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Introduction

On June 20\textsuperscript{th} and 21\textsuperscript{st} of 2007, the Center for Private Equity and Entrepreneurship hosted 54 private equity practitioners and other professionals for its third conference on trends and developments in valuation in the industry. Attendees offered a wide range of experiences, with representation from the following groups:

- General Partners (both Venture and Buyout)
- Limited Partners
- Fund-of-Fund Managers
- Accountants
- Consultants and Service Providers
- Academia
- Industry Organizations
  - Association Francaise des Investisseurs en Capital (AFIC)
  - European Private Equity and Venture Capital Association (EVCA)
  - Financial Accounting Standards Board (FASB)
  - Institutional Limited Partners Association (ILPA)
  - International Private Equity and Venture Capital Valuation Board (IPEV)
  - National Venture Capital Association (NVCA)
  - Private Equity Investment Guidelines Group (PEIGG)

The purpose of the conference was to bring groups and individuals together to discuss openly and without attribution the issues regarding valuation practices in the private equity industry. This discussion format was important for the industry in its efforts to promote best practices. With the increased visibility from IPOs of private equity firms and greater regulatory attention to transparency and fair value it becomes increasingly important for the industry to demonstrate foresight and self-governance.
The Center for Private Equity and Entrepreneurship conducted a survey of US GPs in the spring of 2007 regarding valuation practices and guideline usage. Of the 650 GPs contacted, 136 completed the survey, representing a 21% response rate. The GPs represented a broad cross section of the industry by geography, investment focus, capital under management, and number of funds under management.

The survey assessed changes in industry trends and practices using results from similar surveys in 2003 and 2005. The key findings were as follows:

- 42% of respondents have adopted the PEIGG guidelines (vs. 19% in 2005).
- Buyout firms are adopting PEIGG at a greater rate than venture firms.
- 86% of respondents have done or will consider non-round write-ups.
- Auditors are paying more attention to portfolio valuation but qualified opinions have not increased significantly.
- GPs believe that LPs are increasingly concerned about fair value.
- 39% of respondents agree with a potential exception to fair value practice regarding portfolio companies with less than one year of revenues.
- A majority of respondents see US and international guidelines converging within 5 years.

This report represents the results of the conference discussions.
Acknowledgements

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- Kevin Delbridge, HarbourVest Partners
- Mark Jensen, Deloitte
- David Larsen, Duff & Phelps
- Tom Reinhart, TPG Capital
- David Russ, Dartmouth Endowment
- Monique Saulnier, Sofinnova Partners/AFIC/EVCA/IPEV
- James Stevenson, ABS Capital Partners
- Phillip Stocken, Tuck School
- John Taylor, National Venture Capital Association
- Leroy Wall, Canada Pension Plan Investment Board

The Center thanks the following members of the staff for producing the conference:

- Paula Tilson
- Sandy Rozyla
- Evy Huppert

The proceedings were developed by the following Center team members:

- Fred Wainwright
- Colin Blaydon
- Joaquin Villarreal
- Ann Schiff
The Center is very grateful to the conference sponsors for their support:

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Conference Proceedings

Dinner Speaker Comments

Professor Matthew Slaughter of the Tuck School had just completed his term as a member of the President’s Council of Economic Advisors. He made a brief presentation during the opening dinner of the conference on June 20th. Professor Slaughter described his experiences in briefing the President and the Cabinet prior to major international trips and interacting with government agencies and members of Congress. He also described his discussions with the newly formed Private Equity Council regarding potential studies regarding job creation and other economic impacts both in the US and internationally as a result of private equity investments.
Opening Remarks

Paul Danos, Dean of the Tuck School, began the second day of the conference by welcoming the participants. As a professor of accounting earlier in his career, Dean Danos expressed his interest in the industry’s efforts to develop best practices and to adjust to the broad global trends in accounting related to fair value and transparency. Dean Danos commented on the depth of experience and range of backgrounds and perspectives represented at the conference. He also encouraged an open dialog in order for the conference to help the industry understand trends, assess best practices, and determine next action steps.
Session 1: Survey Results and International Guidelines

**Moderator:**
Adjunct Associate Professor Fred Wainwright, Center for Private Equity and Entrepreneurship

**Panelists:**
1. Representative from industry association
2. Representative from financial services firm (active with the Private Equity Investment Guidelines Group)
3. Representative from European GP (active with the Association Francaise des Investisseurs en Capital and with the International Private Equity and Venture Capital Valuation Board)

*Editors’ note: these proceedings include quotes that are paraphrases of what was discussed.*

A pension plan representative expressed skepticism about the number of survey respondents (42%) that indicated they had adopted PEIGG guidelines. One of the panelists commented that one does not need to adopt PEIGG to be GAAP compliant. An audience member stated that the survey questions focused on guideline usage rather than GAAP.

