A global regulatory emphasis on Fair Value (mark-to-market) accounting and auditor attention has led to meaningful changes in GP valuation practices and significant adoption of the Private Equity Industry Guidelines (PEIGG). This has happened despite no change in GP attitudes in the past four years about the basic usefulness of an industry valuation standard, partly due to general partners receiving more attention from their auditors regarding portfolio valuation.

A new survey of GPs by the Center for Private Equity and Entrepreneurship at the Tuck School of Business at Dartmouth shows that 67% of general partners have formally adopted PEIGG, up from just 30% in 2005 (see Figure 1). The survey is still in process, but the preliminary results are sufficiently robust (n = 101) to gauge current industry practices.

**Fair value history**

The fair value measurement project was begun at the Financial Accounting Standards Board (FASB) in 2003. There was general agreement by the board and users of financial statements that fair value information was relevant and fit with an overall principles-based approach. The International Accounting Standards Board (IASB) has had a similar initiative. In 2006, FASB issued its Statement Number 157, which becomes effective in November 2008. FASB 157 refines the definition of fair value (in essence, the price received to sell an asset in the main market for that asset) and establishes a framework for measuring fair value in generally accepted accounting principles (GAAP).

The Private Equity Industry Guidelines Group (PEIGG) began its work in 2002 and issued its initial valuation guidelines in 2003. The guidelines were endorsed by the Institutional Limited Partners Association (ILPA) and commended by the National Venture Capital Association in 2004. Following FASB 157, PEIGG updated its guidelines earlier this year to be GAAP compliant.

According to the survey, more than half of GPs would like to see an industry standard for valuation. About the same number held that view in Tuck’s first survey on the subject in 2003 and a second survey in 2005.

To put the survey into perspective, 61% of the respondents were venture capital fund managers, while 28% were buyout fund sponsors. Nearly 56% of respondents had four or more funds under management, and 29% managed $500 million or more in their current fund.

**Interim valuations**

Paragraph 30 of the PEIGG guidelines calls for write-ups to reflect fair market value even in the absence of a new round of financing. Some GPs have argued that interim valuations of a portfolio company are not important in relation to the ultimate goal of a successful exit, while others have complained that interim valuations create unnecessary volatility.

Paragraph 30 remains a sticking point for some GPs, with 13% of those surveyed saying that concerns about interim valuations kept them from
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Adopting PEIG. However, the survey also shows that fewer GPs prefer write-ups based on a new round of financing, and GPs say their LPs are paying more attention to interim valuations.

Finally, one fifth of respondents provide their LPs with “side schedules” that contain up-to-date valuation estimates that differ from audited financial statements.

Attention from auditors

In light of post-Enron and Sarbanes-Oxley pressures, we stated in a 2005 article that “despite the barking, outside auditors appear not to be biting.” The current survey results indicate that auditors are now nipping at the heels of GPs. The percentage of respondents who experienced greater attention or oversight from their auditors regarding portfolio valuation in their most recent audit shot up from 53% in 2005 to 77% this year (see Figure 2).

Likewise, the percentage of GPs who were told they had a cost-based valuation policy that needed to be transitioned to fair value (or risked receiving a qualified opinion) jumped from 2% in 2005 to 12% in 2007.

Conversely, there was a drop from 68% to 40% of GPs who stated that their auditor accepted as GAAP a “fair value” valuation policy that excluded non-financing round write-ups. This trend was supported from an additional perspective—two thirds of the 2007 survey respondents acknowledged having done a non-round write-up.

LP attitudes seem to be changing, as well. In 2005, 60% of GPs stated that LPs would be willing to overlook qualified audit opinions as long as fund performance was satisfactory, but that figure dropped to 48% this year.

Greater attention to fair value seems to indicate that business appraisers and valuation consultants will have a bonanza. However, they may want to hold off on ordering their yachts. Surprisingly, 89% of the respondents to this year’s survey did not use third-party valuation services.

Although there is no industry proposal on the table, we asked GPs about the possibility of FASB making any exceptions to fair value practices and FASB 157 for valuing early stage companies. Of the respondents, 40% said that companies with less than one complete year of revenue were the best candidates for a fair value exception.

International perspective

Led by the British, French and European industry associations, the International Private Equity Guidelines have been adopted by virtually every country or region outside of the US. The international guidelines comport to International Accounting Standards Board.

About 53% of this year’s survey respondents believe U.S.-international convergence will occur within five years. This figure is up significantly from 2005, when only 32% of respondents were as optimistic. Alternatively, there are fewer naysayers who believe convergence will never occur (20% this year vs. 38% in 2005).

Conclusions

Despite continued skepticism by a core group of GPs about the usefulness of interim valuations, the reality of FASB pronouncements and auditor pressure is making most GPs either adopt formally or inch toward mark-to-market portfolio valuations. Given the difficulty of achieving consistency from firm to firm in valuing early stage companies, it remains to be seen whether the industry will seek an exception from FASB’s broad based rules.

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