



Valuing Assets Held by Private Equity Funds— New Guidance from PEIGG

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Valuing Assets Held by Private Equity Funds— New Guidance from PEIGG

By **David L. Larsen, CPA**

In September 2006 the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards No. 157 *Fair Value Measurements*. While the FASB fair value standard is applicable to all areas where fair value is used in Generally Accepted Accounting Principles (GAAP), its release has again focused attention on valuation processes in the private equity industry.

Just-revised PEIGG guidelines

In December 2003, the Private Equity Industry Guidelines Group (PEIGG) released its *U.S. Private Equity Valuation Guidelines*, currently available on its web site, www.peigg.org. To ensure harmonization with SFAS 157, PEIGG has recently revised their Valuation Guidelines for release in February 2007 (there were no substantive changes to the existing PEIGG guidelines expected). The PEIGG *Valuation Guidelines* were created jointly by managers (i.e. general partners) and investors (i.e. limited partners) incorporating feedback from a wide number of industry participants from around the world to address this need in the industry.

* David Larsen is a Managing Director in the Transaction Advisory Services practice at Duff & Phelps, LLC, San Francisco, where he leads the accounting due diligence practice. Mr. Larsen also leads the Institutional Investor segment of Duff & Phelps' Private Equity practice. He is a special advisor to the Board of Directors of the Institutional Limited Partner Association (ILPA) and serves as a PEIGG Board member and technical advisor to PEIGG and PEIGG's Valuation Subcommittee; David.Larsen@duffandphelps.com. The opinions noted in this article are those of Mr. Larsen and not necessarily the opinions of Duff and Phelps, ILPA or PEIGG.

Historically, the U.S. private equity industry had not seen a great need for valuation standards until the technology bubble burst in 2000, and limited partners began realizing they were not getting an accurate assessment of how fast the values of their portfolios were changing. Since then, there continues to be a huge influx of capital into the private equity market. Valuation guidelines are necessary to provide investors with sufficient transparency to evaluate and monitor investments on a consistent basis.

Most investors (limited partners) prepare financial statements in accordance with GAAP and are required to record their investments at "fair value". Most managers (general partners) are required in their partnership agreement to prepare fund financial statements in accordance with GAAP and therefore record their investments at fair value. As many business appraisers are aware, SFAS 157, paragraph 5, defines 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.

If limited partners receive valuation information from their managers on a "cost" basis, the limited partners are required to adjust the carrying value of their investments to "fair value" for their own financial statements.

It should be fairly obvious that the investment manager is in a far better position to determine fair value than are the individual investors. SFAS 157 provides a framework for determining fair value. The PEIGG *Valuation Guidelines* provide supplemental guidance consistent with SFAS 157, specifically designed for the private equity industry.

A framework for fair value PE determinations

SFAS 157 requires managers take into account all available information without incurring undue cost or

Continued to next page...

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Valuing Assets

...continued from front page

effort. Some, though not all, managers utilize a third party to assist in the fair value determination; Duff & Phelps specializes in this service and has been able to assist in creating a best practices framework for its clients.

Fair Value in private equity ensures managers are using the same valuation in their GAAP financial statements, their investor conferences and in their fund raising documents. Private equity's historic cost bias often resulted in different values being presented by managers in their financial statements and their marketing and solicitation documents.

The use of fair value requires managers to exercise judgment. The PEIGG *Valuation Guidelines* provide a framework whereby different managers will approach the valuation process using a common methodology. While the managers' judgment will result in different, but supportable, views on valuation, using a common methodology should narrow the range of these results.

The first and greatest impact the PEIGG *Valuation Guidelines* had on the private equity industry was to provide a framework whereby all private equity investments could be valued at fair value using a consistent and prudent approach. A second major impact was to highlight that GAAP requires fair value reporting for private equity investments, and the historic cost bias to estimating fair value is no longer appropriate.

It should also be noted that PEIGG's work was a factor in encouraging European venture capital and private equity associations—Association Française des Investisseurs en Capital (AFIC), British Venture Capital Association (BVCA), and the European Private Equity & Venture Capital Association (EVCA)—to come together and create new international private equity valuation guidelines in late 2005. (See <http://www.privateequityvaluation.com>.)

Initially, some industry participants expressed the concern that managers would be tempted to raise valuations too quickly. However, GAAP requires fair value; therefore, when utilizing fair value concepts there should be no bias to move valuations up more quickly than to move them down. Fair value is fair value and should be recorded as such.

Managers and investors must realize that having a valuation policy which states: "We value our investments at cost or the value of the latest round of financing," is not compliant with GAAP and is not consistent with the PEIGG *Guidelines*. However, a policy which states: "We value our investments at fair value..." with further description as to how fair value is determined, could reasonably result in a fair value equivalent to the value of the latest round of financing, in particular for venture-backed companies—assuming all relevant information is taken into account.

Continued to next page...

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Valuing Assets

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Encouraging greater consistency and credibility

As the private equity industry has matured in the United States, the need has grown for common valuation standards and greater consistency of reported results. The PEIGG *Valuation Guidelines* provide managers a framework for valuing investments in portfolio companies at fair value, and encourages greater consistency within the private equity industry with regard to valuations. One does not have to use the PEIGG guidelines to be in conformity with GAAP, but if one does use the PEIGG guidelines they should be in conformity with GAAP.

The PEIGG *Valuation Guidelines* were designed to provide a framework whereby private equity investments could be valued, in accordance with GAAP using consistent and transparent methodologies. Managers must always exercise judgment in determining the value of an investment in a private company. However, application of the most current PEIGG *Valuation Guidelines* will encourage managers to proactively determine, on a prudent basis, the fair value of their investments. As a result, the simplistic cost basis has been eliminated and managers and investors are able to base decisions on their best estimate of “fair value.”

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