Another panelist commented that variations in the titles and responsibilities of the survey respondents (CFO vs. deal partner) would lead to potentially different answers to certain questions in the survey. *Editors’ note: while 20% of all survey respondents chose to remain anonymous, 45% of respondents had senior executive or financial titles such as CEO, CFO,*
Controller, and VP of Finance. The remaining 35% had titles such as Partner, Managing Partner, and Managing Director.

Paragraph 30 of PEIGG, allowing non-financing round write-ups and write-downs, was developed to make the guidelines conform with GAAP. A panelist commented that there is a difference between having a policy that is not GAAP and having guidelines that are not GAAP.

One of the survey questions asked the following: “If your valuation policy does not allow for non-financing round write-ups, does your independent auditor accept this without qualification as GAAP “fair value”?” The survey results are shown below:

Adoption of fair value concepts is taking time

<table>
<thead>
<tr>
<th></th>
<th>Yes 39%</th>
<th>Venture 33%</th>
<th>Buyout 6%</th>
</tr>
</thead>
<tbody>
<tr>
<td>No 61%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: For each percentage shown above, 100% = 69 respondents who answered the question.
One accounting representative stated that from an auditor’s perspective there should be zero GPs who have a policy that requires financing rounds in order to write up valuations. Such a policy is not GAAP. Auditors would make their clients change their policies to allow non-round write-ups. The accounting representative expressed his belief that the question was misunderstood.

A panelist followed up by saying that it is possible that some GPs’ internal operating policies do not allow write-ups without financing rounds. An audience member asked another, who is a venture capital CFO, whether auditors were challenging his non-round write-ups. The CFO answered “absolutely.”

Another audience member, a GP, commented as follows: “We know a lot about how a portfolio company is functioning. If its marketplace is changing should we start tracking those changes and changing our valuation? We are not comfortable with that idea.” Another person stated that it is a long process for the mindset regarding write-ups to change.

Another panelist commented that if the following question was asked of the industry: “Is your valuation policy GAAP?”, there would be around 90% responses saying “Yes, it’s GAAP.”

A panelist followed up by saying that non-round write ups are the exception rather than the rule in early stage venture. An audience member commented that in the buyout world it is rare to have multiple rounds of equity financing.

The conversation moved to the change in attitudes in the past few years from a focus on consistency, regardless of valuation methodology, to a focus on fair value.
An LP in the audience commented that the following slide was disturbing:

**The use of side schedules continues**

“Do you provide your investors with “side schedules” that contain up-to-date valuation estimates that differ from audited financial statements?” (n=131 in 2007)

<table>
<thead>
<tr>
<th>Year</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>26%</td>
<td>74%</td>
</tr>
<tr>
<td>2007</td>
<td>24%</td>
<td>76%</td>
</tr>
</tbody>
</table>

A panelist commented that reactions to the data should vary depending on whether the schedules were being provided to LPs or to boards. The former would be acceptable but the latter would not.

An audience member commented that deal partners who are compensated on performance may have interim side schedules that track valuation changes more closely.
Fair value will impact portfolio write-ups

- In the 2007 survey, 51% of respondents indicated that at least part of their portfolio would be written up if they were to apply fair value principles. This is down from 69% in 2005.

“If you only allow write-ups on a new financing round but you were to apply "fair value" principles, on average, what percentage of your portfolio companies would likely be written up that aren’t written up now?” (n=116 in 2007)

<table>
<thead>
<tr>
<th>% of portfolio that would be written-up</th>
<th>2007</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;50%</td>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>41% to 50%</td>
<td>3%</td>
<td>2%</td>
</tr>
<tr>
<td>31% to 40%</td>
<td>3%</td>
<td>10%</td>
</tr>
<tr>
<td>21% to 30%</td>
<td>7%</td>
<td>12%</td>
</tr>
<tr>
<td>11% to 20%</td>
<td>15%</td>
<td>17%</td>
</tr>
<tr>
<td>Zero to 10%</td>
<td>19%</td>
<td>20%</td>
</tr>
<tr>
<td>N/A (FV)</td>
<td>49%</td>
<td></td>
</tr>
</tbody>
</table>

Note: For each percentage shown above, 100% = 116 respondents who answered the question

Regarding the slide above, a panelist commented that it was encouraging that fair value is being used more often but discouraging that half of respondents say that they will deliver financial statements without applying fair value. So what GPs are saying is not consistent, as an industry, with what they are actually doing. An audience member commented that the slide seemed inconsistent with another survey result stating that over 80% of respondents have done or will consider doing write-ups. He stated that he believed the survey answers meant that “we are still refining fair value, but not really doing it yet.”
A participant asked “what if its prudent or conservative fair value that is being used?” An auditor in the audience quoted “a policy designed to always give you the lowest number is wrong.” Another participant commented about a PE firm that was struggling to adopt fair value but also trying to reassure its LPs that the firm was still being conservative.

