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RE: Comment Letter on the IASB's proposed Measurement Uncertainty Analysis Disclosure for Fair Value Measurements and the FASB's proposed Accounting Standards Update (ASU) "Fair Value Measurements and Disclosures (Topic 820)"

Dear Board Members,

The International Private Equity and Venture Capital Valuation Board (IPEV Board) appreciates and welcomes the opportunity to respond to the Exposure Drafts (EDs) on Fair Value Measurements and Disclosures. As we have always stated with our responses in the past, there is great importance for the private equity investment community to be able to obtain and rely on consistently determined fair value estimates. Fair Value Measurements is a subject area where preparers, users and auditors face challenges in understanding true measures of value.

The International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines), launched in March 2005 and revised in September 2009, provide the private equity industry with best practice in consistently estimating the fair value of investments compliant with IFRS and US GAAP accounting principles. Valuation guidelines are used by the private equity and venture capital industry for valuing private investments and provide a framework for fund managers and investors to monitor the value of existing investments.

Our responses are presented with the objective of providing the boards with practical input on the impact of the proposed changes on the global private equity industry. Because of the unique nature of the private equity[1] industry, in particular regularly valuing illiquid or infrequently traded assets, we can provide the boards with our experience of the challenges inherent in exercising judgment to value such assets consistent with the principles espoused by both the IASB and FASB. We acknowledge that other asset classes also include illiquid financial instruments. We believe that our significant experience valuing private equity investments will be of assistance as fair value principles are modified

The IPEV Board supports the use of fair value as the best measure of valuing private equity portfolio companies and investments in private equity funds. The following represent our comments

[1] For ease of reading, the term private equity as used in this document means: buy-out funds, mezzanine debt funds, venture capital funds, and certain fund-of-funds.

to your specific questions where we have input; we have organized our response to follow FASB's questions and have included our response to the IASB questions in the relevant FASB section. :

FASB Question 1

This Exposure Draft represents the Board's commitment toward developing common fair value measurement guidance with the IASB. Do you think the proposed amendments:

a. Would improve the understandability of the fair value measurement guidance in U.S. GAAP? If not, why not?

We fully support converged U.S. GAAP / IFRS Fair Value Measurement and Disclosure standards. However, as more fully explained in our responses below, we do not believe the proposed US GAAP changes (and the implicit IFRS expected guidance) will always result in consistent, useable and understandable fair value estimates.

Generally, for the private equity industry, a fair value measurement represents the sale of a private company at an estimated *exchange price*. For private equity, *market participants* could include strategic (corporate) buyers, financial (private equity) buyers, or the public market (initial public offerings). Observable transaction prices are generally available only twice, once at entry and once at exit, usually several years later, or at times when an early stage investee company requires additional funding rounds, which can be years apart.

We are concerned that the Board's proposal leads one to assume that an asset is **sold individually**, i.e., not as part of a group of assets or a business. In particular, we believe that the "individual" premise could be grossly misunderstood as an individual share, rather than the group of shares making up an ownership interest. Specifically, when the asset is an ownership interest in a private company, it should be clear that the percentage ownership of the entire company is being valued, not each individual share representing an ownership interest. A corresponding problem is the prohibition to look at an ownership interest as a block. Private equity investors buy and sell portions of private companies. They rarely purchase individual shares. Therefore the unit of account should be the ownership interest in the private company, not an individual share of a private company. The unit of account concept can be used effectively to describe how each ownership interest may have its own unique legal and economic terms. But to be useful for private equity, the unit of account concept needs to be broad enough to take into account a wide range of equity and debt/equity ownership structures and also ownership interests with a wide variety of rights. Unit of account from a private equity perspective should be viewed as just a convenient way to measure ownership, no different than if ownership was stated as a direct percentage of the business as a whole.

While we do not believe it is the Board's intent, we believe that the proposed changes would alter fair value estimates from current practice. We outline our concerns below.

b. Would result in any unintended consequences on the application of the proposed amendments? If so, please describe those consequences.

As noted above, while we do not believe it is the Board's intent, the proposed changes could result in an interpretation where all private equity investments are valued on an individual share basis. As we further describe below, the removal of the highest and best use and in-exchange valuation premise for financial instruments and the prohibition from using the concept of a block for assets valued using level 3 inputs, would effectively remove the valuation premise used by market participants

As outlined in the IPEV Valuation Guidelines, and as is industry practice, market participants generally determine the overall enterprise value of a private entity and allocate that enterprise value to various claims on the entity's capital structure, depending on specific facts and circumstances, to estimate fair value. The proposed changes could cause values to be estimated without regard to the market participant view for certain securities. The unintended consequence of individual share valuation could be corrected by retaining the concepts of highest and best use, and in-use valuation premises for financial instruments and by reinforcing that the unit of account should be determined from a market participant view. For private equity investments in non traded securities, the unit of account should be the ownership interest.

