ILPA
FASB 157 Fair Value Measurements Webcast
Questions & Answers
Original Broadcast December 11, 2007

The answers provided in the following document were in response to the questions submitted during the ILPA FASB 157 Webcast on December 11, 2007 and represents the opinions of the speakers and not that of the ILPA.

Q1: We've heard that there are new disclosures with respect to 157 that are a concern to certain GPs and their confidentiality agreements. Can you discuss these disclosures?

A: Statement 157 requires disclosures increasing the transparency regarding how fair value is determined. Tabular disclosure of the level in the fair value hierarchy by major category is required. Additional disclosures for Level 3 measurements are also required.

GPs who prepare financial statements in accordance with US GAAP will need to comply with these disclosure requirements.

Q2: What is the preferred method to arrive at a fair value measurement for an investment in a private equity partnership as of and for a public investor's fiscal year end financial statements?

A: At each reporting date (each time financial statements are prepared; which could be monthly quarterly or annually) management must determine the fair value of their investment holdings. Therefore, procedures need to be developed which allow the LP to come to a regular fair value assessment. Further detail is available in the AICPA publication *ALTERNATIVE INVESTMENTS – AUDIT CONSIDERATIONS A Practice Aid for Auditors.*

Q3: How can we all sell and get anything better than a fire sale price?

A: Fair Value is determined using the best information available for a hypothetical transaction at the measurement date, not using forced sale or fire sale pricing.

Q4: Most GP's we deal with say we are receiving fair value. Some say additionally this is conservative. So I guess we are receiving a conservative fair value. This is not really a question but a comment.

A: Historically conservative was deemed appropriate. However, post Enron, “conservative” has come to mean “purposefully understating”. A better term and approach may be to use the concept of “prudence”. Fair Value is an estimate, but is not intended to be biased low or high.

Q5: Does an LPs role on an advisory committee provide substantive support for an LPs practice or policy on asserting that the GP is reporting Fair Value?

A: The advisory committee is primarily "advisory" in nature and the LP may or may not agree with the individual valuation assessments of the GP. Therefore while membership on an advisory committee may allow an LP to obtain relevant information, the LP is ultimately responsible for determining fair value in its own financial statements.

Q6: Are there any new contract languages you would recommend LPs to have included in agreement, to cover the areas of today's' discussion.

A: Contractual language is best determined between the LP and its legal council. In general, it would be appropriate to include language which requires the GP to provide the LP with all pertinent data necessary to reach its Fair Value assessment on a periodic basis.

Q7: I deal in a real market not a hypothetical market. I deal in real values not hypothetical ones. In the real market, NAV is a principled guess not a hypothetical guess. How do you reconcile between hypothetical and reality?

A: GAAP requires making a determination of Fair Value using appropriate judgment in a hypothetical market. GAAP Fair Value is not necessarily economic Fair Value.

Q8: How much Alternative Assets is "material" to your total corpus? For example, if you have 7% of your total corpus's assets in Alternative Investments, and the vast majority of your funds within Alternative Investments report at Fair Value (according to GAAP -- and have audited financial statements), is that not something you can rely on from a materiality standpoint?

A: Materiality is a judgment assessment made by management and the auditors. It may vary from situation to situation and is usually assessed not only from the investment balance point of view, but from the investment income point of view. Again, funds that report fair value are a starting point. LP management has the ultimate responsibility for determining the fair value if its investments.

Q9: Can you comment on how/if you would value unfunded commitments. Would/should you add value to an existing partnership that was oversubscribed, successful, etc. and visa-a-versa?

A: Conceptually, the contractual right to make investments through a fund manager in the future may have value. Such value could be assessed by considering secondary

transactions, considering the extent of oversubscription, and modeling future cash flows. Modeling future cash flows is complex and would be highly dependent on estimating the timing of investments and returns, the rate of appreciation, and the applicable discount rate.