A panelist commented: “How much effort should go into a valuation that doesn’t mean much?” He added: “I’d say it does mean something, but other interests get in the way.”

An audience member asked: “Do investors really want their GPs to be spending time in deciding the value of a company with no revenues?” A panelist stated that there is a cost of doing fair value estimates and hard costs get passed on to the LPs. He also asked “What is the benefit on the other side? Who benefits?” Another panelist noted that now we have no top quartile, but if we actually used fair value, we would be able to compare performance.

Adjunct Associate Professor Wainwright introduced the European panelist and she provided a brief summary of developments regarding the International Private Equity and Venture Capital Valuation (IPEV) guidelines. The guidelines were originally a joint venture of the Association Francaise des Investisseurs en Capital (AFIC), the European Venture Capital and Private Equity Association (EVCA) and the British Private Equity and Venture Capital Association (BVCA). She stated that Europe is much more regulated compared to the US and that is probably why European investment firms are more willing to accept standards.

The members of the IPEV board are:

- Professor Dr. Dr. Ann-Kristin Achleitner (Center for Entrepreneurial and Financial Studies)
- Mr. Jens Bisgaard-Franzen (ATP Private Equity Partners)
• Mr. Anthony Cecil (KPMG)
• Mr. Hervé Claquin (ABN AMRO Capital)
• Mr. Gilles Duruflé (Canada’s Venture Capital & Private Equity Association)
• Mr. Jonathan Lowe (Permira)
• Mrs. Monique Saulnier (Sofinnova Partners)

The mandate of the IPEV board includes monitoring market practices, accounting standards, updating the guidelines, and answering questions from practitioners, regulators and investors.

Thirty five associations throughout the world have endorsed the international guidelines, including Canada’s Venture Capital and Private Equity Association (CVCA) and the Institutional Limited Partners Association (ILPA) in North America. The list of associations and other information can be found at www.privateequityvaluation.com.

The European panelist also described the results of a study published in the Journal of Alternative Investments (Fall 2006) by Pierre-Yves Mathonet and Gauthier Monjanel. The authors surveyed over 200 funds in the portfolio of European Investment Fund, a fund of funds. Eighty percent of the EIF portfolio funds indicated that they will adopt the IPEV guidelines. A professor in the audience asked what percentage of respondents were venture capitalists. The panelist stated that 41% of the funds were early stage investors, while 19% provided expansion capital and 14% were buyout funds. Another professor in the audience commented that the percentage of early stage investors was surprisingly high compared to US views of European-based funds being mostly buyout oriented. (Editors’ note: EIF and the authors acknowledge that EIF’s portfolio is weighted toward venture capital and most market participants in Europe tend to invest in buyout funds.)
Another panelist asked about the expected changes in a proposed 2008 update of the IPEV guidelines. The European panelists answered that the ’08 version will address early stage venture issues. A follow-on question was made: “Will interpretation of FAS 157 cause any changes in the IPEV guidelines?” The speaker responded that IPEV follows International Accounting Standard Number 39 (Financial Instruments: Recognition and Measurement), which provides a slightly different hierarchy of valuation methodologies than FAS 157, however, the October 2006 version of the IPEV guidelines meets FAS 157 requirements. Another panelist commented that discounting is one of the differences - the International Financial Reporting Standards (IFRS) recognize that it is not always possible to determine fair value and “with IPEV you can do such things as decrease valuations in increments. There is no such alternative allowed by FASB.”

An audience member asked: “What is the role of industry guidelines in Europe given the International Accounting Standards? Are the guidelines offering best practices or are they helping people achieve consistency?” The presenter responded that many European firms needed help in knowing how to implement accounting regulations. The guidelines were not prescriptive, they were a set of best practices. The industry associations wanted to be helpful to their constituents and the demand for guidelines was high because firms wanted to be fair value compliant but did not know how to do it.

An auditor in the audience commented: “I think we’re getting confused. PEIGG is not a standard setting body and the FASB does tell us what fair value is and those are the rules we follow. Guidelines are fine, and it’s a start, but we’ve got to get to fair value.” A panelist added that there are some questions guidelines cannot answer in getting to fair value.

The same auditor asked an LP in the audience whether he was seeing more fair value coming out of Europe in the firms’ financial statements. The LP representative answered that a large
part of his portfolio was in buyout funds and that he still saw a lot of funds reporting to be fair value that are not. He added that he was in over 100 partnerships representing several thousand portfolio companies and that he could analyze portfolio company data for companies that appeared in more than one partnership. He could see that companies were appearing in reports with different value usually because one GP made an attempt at valuing the company while another GP did not.