Further, the elimination of the concept of highest and best use, the elimination of the in-use valuation premise, and the prohibition to assess the unit of account using a block, or group, perspective are all counter to the market participant perspective of estimating and then allocating enterprise value to determine the fair value of private equity investments. The Board's proposal would represent a significant change to established practice.

FASB Question 2:

The Board has decided to specify that the concepts of highest and best use and valuation premise are only to be applied when measuring the fair value of nonfinancial assets. Are there situations in which those concepts could be applied to financial assets or to liabilities? If so, please describe those situations.

As included in our response to the IASB Fair Value Exposure draft, we concurred that "The fair value of an asset should consider a market participant's ability to generate economic benefit by using the asset <u>in its highest and best use</u> or by selling it to another market participant who will use the asset in its highest and best use."

The concepts of highest and best use and valuation premise are important in determining how a market participant would view an investment in a private company. As noted above, when the asset being valued is an ownership interest in a private company, it should be clear that the percentage ownership of the entire company is being valued, not each individual share representing an ownership interest. The concept of highest and best use is one of the main investment premises and drivers of transactions in the private equity industry.

There are circumstances in which the value to the current owner is greater than the value in an exit transaction. For example, a company with a large tax operating loss carry forward may be of more value to an existing owner than it would be to a buyer who may lose the benefit of the tax loss carry forward due to change in control provisions of the applicable tax code. Therefore, the highest and best use to both buyer and seller may be to exchange only that portion of ownership which would not trigger the loss of the tax benefit. Said another way, selling a 49% interest could be more valuable than selling a 100% interest. The proposed standard should allow for the exercise of judgment and the assessment of market participant perspectives. Eliminating the concepts of highest and best use and valuation the in-use premise for financial instruments would limit the ability to exercise such judgment, because the investment may be viewed from a single share basis rather than from a market participant perspective.

FASB Question 3:

Do you agree with the proposed guidance for measuring the fair value of an instrument classified in shareholders' equity? Why or why not?

Not applicable to Private Equity and Venture Capital.

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FASB Question 4:

The Board has decided to permit an exception to fair value measurement requirements for measuring the fair value of a group of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to a particular market risk (or risks) (that is, interest rate risk, currency risk, or other price risk) or to the credit risk of a particular counterparty.

a. Do you think that proposal is appropriate? If not, why not?

b. Do you believe that the application of the proposed guidance would change the fair value measurements of financial assets and financial liabilities that are managed on the basis of the reporting entity's net exposure to those risks? If so, please describe how the proposed guidance would affect current practice.

Not applicable to Private Equity and Venture Capital.

FASB Question 5:

The Board has decided to clarify the meaning of a blockage factor and to prohibit the use of a blockage factor when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). Do you think that proposal is appropriate? If not, why not?

We do not agree with the Board's prohibition of the use of blockage factors for assets valued using level 3 inputs. The issue of "blockage" should be viewed as a valuation premise. As noted above, we believe that valuing individual instruments could be misconstrued to mean individual shares rather than the specific ownership interest of a private company. Therefore, we strongly encourage the Board to clarify, for purposes of valuing investments in private companies, that a market participant view should be used; e.g. that the ownership interest is the "unit of account" to be valued.

We also do not agree with the prohibition of using a blockage discount or premium for assets valued using level one or two inputs. Private equity funds hold shares in actively traded companies, generally because of an initial public offering. Investors in private equity funds (endowments, pension funds, etc.), generally prefer receiving cash proceeds from the sale or flotation of an underlying investee company. Therefore, to monetize investments in actively traded shares, with thin volume, a private equity fund will seek either a "block" trade or must wait until sufficient volume exists to sell a block of shares. Private equity funds do not sell individual shares.

Empirical evidence exists which demonstrates that a limited partner investor that receives the distribution of shares from a fund manager, generally realizes a 5-15% discount from the distribution price, as shares are sold and converted to cash over the ensuing period. We understand the Board considered this problem when it prohibited the use of blockage discounts for level one inputs in SFAS 157. However, as the Board now considers prohibiting all blockage discounts (the proposed ASU does not prohibit blockage premiums), we strongly encourage the Board to acknowledge and address the fact that market participants who are the theoretical buyers of private equity investments do not purchase individual shares, they purchase blocks of shares.

