

VALUATION observations



Private Equity Firms Face Increasing Pressure for Independent Valuation Assistance

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As the U.S. private equity industry has expanded over the years, the focus of participants and regulators on the appropriateness of reported fund values has become increasingly acute. For many years, private equity funds carried investments in illiquid companies at cost unless a subsequent financial transaction or fund liquidation supported a different value. Now the rules have changed, amidst a severe decline in market liquidity. Private equity firms, many of which report under the guidance laid out in Statement of Financial Accounting Standards No. 157 - *Fair Value Measurements* ("SFAS 157"), can no longer simply rely on the historical cost or values provided by the latest round of financing as an approximation of fair value. Many funds are conducting comprehensive evaluations of the recorded values of the fund's investments in order to assure compliance with applicable fair value guidance and investor and regulatory requirements.

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Before SFAS 157

Until the release of SFAS 157 in September 2006, private equity funds and their auditors could plausibly argue that historical cost provided an adequate approximation of fair value for many private companies. Supporting this argument was the lack of guidance provided by the Financial Accounting Standards Board, which neglected to define the market forces and other external factors that could cause a material variation in asset value from historical cost. However, the new fair value guidance in SFAS 157 mandates applicable assets and liabilities, including investments in illiquid assets, are now required to be carried at "fair value," taking into account specific valuation drivers and paying additional attention to the methodologies by which these valuations are established.

Benefits of Fair Value Measurement

Private equity firms have a vested interest in reporting assets at fair value for a number of reasons, including: (1)

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investors' desire to measure interim performance; (2) investor's need for fair value data to report investments in their own financial statements; (3) a manager's need to report and measure valuations in accordance with fund agreements; and (4) the need to determine the allocation of distributions of fund realizations.ⁱ Further, some general partners are required to furnish GAAP-compliant financial statements to their limited partners. Should general partners of private equity firms fail to properly establish fair value in accordance with SFAS 157, significant problems are also created for some limited partners. For example, public pension systems are legally required to produce annual GAAP-compliant financials, and their fiduciaries must distinguish fair market value of the private equity investments to evaluate whether these investments remain prudent for the plan.

Are Independent Valuers Needed?

That being said, even if private equity firms provide investors with the fair values of investments, regulatory authorities have established that "a process which merely uses the general partner's established value for all funds without additional analysis may not insure that the alternative assets are valued at fair market value."ⁱⁱ While authorities have not explicitly explained how pension plan fiduciaries are supposed to value alternative assets on annual Form 5500 filings with the Department of Labor ("DOL"), according to a 2008 investigatory letter from the DOL's Boston office to an

unnamed pension plan, plans should have a process in place to independently value alternative assets. As a result, private equity firms may be forced to either produce independent valuations to support reported fair values, or subject their records to the inspection of independent valuation specialists. Valuation specialists can be useful in helping investors comply with the increasingly stringent regulatory environment. 

ⁱ Private Equity Industry Guideline Group. *Guidelines for Valuations of Private Equity Investments*. www.peigg.org.

ⁱⁱ 2008 ERISA Advisory Council on Employee Welfare and Pension Benefit Plans

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