A panelist commented that the big differences are likely between the partnerships that leave valuations at cost and those that mark to market - among those that mark to market the valuations vary, but around a mean. The LP answered: “We actually adjust the value for whichever of our GPs’ valuation we consider “better”. A GP in the audience asked: “How do you come to a conclusion regarding that?” The LP responded: “It’s a judgment. If we have a distribution of values on a company that are reasonable and a GP that has done nothing, we would adjust the value for the GP who had done nothing. Generally we would not adjust the value if the GP made a reasonable attempt at valuing the company. We would never value a company that was held in a fund in which we invested because we don’t have enough information on portfolio companies.”
Session 2: Accountant / Auditor Perspectives

Moderator:
Professor Phillip Stocken, Tuck School

Panelists:
1. Representative from a “Big Four” accounting firm
2. Representative from a “Big Four” accounting firm
3. Representative from a “Big Four” accounting firm

Professor Stocken asked the panelists what were the key issues regarding FAS 157. One panelist commented that investment companies cannot use discounts for large blocks of stocks and another issue is transaction cost.

Another panelist stated: “FAS 157, and also FAS 159, may be fine in how they define fair value but frankly everyone should be on fair value for starters.” He added: “Relative to VC vs. buyout - in venture there is less information, and buyout firms have a lot of financial data and comparables, which is easier - but the concepts are the same.”

A panelist commented: “FAS 157 is a very broad pronouncement. Investment companies were ALWAYS supposed to be on fair value. Now the focus is on exit price rather than entry price. What would be the value if you were to sell it today? What’s the best way of doing that?” Another panelist added that there is some confusion on what changed after FAS 157. The fair value concept for investment companies has been required for some time, so there is no change in that sense. GAAP really has not changed much, it’s the industry practice.

Turning to the possibility of carveouts or exceptions to fair value, one panelist expressed his skepticism that any exceptions would be made. Professor Stocken stated: “I understand the motivation for the survey question in that it is very difficult to value early stage companies and that makes sense, perhaps.”

A GP in the audience commented that the value of a venture investment when he tries to sell it might be zero. A panelist followed up by asking as of the measurement day, in the normal course, what would the GP expect to get upon the sale of the company? The GP needs to come up with a methodology and it has to be consistently applied. Another panelist stated:
“We are not valuation experts. People have to apply FAS 157. The auditor’s job is to make sure the financial statements reflect that. We are not there to discuss about the number itself of the valuation.”

A panelist reiterated another panel’s point - he did not see FASB moving in the exceptions path.

An audience member asked if accounting firms are doing anything to change training models to give people the skills needed to audit fair value. He commented that he was skeptical that accountants have the skills to do fair value audits. A panelist answered that it depends from firm to firm. His firm has additional resources that can be drawn in if a validation of results is necessary. Another panelist stated that in his previous job he did precisely that – he was brought in because he had the skills as an expert to monitor the results of an audit.

An LP in the audience commented that the inconsistency among opinions and the underlying financing practices is the problem. He added: “We can see examples purported to be fair value that clearly are not fair value. What are accounting firms doing to address this?”

A panelist responded by saying that his firm’s engagement team makes the decisions, they understand the concept, they should be applying it. His firm does not receive financial statements that are clearly off fair value regulations. Another panelist stated that there is a range of reasonable results. According to another member of the panel, if valuations are all based on management assumptions and there are no comparable companies, the regulations highlight the procedures that should be followed.

An audience member commented that usually, in the cases that a GP keeps valuations at cost, the fund is very conservative and will not write up unless there is a financing event with a third party making the valuation. A panelist followed up by saying that FAS 157 is supposed to point to how fair value is calculated.

Another participant who is an auditor stated: “Auditors can’t audit what management doesn’t do. Management teams at investment firms are not doing a very good job up front and trying to make auditors accept what their numbers are. We are asking for a lot more information. We might also ask for projections. As for third party (appraiser) valuations, we are not asking for those, but we might. Third party valuations are a bit problematic on the LP side.”

Professor Stocken commented that FAS 157 has to be implemented in November this year. A panelist added: “You can early adopt it and not wait for the big bang. You can work with your auditor or bring in experts on the valuation side. It’s important to understand that this is coming and work on it before you get to the end.”

An audience member asked what would be needed to use the multiples approach to valuation [enterprise value as a multiple of sales or EBITDA, for example]. One panelist commented
that he did not know if his auditing firm would require it. Another panelist added that it would depend if different approaches could help in that particular case.

Professor Stocken asked the panel of accountants what kind of documentation would they be asking from GPs to come up with a valuation. A panelist answered that he relies on GP managers’ due diligence process. Another panelist commented that the LPs have the ultimate responsibility to demonstrate the valuation. “Is the LP in a position to receive a valuation from a partnership and determine whether that value makes sense?” asked the panelist. His own answer was that “LPs are probably never going be able to do that, but they can get a sense of what GPs are doing by understanding their process and what guidelines they are following. That requires a lot more transparency. The base mindset is that the LP has to be in a position to assess what is going on in that valuation number.”