FASB Question 6:

The Board has decided to specify that other premiums and discounts (for example, a control premium or a noncontrolling interest discount) should be taken into account in fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy when market participants would take into account those premiums or discounts when pricing an asset or a liability consistent with the unit of account for that asset or liability.

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a. Do you think that proposal is appropriate? If not, why not?

As previously noted, we fully agree that all features of an ownership interest in a private company should be valued from a market participant perspective. The ideas of control premium or noncontrolling interest discount are to a great extent theoretical valuation concepts. We believe it is the Board's intention, by introducing these concepts in the proposal, to ensure that all features of an investment, including control, are properly included in the valuation estimate. However, because of the prohibition from considering highest and best use, valuation premise, and grouping (blockage), we are concerned that there may never be a situation in which an individual instrument would be valued using the concept of control.

We suggest that the Board clarify language to focus on determining the fair value of an asset, including all of its features (one of which may be the extent of control), from a market participant perspective. Again, a market participant in private equity would group all shares together in estimating the value. As currently drafted the proposal appears to conceptually allow control features to be included in the valuation estimate, but effectively prohibits their inclusion because a "control block" is prohibited from being valued as a unit. Therefore, if adopted, the proposal will create confusion and will cause divergence in practice when valuing all features of an investment including control or non-control.

b. When the unit of account for a particular asset or liability is not clearly specified in another Topic, how would you apply that proposed guidance in practice? Please describe the circumstances (that is, the asset or liability and the relevant Topic) for which the unit of account is not clear.

The unit of account for a Private Equity investment should be determined from a market participant perspective. As we have previously stated, private equity investors buy and sell portions of or entire private companies. They rarely purchase individual shares. Therefore the unit of account should be the ownership interest in the private company, not an individual share of a private company. The proposed guidance, even when considering guidance found in Topic 946, Investment Company Accounting, does not appear to allow the ownership interest to be deemed the appropriate unit of account.

FASB Question 7:

The Board has decided to require a reporting entity to disclose a measurement uncertainty analysis that takes into account the effect of correlation between unobservable inputs for recurring fair value measurements categorized within Level 3 of the fair value hierarchy unless another Topic specifies that such a disclosure is not required for a particular asset or liability (for example, the Board has decided in its project on the accounting for financial instruments that a measurement uncertainty analysis disclosure would not be required for investments in unquoted equity instruments). Do you think that proposal is appropriate? If not, why not?

IASB Questions 1 & 2:

Are there circumstances in which taking into account the effect of the correlation between unobservable inputs (a) would not be operational (eg for cost-benefit reasons) or (b) would not be appropriate? If so, please describe those circumstances.

If the effect of correlation between unobservable inputs were not required, would the measurement uncertainty analysis prove meaningful information? Why or why not?

We agree with the provision provided in FASB's proposed Financial Instruments Standard to exempt investments in the equity of private companies from measurement uncertainty disclosure. We also believe that private equity investments in the private debt of investee private companies should be exempted. In certain jurisdictions, private equity investments in the equity of a private company are structured as debt to take advantage of local tax regimes. Therefore, requiring measurement uncertainty disclosure just because an investment is labelled debt, rather than equity, is not congruent.

From a technical point of view, we are concerned that the proposed fair value amendments may become effective before the Financial Instruments Standard becomes effective. Therefore, we suggest that the Board include the exemption from disclosure for investments in the equity of private companies (and investments in debt of private companies) within Topic 820 to avoid confusion and to prevent the need for yet another subsequent change to disclosure guidance.

We do not believe that the proposed requirement for Limited Partner investors in private equity funds to provide measurement uncertainty estimates (example at paragraph 820-10-55-80) or from the "fund investment statements" (IASB exposure draft, example 1), is either operational or decision useful. Private equity limited partner investors are already aware of qualitative measurement uncertainties through required investment due diligence and ongoing monitoring of the expertise of the general partner, their investment plans for that fund, and their candid views on the prospects for the investments they have made. A measurement uncertainty analysis, particularly summarized at the portfolio level, is not something currently provided by the general partners and it is unclear how such an analysis would add actionable information to that already provided to investors. In addition, ASU 2009-12 already requires significant disclosures related to investments in such funds.