Q10: Fund Managers are responsible for establishing and documenting valuation policy, practices, procedures and methodologies as well as valuing their investment in portfolio companies. Would obtaining a copy of the valuation policy, practices, procedures and methodologies from each of the fund managers be sufficient from an audit perspective or is a more detailed involvement needed to determine our own fair value?

A: Obtaining such information is a great starting point. As further described in the AICPA publication *ALTERNATIVE INVESTMENTS – AUDIT CONSIDERATIONS: A Practice Aid for Auditors* LP management is responsible for determining the fair value if its investments. The LP needs to establish policies and procedures to determine fair value. ILPA has provided previous workshops and documentation on this topic.

Q11: How do the LPs tie back their unaudited quarterly account balances back to the year-end audited financial statement [where LP capital account is collectively audited but individual account balances are not (mostly)]? i.e. how do the auditors give a clean opinion when the statements are out of date and the capital account balances haven't been audited?

A: As noted above the LP is responsible for determining the fair value of its investments. Many LPs use as a starting point the funds audited financial statements. The LP must make a determination if the information contained in the audited financial statements represents fair value at that point in time. Such balances are then rolled forward or backward to the LPs reporting date taking into account new cash investments, investment returns, and other qualitative information available. The AICPA publication *ALTERNATIVE INVESTMENTS – AUDIT CONSIDERATIONS: A Practice Aid for Auditors* provides some further detail as to roll forward or roll back procedures.

Q12: It strikes me as fundamentally problematic, and circular, that you cannot simply rely on the audited financial statements of the fund if they are prepared in accordance with GAAP and are therefore purported to be on a fair value basis. Auditors rely on other auditors work all the time. Why is this situation different (absent the formal legal arrangement for reliance)?

A: LP management is responsible for the fair value assessments contained in its own financial statements. Management cannot abdicate this responsibility. Management uses all available information, including audit reports from its investee funds to come to its fair value assessment.

Q13: Any comments for LPs that invest in fund-of-funds or secondary partnerships?

A: The principals discussed above are applicable whether an LP invests directly into a Fund or through a Fund-of-Funds. LP management is responsible in both cases for determining fair value and needs to obtain as much information from fund managers as is necessary to reach its fair value conclusion.

Q14: Accounting for carried interest. A number of back offices are looking to expense while front offices point to the LPA to show that the value never belonged to the LP, so should be ignored.

A: Treatment varies. Most LPs have concluded that carried interest is a contractual allocation of investment returns and as such is not an expense. It is not something that the LP is obligated to pay as the LP never had any interest in the "carried interest" in the first place.

Q15: How is FAS 157 affected by carried interest?

A: If carried interest is deemed a contractual allocation of investment returns as described above, then carried interest does not impact the fair value assessment if it is properly allocated. In other words, if the GP reports fair value to the LPs net of carried interest then there is not impact on the LPs fair value assessment. If the GP reports fair value gross, e.g. before carried interest, then the LP would have to take that fact into account in making its fair value assessment.

Q16: The level of work and the skill level required under each scenario are considerably different. The question for me is: what is the depth of additional work that will be required of LP's?

A: The amount of effort necessary will be determined by the fair value policies and procedures enacted by LP management. General guidelines are included in the AICPA publication *ALTERNATIVE INVESTMENTS – AUDIT CONSIDERATIONS: A Practice Aid for Auditors*

Q17: Provide examples of valuation policies and illustrate the concepts discussed in FAS 157

A: ILPA has provided workshops on the topic and should have example polices available.

Q18: I really didn't learn anything new. I was told that additional procedures need to be performed by LP's, yet I didn't get a solid understanding as to what those procedures should be. For example, should LP's re-perform valuation techniques for its investments or should LP's merely conduct diligence at the GP level to understand and review the GP's valuation policies?

A: Re-read the AICPA Technical Practice aid and review the ILPA example policy statement. Each LP is responsible for the fair value assessments in its financial statements and for determining its valuation policy.