The panelists stated that their firms would not be requiring third party valuations as part of their audits as a general rule. They did leave open the possibility that problematic situations may require third party valuations.

A panelist noted that hedge funds do not want to disclose anything. They are more of a challenge regarding valuations of their private company holdings.

An LP in the audience had a request for auditors: “I’d like more precision on what exactly is expected from an LP. It seems that the more we do, the more auditors want. If we leave it at cost, auditors ask why we did not change it, and if we change it they ask why did we choose that number versus other figures. It is cost prohibitive to keep going on this path.”

Another panelist used Nabisco / KKR as an example to note that funds of funds might be responsible for drilling down three tiers to underlying companies and that seems an impossible standard for large funds of funds.

Another LP in the audience commented that GP reporting dates can be problematic for institutions who are on a June fiscal year end. A panelist noted that March fiscal year end information might not be sufficient and portfolio companies file at different times.

A GP in the audience commented that it seems that the level of requirements in financial reports in private equity are higher than what is required in public companies. A panelist added that public companies are regulated by SEC and they have periodic filings to complete.

Professor Stocken questioned the panel regarding what GPs and LPs can do to add value to the process. A panelist answered: “Sit down with your auditors.” Another panelist added: “Start dealing with 157 - where you are now and where you have to be, and figure out what you have to do. All 157 did was expand the definition of FV and how it is to be applied.” One of the panelists commented that FAS 157 does change GAAP in some small areas.”
Preamble to Afternoon Discussions

Participants returned from lunch having discussed in small groups the morning’s panels, the role of PEIGG guidelines, and key issues regarding valuation. Their comments and questions are summarized below. Participants and panelists were urged to keep them in mind during the afternoon sessions.

- Early stage company valuation is much more challenging than buyout portfolio company valuation.

- Blockage discounts should be used based on average daily trading volume. (Note: FAS 157 does not allow blockage discounts.)

- Accountants should not drive the practice of investing. They are running up the bills. Use PEIGG guidelines to be efficient.

- From a venture perspective, the value of a portfolio changes a lot. PEIGG is a way for the industry to say “here’s what we think”.

- Industry guidelines can help translate accounting jargon into something more practical.

- Guidelines should be more principle based and less prescriptive or rules based.

- If the organization issuing the guidelines can be forward thinking, then industry adoption would be easier.

- The increase in cross border deal flow means that there should be global convergence of guidelines.

- Why does FAS 157 even exist?

- LPs are driving the mark-to-market efforts. They are doing more direct investing.

- Many LP executives are being compensated according to the market values of their portfolios.

- The industry has traditionally been a cash-on-cash business, but accountants are saying that fair value is out there.
• Incentive based compensation (of GPs) based on interim valuations would be a big problem.

• Beware of unintended consequences.

• Documentation requirements can become onerous yet the attitude among accountants seems to be that if it cannot be documented it is not valid.

• To use a bowling analogy, guidelines will not help you hit a strike, but they do provide inflatable bumpers to keep the ball in the lane.

• A more accurate portfolio value has the following benefits for LPs:
  o More comparable information
  o Improve investment allocation decisions
  o Improve the application of performance-based compensation
  o Increase the chances of a clean audit opinion, which can lead to better credit ratings and lower borrowing costs.

• Does marking to market really add information for illiquid assets?

• Variations in state laws may create additional hurdles.

• Transactions are getting more complicated and audits are very time consuming.

• There seem to be issues with the lack of consistency and the lack of frequency with which auditing firms train their own employees.

• FAS 157 is going to be THE guideline for valuation.
Session 3: GP Perspectives

Moderator:
Representative from firm active in late stage growth and buyout financings

Panelists:
1. Representative from venture capital firm based on the east coast
2. Representative from venture capital firm based on the east coast
3. Representative from venture capital firm based on the west coast
4. Representative from buyout firm based on the east coast

The moderator began: “Why not go with tax basis financials and don’t even bother with GAAP financials?” A panelist responded: “Why use something other than GAAP for reporting? Deal partners focus on returns and don’t care how results are reported, but CFOs do care, and people want GAAP financials.” According to the panelists, most limited partnership agreements require GAAP but tax-based financials might be acceptable, especially if the specific fund’s capital is immaterial compared to an LP’s total assets under management.

Another panelist stated “Valuations change every day, we need to run a portfolio’s values to make good decisions, this exercise addresses that, forget about FASB.”

A panelist added that after 2003 his firm standardized a form to prepare the information that was needed for valuations – historical financials, projections at high level, market comparables, then comments on why choosing particular discount, and so on. The standardization helped.