Limited partner investors rarely have sufficient additional information to determine the effect of the correlation between unobservable inputs. Additionally, when multiple interests in underlying funds are added together, the result becomes even less useful. Significant cost and effort would be required to provide disclosures which on an aggregated basis would be meaningless.

FASB Question 8; IASB Question 3:

Are there alternative disclosures to the proposed measurement uncertainty analysis that you believe might provide users of financial statements with information about the measurement uncertainty inherent in fair value measurements categorized within Level 3 of the fair value hierarchy that the Board should consider instead? If so, please provide a description of those disclosures and the reasons why you think that information would be more useful and more cost-beneficial.

Existing disclosure requirements (Topic 946 and Topic 820) for Investment Companies are extensive and we believe sufficient for the users of those financial statements. Investment Company disclosures include a schedule of investments and other investment related disclosures designed to provide the readers of these financial statements with sufficient information about the investment assets held. ASU 2009-12 (also included in Topic 820), provided additional disclosure requirements for Limited Partner investors in private equity. To the extent the existing Topic 820 disclosure requirements are adopted by the IASB, they are sufficient for both private equity fund financial statement users and limited partner financial statement users.

FASB Question 9:

The Board has decided to require limited retrospective transition. Do you think that proposal is appropriate? If not, why not?

No comment.

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FASB Question 10:

There is no link to the transition guidance for the proposed amendments that the Board believes would not change practice. Are there any proposed amendments that are not linked to the transition guidance that you think should be linked? If so, please identify those proposed amendments and why you think they should be linked to the transition guidance

No comment

FASB Question 11:

The amendments in this proposed Update would apply to public and nonpublic entities (that is, private companies and not-for-profit organizations). Should any of the proposed amendments be different for nonpublic entities? If so, please identify those proposed amendments and describe how and why you think they should be different.

As noted above, we do not believe that the proposed measurement uncertainty disclosures would provide useful information for financial statement users. If the Board disagrees, we recommend that measurement uncertainty disclosures be exempted for all investment made by private equity funds and in private equity fund interests.

FASB Question 12: How much time do you think constituents would need to prepare for and implement the amendments in this proposed Update?

As noted above, the measurement uncertainty disclosure requirements are not operational for limited partner investors in private equity. It could take years for limited partners to create models and data sources to comply with the proposed disclosures. Further, the change in fair value estimates that will result from the elimination of highest and best use, in use valuation premise, prohibition of blockage factors and narrow use of unit of account will require time for investors to understand and explain to their management, investors and boards. If the Boards modify the proposal to eliminate confusion around unit of account, allow judgment to be exercised in assessing highest and best use, valuation premise and blockage, as is done in practice today, combined with excluding private equity investments in debt and equity and in interests of private equity funds from measurement uncertainty disclosure, the proposal could be implemented rapidly.

Other Matters

Restrictions:

The effect on fair value from a restriction as shown in the example at FASB ASC 820-10-55-51/52 is inconsistently applied in practice. We believe, consistent with our understanding of the Board's intent, that a restriction should be evaluated from a market participant perspective. When the owner of a security is contractually obligated not to sell a security for some period of time, the owner cannot sell the security without transferring the same contractual obligation to the buyer. The Board added language at ASC 820-10-35-38A *"if a market participant would consider the effect of a restriction on the sale of an asset when estimating the price for the asset, a reporting entity shall adjust the quoted price to reflect the effect of that restriction."* Many have interpreted existing guidance to prohibit the use of a discount in all cases where it cannot be determined that a legal restriction (not contractual) exists, such as under SEC Rule 144. We believe the proposed language clarifies the question, but deviates from current practice. We suggest that the Board consider enhancing the language to ensure that all restrictions which would impact the amount paid by a market participant would be taken into account when estimating fair value. This could be accomplished by changing the wording in paragraph ASC 820-10-55-52 to focus on a contractual restriction rather than a SEC Rule 144 restriction.

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Fair Value of Contractual Rights (Contingent consideration arrangements)* (Our comment is included in this letter because of inconsistent current treatment in estimating or using fair value)*:

We have observed great confusion exists when evaluating the proper accounting treatment for contractual rights (contingent consideration arrangements). It is becoming increasingly common for private equity firms sell an underlying portfolio company, for both cash consideration and some form of future consideration. The future consideration may depend on the investment being sold meeting certain milestones.

We are not aware of instances where the Board, the Valuation Resource Group (VRG) or the Emerging Issues Task Force (EITF) have considered the question of estimating the fair value of contractual rights for Investment Companies complying with Topic 946. Our understanding of Topic 946 is that all assets of an Investment Company should be measured at fair value. Further, we understand that for a limited partner to use Net Asset Value when valuing an interest in a private equity fund in accordance with ASU 2009-12, that all underlying investments must be measured at fair value.

