another price within the bid-ask spread might be more representative of fair value? Why or why not?

See answer to question 21

Q23 Should bid-ask pricing guidance apply to all levels of the hierarchy, including when the fair value measurement includes unobservable inputs? Why or why not?

No comment

Q24 Do the disclosure requirements of SFAS 157 provide sufficient information? If not, what additional disclosures do you believe would be helpful to users and why? Alternatively, are there disclosures required by SFAS 157 that you believe are excessive or not beneficial when considered in conjunction with other disclosures required by IFRS? Please provide a basis for your view.

No comment



Annex: The IPEV Valuation Board

The IPEV Valuation Board was created in June 2005 following the development of the International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) by AFIC (French private equity and venture capital association), BVCA (British private equity and venture capital association) and EVCA (European private equity and venture capital association).

The Board monitors market practices in the use of the IPEV Guidelines. It also proposes amendments to the Guidelines following any relevant changes to accounting standards and market practices and formally reviews the Guidelines every three years. The Board has an advisory role and gives guidance on the application of the Guidelines to all stakeholders (practitioners, investors, regulators and auditors).

The IPEV Guidelines are endorsed by 35 associations worldwide (list as of 2nd January 2007):

- AIFI - Italian Private Equity and Venture Capital Association
- AFIC - French Private Equity and Venture Capital Association
- APCRI - Portuguese Private Equity and Venture Capital Association
- APEA – Arab Private Equity Association
- ASCRI - Spanish Private Equity and Venture Capital Association
- ATIC – Tunisian Venture Capital Association
- AVCA - African Venture Capital Association
- AVCAL - Australian Private Equity and Venture Capital Association Limited
- AVCO – Austrian Private Equity and Venture Capital Organization
- BVA - Belgian Venturing Association
- BVCA – British Venture Capital Association
- BVK - German Private Equity and Venture Capital Association e.V.
- CVCA – Canada's Venture Capital and Private Equity Association
- CVCA - China Venture Capital Association
- CVCA - Czech Venture Capital and Private Equity Association
- DVCA - Danish Venture Capital Association
- EMPEA - Emerging Markets Private Equity Association
- EVCA – European Private Equity and Venture Capital Association
- FVCA - Finnish Venture Capital Association
- GVCA - Gulf Venture Capital Association
- HKVCA - Hong Kong Venture Capital Association
- HVCA - Hungarian Venture Capital and Private Equity Association
- ILPA - Institutional Limited Partners Association
- IVCA - Irish Venture Capital Association
- LAVCA - Latin American Venture Capital Association
- LVCA - Latvian Venture Capital Association
- NVCA - Norwegian Venture Capital & Private Equity Association
- NVP - Nederlandse Vereniging van Participatiemaatschappijen
- PPEA - Polish Private Equity Association
- Réseau Capital – Québec Venture Capital and Private Equity Association
- RVCA - Russian Private Equity and Venture Capital Association
- SAVCA - Southern African Venture Capital and Private Equity Association
- SECA - Swiss Private Equity and Corporate Finance Association
- SLOVCA - Slovak Venture Capital Association
- SVCA - Swedish Private Equity and Venture Capital Association

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