For portfolios with many companies that are pre-revenue, there are greater challenges. A panelist commented that his firm has always been in fair value and added: “The old approach was to sit down and review information about the company, then partners decided write ups on that company. Fair value in those days was to identify companies that needed to be written down. Now, with FAS 157, everyone needs to think about write ups. Summaries are prepared by finance, we sit down and audit the portfolio and ask what we think auditors will ask. Then
we go into the portfolio review and challenge our write ups, then we make the decision on whether it makes sense to do the write up. It’s all internal information.”

“The difference with 157,” said another panelist, “Is the rigor of the required documentation. A write up rolls around every quarter, internally, on every company. We sit with partners, company CFOs, so we have a pretty good sense of where companies are. I don’t think is that difficult or complicated. We don’t give our internal work to any LP or advisory committee or valuation committee. The committee has to approve, signing their name, but they don’t have full information. We do discuss with them every company and we answer questions. At the end of the day, I don’t think it is that difficult to come up with a range, but in early stage companies, this changes a lot. It’s a question of documenting why you are booking the numbers you are booking.”

The moderator asked if out of pocket costs have been rising. A panelist answered: “Yes, I see it in staff costs. I require more discipline from the analysts, absolutely more hours spent putting together valuation reports, looking at companies’ financials, more rigor and more documentation. I left out the audit costs.”

Another panelist commented on appraisals: “There was a fear that we would have to get independent third party valuations. It wasn’t clear whether FASB, auditors or our paranoia was driving it. When FAS 157 came out, it essentially said that we don’t have to go thru “…undue cost or effort”, that relieved some pressure. Today in this conference we’ve heard that accounting firms won’t require third party valuations. But it doesn’t mean we don’t need them. It’s our responsibility to come up to fair value and if you feel you need an appraisal, you should get it. The cost is going to depend on what kind of infrastructure you have. LPs want to make sure that the firm’s partners are spending time in things that will make returns and money. To this point, the minute we start using up the time of the GPs on valuations, we start having problems.”

An audience member who is an auditor asked “What internal controls do you have over your firm partners to make sure they have the info they need?” A panelist responded that when information is prepared for each company it is reviewed by all partners.

The same audience member followed up with a question about the new auditing standard: “Even when an auditor is not relying on internal controls, the auditor is required to look at internal control implementation. It may be as simple as having a signature or email, but it needs to be documented.”

After one of the panelists finished describing internal valuation processes, an LP in the audience commented: “Your practice sounds exactly like what we want to see. Do you think you represent the majority?” The question was not addressed definitively but the group conversation about best practices continued.
A panelist (with LP investment committee experience) noted: “I see a lot of reporting, and I still think LPs are not getting the info they need to have. Very little is communicated to them. FAS 157 really helps the secondary market become more efficient. In life sciences in particular it is very difficult to define fair value and it can change by hundreds of millions of dollars because of minor events.”

A GP in the audience commented: “I’m more concerned about the non-round write ups. What percentage are they? Is it a significant portion? How much of a change is it in the magnitude above the cost? I can argue that the valuation of the last round of financing IS a fair market value. Tax basis is a little pejorative.”

A buyout GP stated: “You would not write up the earlier rounds. They have historically been based upon anticipation of a major transaction, either IPO or acquisition. At the time that the information becomes available we question how likely it is and how much of a change in valuation it is going to cause. Our judgment would take into consideration how long it would take until the event and how big a change it would be. If we think there’s an 80% likelihood of the event then we need to adjust, discount, etc. The next time we have to deal with that valuation, we consider the time left to the event again, and run the same analysis, and check why we didn’t get to the IPO, for instance, and consider that in the valuation.”

An audience member asked a panelist: “Would you do a write up without an IPO or acquisition?” The panelist answered: “Exceptionally rare, for instance, a biotech company just getting FDA approval or something like that.” Another panelist stated that his firm only does such write-ups in anticipation of an IPO or M&A exit. A panelist asked another panelist about who receives the fair value calculations and the answer was that the LPs are given the information if they are not subject to public reporting structures.

Another audience member commented: “In this case you have to check the exit value. The prime example is YouTube. The VCs put in $8 million and rode it up to $400 million. My point is that a positive event causing the write up and a negative one afterwards, they both have to be recognized, valuation has to go up, and then go down as circumstances change.”

An LP in the audience asked: “If you have an offer from a third party to purchase one of your portfolio companies but you do not accept that offer, doesn’t that become the floor for your valuation of that company?” A panelist answered: “Well, you could be wrong.” Another panelist commented that in early stage investing there are relatively few companies in a portfolio, 10% to 20%, that generate massive returns. Significant write-ups are relatively rare events in a typical portfolio.