We understand that part of the confusion surrounding this issue results from the non-consensus EITF decision on topic 09-4 combined with the Board's views included in paragraphs BC142 through BC146 of the Financial Instruments exposure draft. EITF 09-4 and Proposed Financial Instruments paragraphs BC 142 – BC 146 seem to be clearly focused on business combinations, not on Investment Company Accounting. However, many preparers and auditors are applying the business combination guidance to the contractual right assets of Investment Companies. Further, the use of the language, "observable market or observable index" could be confused with the concept of observable used in determining the level (1, 2) of inputs used for fair value measurement.

We recommend that the Board provide clear guidance reinforcing that Investment Companies, complying with Topic 946, must measure all assets, including contractual rights (which are similar to options and warrants), at fair value. Paragraphs 820-10-55-4 through 820-10-55-20 provide sufficient guidance to estimate the value of assets such as contractual rights. The Board should also clarify that level 3 inputs (unobservable in the general market place) but which are observable to those estimating fair value (items such as the contract and projected cash flows) can and should be used in estimating fair value. Without these clarifications, practice will diverge and investors in alternative assets may not be able to use ASU 2009-12 because reported NAV would not include all underlying assets at fair value.

Fair Value of Investment Company Liabilities (comment pertains to the Board's Financial Instruments Exposure Draft):

Because of its fair value implications, we have included in this document our response to Question 5 of the Board's Financial Instruments exposure draft. The proposed financial instrument guidance would require financial liabilities of investment companies be measured at fair value.

Because of the flow-through legal structure of most investment companies, liabilities, if any, generally would be repaid when underlying investments are sold. The fair value of the assets of an investment company is determined based on estimating the amount that would be received if the underlying investments were sold on the measurement date. If they were sold, then liabilities would be repaid at the contractual amount, also referred to as par. The contractual amount, or par value of liabilities, effectively represents fair value because a market participant would view the term of the debt as zero because of the call feature, liabilities must be repaid when the assets are sold. It is difficult to conceive that the liabilities of an investment company should be valued at any amount other than that which brings the fund to a zero NAV upon distribution of the proceeds from the hypothetical orderly sale of all underlying investments (which is the premise of Topic 820—assets are sold as of the measurement date).

We are concerned that the proposed changes to Topic 820, in particular those that eliminate highest and best use, and the in-use valuation premise, would force the liabilities of an investment company to be valued without taking into account the legal structure and the fact that liabilities are repaid when the assets are sold. Further, if the fair value of liabilities was deemed to be an amount other than par value, there would be a corresponding impact on NAV. As a result, the premise for using NAV to estimate the fair value of interests in private equity funds is called into question (i.e. NAV represents the cash that an investor would receive if the underlying investments were sold on the measurement date).

Most private equity funds do not have much leverage, so this may be more of a conceptual than a practical issue. We are not opposed to measuring investment company liabilities at fair value, if Topic 820 is modified to allow, as appropriate, the fair value of liabilities to equal the par value of liabilities by taking into account the "in-use" valuation premise. If the in-use valuation premise is not allowed for financial instruments, we are opposed to measuring investment company liabilities at fair value because fair value of the liabilities may not be estimated consistent with a market participant perspective and the features of the Fund structure.

* * * *

We appreciate the opportunity to provide the Boards with our feedback. We would be pleased to discuss any questions you may have with you.

Very truly yours,

The International Private Equity and Venture Capital Valuation Board

Prof. Herman Daems

Chairman of the IPEV Board

The International Private Equity and Venture Capital Valuation Guidelines

The International Private Equity and Venture Capital Valuation Guidelines (IPEV Guidelines) were launched in March 2005 and revised in September 2009 to reflect the need for greater comparability across the industry and for consistency with IFRS and US GAAP accounting principles. Valuation guidelines are used by the private equity and venture capital industry for valuing private equity investments and provide a framework for fund managers and investors to monitor the value of existing investments. The IPEV Guidelines are based on the overall principle of 'fair value' in order to be consistent with IFRS and US GAAP.

The International Private Equity and Venture Capital Valuation Board (IPEV Board) reports and is accountable to a general assembly composed of all the endorsing associations to manage the evolution of the guidelines going forward. The IPEV Guidelines have been endorsed by 40 national and regional trade associations.

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