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Keynote interview: Duff & Phelps on fair value's importance

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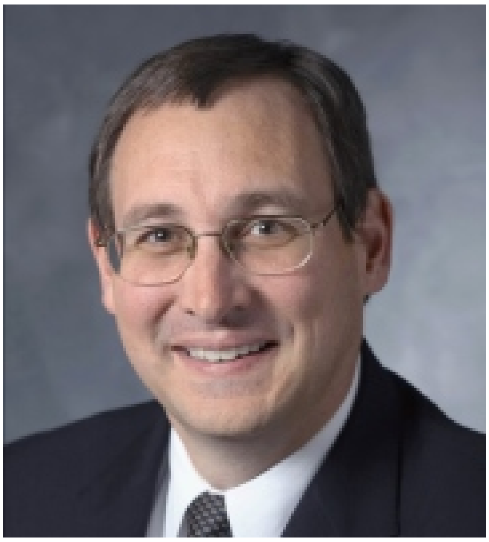
The valuation framework is as crucial as it has ever been. David Larsen, a managing director at Duff & Phelps, discusses why both LPs and GPs need to rigorously determine full value.



David Larsen

For more than 70 years the term ‘fair value’ has been the accounting standard for reporting on investments held by funds. In September 2006 the US Financial Accounting Standards Board issued “SFAS 157” Fair Value Measurements which is now known as ASC Topic 820. Fast forward 10 years and the valuation framework is arguably even more relevant to the private equity industry despite being played down by some market participants.

David Larsen, a managing director of Duff & Phelps, based in the San Francisco office of the valuation and corporate finance advisory firm, explains how fair value impacts alternative asset investments and why it is critically important for LPs and GPs to adhere to fair value measurements.

Why is valuation of critical importance to limited partners and why does it seem to be played down?
LPs are under increasing scrutiny to demonstrate good governance in exercising their fiduciary duty, make superior investment decisions, manage risk, be transparent, and produce high quality reliable financial statements themselves. To achieve these objectives, LPs need timely fair value estimates from managers of funds in which they invest. Historically, the individuals from the LP organization that interact with GP personnel have focused more on ultimate investment performance rather than all these other items. As such, GPs may not appreciate that LPs truly need timely, robust, rigorously developed fair value estimates each time the GP reports.

What is fair value?
The main accounting standards boards – the FASB, the IASB and the GASB – all use the same definition of fair value. Accounting standards require investment companies – hedge funds, venture capital and private equity firms, real estate and mutual funds – to report investments at fair value. LPs are also required to report their investments at fair value. Fair value is the basis that both GPs and LPs use to report quarterly and yearly performance to their investors, beneficiaries and boards. For LPs, fair value is the best basis to make “apples-to-apples” asset allocation decisions. It is also an important data point in making follow-on or new fund commitments. Fair value also provides a consistent basis for risk monitoring and assessment and is often necessary to make incentive compensation decisions.

Is fair value reporting mandatory for LPs?
Most investors, including retirement funds, are required by relevant GAAP to report their investment on a fair value basis. Investment companies (under IFRS and US GAAP) are exempt from consolidation rules because their investments are carried at fair value. The new US GASB fair value accounting rules, which are applicable to government entities, such as public pension plans, reemphasize the need for LPs to rigorously determine fair value.

Can NAV be used by LPs to estimate the fair value of a fund interest?
For LP interests that are not actively traded and have not been designated to be sold, NAV can be used to estimate fair value if three conditions are met: The fund meets the definition of an investment company (ASC Topic 946); net asset value is fair value based (ASC Topic 820 compliant), and NAV is as of the same date as the investors measurement date with no reporting lag.

What do LPs need to do to satisfy themselves that they can use NAV to estimate fair value?
There is guidance on using NAV as a fair value estimate for a fund interest provided by the American Institute of Certified Public Accountants in TIS Section 2220. In particular, section 2220.20 lists 10 considerations, such as the fund’s fair value process, the quality of the fund’s auditor and the use of a third party valuation expert. LPs cannot blindly accept NAV reported by the GP, but must undertake steps during due diligence and ongoing monitoring to ensure that underlying investments are reported on a fair value compliant basis. The fact that a fund is audited, while important, is not sufficient without other supporting analysis, processes and information for the LP to conclude that NAV is an appropriate basis for estimating fair value.

Why do some GPs use third party valuation experts?
Ultimately, the GP is responsible for the fair value based NAV reported to LPs. Valuation responsibility cannot be outsourced. However, an increasing number of GPs (and for that matter LPs) have concluded that they can improve the rigor, transparency and independence of their valuation procedures by

augmenting their internal processes with the objectivity provided by a qualified, experienced third party valuation expert.

How does the involvement of a third party impact cost and timing?
Many GPs have re-engineered their valuation process such that final valuation estimates are concluded upon within five days of month/quarter end. The use of a qualified, experienced third party valuation expert does not increase the time required for the fund to conclude on value. From a cost perspective, depending on the fund agreement, third party valuation expenses are generally deemed a fund expense. As such the cost is spread among all LPs in the fund who thereby benefit by being able to reduce their own internal fair value of NAV monitoring expenses. LPs benefit when a qualified experienced third party is involved and, in a similar way to audit fees, having the valuation expert's cost borne by the fund adds a layer of independence from the GP. If third party valuation fees were borne by the GP, there could be economic pressure to limit the use of the third party which in turn would adversely impact LPs as they would have to potentially bear costs individually which could have been shared among the investors. And finally, when a GP’s valuation process is enhanced through the use of an experienced knowledgeable third party, over time audit fees can be decreased or the rate of increase can diminish.

How do LPs ultimately decide on whether NAV can be used as their fair value estimate of a fund interest?
LPs exercise their judgment in various ways to determine if NAV is sufficiently robust to be used as the LP fair value estimate. Some managers have strong valuation processes and use a qualified experienced third party, and have demonstrated that they consistently provide timely and reliable fair value estimates. Others have less rigorous processes or do not report consistently, with some not reporting fair value at all, preventing the LP from using NAV as their fair value estimate. Breaking down their fund interests into which managers have robust procedures and which don’t will allow an LP to review its entire portfolio in a summary fashion, immediately highlighting where attention is needed.

Do you have any concluding thoughts?
Fair value, while requiring informed judgment, continues to be the best basis for reporting and monitoring investments. LPs are under greater and greater pressure. The best GPs provide vetted, timely, rigorously developed fair value estimates.

David Larsen CPA is a managing director and a leader of the Alternative Asset Advisory practice in the San Francisco office of Duff & Phelps. He serves a wide variety of investors and managers in focusing on valuation and governance-related questions. Larsen serves on the AICPA PE/VC Valuation Guide Taskforce, is vice chair of the International Private Equity and Venture Capital Valuations Board (IPEV), led the team that drafted the US PEIGG Valuation Guidelines and was the private equity representative of FASB’s Valuation Resource Group.

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