A GP in the audience followed up: “When you mark a company up, but something negative happens afterwards, you’ll have to explain this write down to every single LP. The nature of private equity is to create value off the public scrutiny so GP partners and portfolio company managers can concentrate on producing returns.”
Another panelist noted: “How many events have to be included in value inflections? Our job as a GP is, within time frames from point A to B as set forth with LPs, is there something that was outside expectations? Only then do I make adjustments.” A panelist countered that fair value brings more disclosure and communication with LPs because things have to be explained to LPs and thus everyone has to figure out what happened. He added: “Before this, companies just sat at cost and no one knew what had happened.”

Regarding 409A valuation reports, a panelist commented that he collects them but does not require them. (Editors’ note: Section 409A of the IRS code prescribes rules for amounts deferred under “nonqualified deferred compensation plans.” Under 409A, a nonqualified deferred compensation plan must be valued at fair market value at the date of issuance or grant.) Another panelist added: “It’s a challenge because 409A’s are a data point that you have to recognize. You never had to do that before. We look at discount rates, comparables, etc. and use the 409A reports as one data point.”
Session 4: LP Perspectives

Moderator:
Representative from university endowment

Panelists:
1. Representative from asset management / fund of funds firm based on the east coast
2. Representative from endowment located on the east coast
3. Representative from purchaser of PE fund and portfolio interests based on the east coast
4. Representative from large scale pension plan

The moderator asked: “In anticipation of a new audit, have you changed your audit practices compared to last year?” A panelist responded that he recently changed auditors because he was seeking more expertise. He sat down with the new auditors and rewrote the documentation policy. He commented that it should be re-evaluated every year.

Another panelist commented: “Our partnership agreements are conflictive in regards to the way we should report. We contact GPs on regular basis, but don’t usually change values - it generates more documentation.” The next panelist added: “We have a huge scale, so we need efficiency and transparency. We drafted what would be an LP valuation policy, so we take what we receive from GPs and get to fair value. We have 13 full time people working on this.

The moderator asked about allocations and panelists gave details about their total assets under management, allocations to private equity, and VC/LBO mix.

The moderator continued by asking if any panelists had requested auditors to bring in any experts from within the auditing firms into the process. An auditor in the audience commented: “Regarding audited financial statements, you should have a better understanding of the underlying assets, and it’s only going to improve by working together.” Another audience member commented that auditing firms should work together better as well.
The moderator asked: “Has anyone started streamlining the valuation process?” A panelist answered: “We’re proposing to our auditors that we can’t rely on statements, we look at the GPs’ investment valuation policy, the management team themselves, and document it as well as possible. We need to know if there have been any significant valuation changes in the underlying companies.” An audience member asked: “Do you immediately write down or up?” A panelist answered that the industry has been writing up or down to reported value then making any necessary unrealized market adjustments that are then realized through disposals.

A panelist commented that his organization tried to sell an LP interest in the secondary market and regardless of what the NAV said, when no one expressed interest, that NAV became the ceiling, and the whole thing was written down. An audience member noted that NAV might not be representative of the fair value of an investment and that is why people are asking for portfolio company information. Another panelist added that if they bought an LP interest at a discount they previously would realize it over time but now they write it up to market value. However, if they paid a premium they carried the premium value even if it was above market.

Another panelist commented that tracking portfolios has required a significant investment in software and people to operate the database - nearly a million dollars invested.

A GP in the audience asked about confidentiality issues. One panelist answered that there are issues with third party providers.

Another panelist noted: “The fair value decision has already been made and apparently a lot of GPs have not bought in. LPs want fair value. GPs might want to be aligned with that in case they ever need capital at a time when capital is generally not as available as it is now.”

A question was asked about how often fair value estimates should be done. A panelist answered: “They are necessary to prepare financial statements and useful prior to making a reinvestment decision. Quarterly is probably too much, but yearly is essential to see what kind of value has been created.” A discussion followed about tactics such as offshoring some of the valuation work and the concept of charging additional fees to LPs. An audience member commented that unions that are LPs place limitations on offshoring.

A panelist asked: “Are you seeing qualified opinions in your portfolio regarding 157?” Another panelist answered: “I’d like to see one. I’m concerned that I’ve not seen them. I look at a lot of financial statements that are not fair value, and they keep passing through the auditors.” Another panelist added: “My preference is audited fair value, but I’ll take unaudited fair value if I can get it.” An audience member commented that the top 25% of GPs call their own shots and an LP would not sell their interest in a top GP solely due to a qualified audit opinion or incomplete fair value reporting.
Session 5: Alternatives and Implications for the Future

Moderator:
Professor Colin Blaydon, Tuck School

Panelists:
1. Representative from a “Big Four” accounting firm
2. Representative from financial services firm (active with the Private Equity Investment Guidelines Group)
3. Representative from university endowment
4. Representative from firm active in late stage growth and buyout financings
5. Professor Phillip Stocken, Tuck School

A panelist began with the following comments: “There’s a lot of noise about what ‘auditors are making us do’. There’s a great interest in private equity and how GPs do things, and transparency in financial reporting is a cornerstone of that. I did get concerned about that noise. There is also noise on auditing and transparency costs, and there is a war for talent too. The train has left the station on fair value - there’s no more discussion on this. Sarbanes Oxley has changed everything and some of what we’re seeing in this industry is an aftermath of that. Public companies are not the only ones affected, it’s rolling down to private entities too.”

