OF INTEREST

Use of Independent Firms in Private Equity Fund Valuations

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Private equity valuations have been subject to increasing review from both limited partner investors and regulators. In addition, the independent accounting firms have seen their audit procedures for fair value determinations and estimates come under increased scrutiny. Publicly-traded investment managers – addressing their valuations in the context of revenue recognition for carried interest on unrealized private equity holdings – are now generally using independent firms to assist with their valuation work. While this may suggest the use of independent firms more broadly by stand-alone private equity managers, neither U.S. generally accepted accounting principles (GAAP) nor industry guidelines require managers to obtain independent valuations.

The IPEV Valuation Guidelines[1] and the Private Equity Industry Guidelines Group (PEIGG) U.S. Private Equity Valuation Guidelines[2] provide a framework for valuing investments in portfolio companies at fair value, consistent with GAAP and ASC Topic 820 (formerly FAS 157). The AICPA has also established a task force to issue a draft practice aid focused on valuing holdings of private equity and venture capital funds, expected to be published in 2016.

1 International Private Equity and Venture Capital Valuation Guidelines, Edition December 2012.

2 Updated U.S. Private Equity Valuation Guidelines, March 2007.

ASC Topic 820 establishes a three-level hierarchy for fair value measurements, based on the observability of inputs used in the determination of fair values:

> Level I: Quoted prices are available in active markets for identical assets as of the measurement date.
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> Level II: Pricing inputs, other than quoted prices in active markets, are either directly or indirectly observable as of the measurement date, and fair value is determined through the use of models or other valuation methodologies.
>
> Level III: Pricing inputs are unobservable and there may be little, if any, market activity.

Portfolio company investments in Level III can include formative, novel or "binary" business models and complex security packages. Early-stage or growth-oriented private equity firms are frequently valuing Level III holdings within their portfolio.

The publicly-traded investment managers are generally making use of independent firms to assist in their valuation process, either for all Level III assets or on a sampling basis quarterly or annually, including to support Sarbanes-Oxley compliance and demonstrate a strong internal controls environment. Many stand-alone private equity managers have been asking whether accounting rules, or industry practices, will require them to also use independent valuation firms. Pressure relating to valuations has grown for these firms for a number of reasons, including:

- more frequent fundraising cycles, requiring the presentation of interim performance data and IRR of "active" funds;
- continued focus on valuation practices in SEC examinations conducted by the Office of Compliance Inspections and Examinations (OCIE);
- prevalence of sponsor-to-sponsor sales of portfolio companies, which can highlight the variance in valuations; and
- institutional investors continuing to have exposure to portfolio companies through more than one private equity firm, and seeking consistency across their various managers.[3]

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[3] As noted in the PEIGG Guidelines, "Managers of funds should, without undue cost and effort, contact other sophisticated investors to discuss the valuations of common investments and the factors considered in their valuations. However, managers are not required to use other investors' valuations since the estimate of fair value is the responsibility of the managers." Any such discussion with other investors should be balanced with commercial constraints and issues relating to confidentiality.

While any of these factors could suggest the use of an independent valuation firm, the benefits of an independent valuation review will depend on the scope and nature of the work, which can prove to be expensive and time-consuming. A robust internal valuation practice is sufficient under current standards and continues to be industry practice for private equity firms not part of a publicly-reporting platform. Private fund managers should maintain a disciplined internal process for periodically valuing their portfolio companies, with appropriate review by finance and accounting personnel familiar with valuation methodologies and able to engage with investment professionals. Firms should consider establishing an internal valuation committee including the firm's Chief Financial Officer and Controller, to assess the recommendations of investment professionals and the methodologies used, with a principal focus on determining mathematical accuracy and the consistency of various assumptions made across the portfolio over time. The internal valuation committee should maintain minutes of its discussions, the information it reviewed and the ultimate approval of valuation recommendations by the manager. The accounting team should conduct periodic back-testing, to assess any variance from events such as a public offering, other external financing or exit, and the prior quarter's carrying value. A written valuation policy should be maintained, and ideally reviewed by the fund's limited partner advisory committee or valuation committee at the time the fund is established and periodically thereafter.

If engagement of an outside valuation firm is being considered, the scope of work should be clear and understood, as valuation firms will generally limit their work to agreed-upon procedures or review of valuation determinations and corroborative calculations to confirm that the manager's marks are within a reasonable range. Further valuation work can be done, in particular for large, concentrated positions or complex securities, but at additional effort and cost. Managers should also carefully consider the allocation of expenses associated with any independent review, as between the manager and the private fund, and whether the limited partnership agreement or other governing document allows for the allocation of third-party valuation expenses to the fund.[4]

Regardless of whether an independent third party is engaged, private fund managers should remember that valuations and determinations of fair value are ultimately the manager's responsibility, consistent with GAAP, industry guidelines and obligations to funds and underlying investors.

4 "Many limited partnership agreements are broad in their characterization of the type of fees and expenses that can be charged to portfolio companies (as opposed to being borne by the adviser). This has created an enormous grey area, allowing advisers to charge fees and pass along expenses that are not reasonably contemplated by investors." Spreading Sunshine in Private Equity, speech by Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, May 6, 2014.

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