Another panelist added: “Transparency in the industry is very important - there’s no such thing as a private industry in the capital markets. The auditors’ knowledge about fair value has changed. Fair value is more engrained now in the literature and better trained people - they may not understand private equity, but they do understand fair value.”

A panelist followed up by saying that auditing clients are expected to have valuation reports. Internal control reports have changed. GPs will go crazy about this, but it will happen.”

An audience member commented that globalization adds pressure to transparency in financial statements.
Another panelist commented: “There are a couple of things that I think the industry can do better. Fair value is decided already - major corporations are fair value, LPs are fair value, FASB has adopted fair value, GPs need to be fair value. If GPs would speak fair value, it would be very helpful. From a self-regulatory perspective, there have been no big frauds under private equity management, so the industry has done a good job managing itself.

Another panelist commented: “Fair value is here. It is non-negotiable. A suggestion might be that auditing teams that focus on private equity funds receive specialized training. Private equity portfolio companies tend to be well-managed so why is valuation so difficult?”

“What struck me,” said a panelist, “Was that in 2003 fair value started gaining momentum, and despite initially a lot of resistance from early stage GPs, I thought the industry moved past that. In that sense I was surprised about the survey.”

The moderator commented that attitudes have not changed, but behavior has.

A panelist followed up by saying: “I talk to a lot of LPs and none of them seem to like fair value.” Another panelist added that a lot of the documentation should have been there all along. A member of academia commented that it is amazing how fair value has changed in the past ten years and how FASB has changed in that regard. He added: “My biggest concern is fair value of non-financial assets – how fair value is implemented and the difficulties and costs in trying to value some portfolio companies. The academic view is that there is a concern regarding implementation.”

Another panelist followed up by saying that users do not want complicated problems with rules - they want to be told clearly what to do. FAS 157 is an effort in that way. Industry guidelines are not rules. They are a good way for firms to communicate but there is a concern that guidelines will replace accounting principles that define fair value. A panelist commented that PEIGG guidelines encouraged GPs to do what they should have always been doing. PEIGG provides a way to take some accounting information that is generic for all companies and put it into an industry context, which can be helpful.

An LP added: “Having a guideline in your back pocket is better than doing something just because one person or firms thinks so. Some people put a lot of thought into PEIGG.” A panelist countered that he certainly did not object to them but he did not think they had to exist because GPs have to make sure they are getting to fair value.

A participant commented that a lot of people do not like volatility, but volatility is there whether you measure it or not.

A panelist made a series of comments. There is a “blame the auditor” mentality. Regulators want to ensure transparency in the system. There are complaints about costs of audits and extra time required. Sarbanes Oxley affects private companies. Audit guides have been
developed and the auditors’ definition of fair value is clear. The auditors’ responsibility for documentation of management decisions has increased. The GPs’ review of policies should be documented. On the venture side, fund sizes are smaller leaving less margin available for increased costs related to fair value – and this is especially important given how many venture funds are dealing with an increasingly international scope of opportunities.
Appendix

Valuation related guidelines, regulations, board membership, and other reference materials can be found at the following URLs:

American Institute of Certified Public Accountants – *Alternative Investments - Audit Considerations*  
([http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.htm](http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.htm))

American Institute of Certified Public Accountants – *SAS 101 / AU 328 Auditing Fair Value Measurements and Disclosures*  
([https://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/auditing_standards.htm](https://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Authoritative+Standards+and+Related+Guidance+for+Non-Issuers/auditing_standards.htm))

Financial Accounting Standards Board – *FAS 157 Fair Value Measurements*  

Financial Accounting Standards Board – *FAS 159 The Fair Value Option for Financial Assets and Financial Liabilities*  
([http://www.fasb.org/st/summary/stsum159.shtml](http://www.fasb.org/st/summary/stsum159.shtml))

International Accounting Standards Board – *IAS 39 Financial Instruments: Recognition and Measurement*  

International Private Equity and Venture Capital Valuation Guidelines  
([www.privateequityvaluation.com](http://www.privateequityvaluation.com))

Private Equity Industry Guidelines Group  
([www.peigg.org](http://www.peigg.org))