# Hard-to-Value Assets in Uncertain Times

# Fair Value Reporting Best Practices for Limited Partners

If you are a limited partner (LP) in private equity, real estate or infrastructure (private investments), and you feel an air of fear and uncertainty as you plan and execute your year-end audit, you are not alone.

The light is shining brighter than ever on fair value, at a time when measuring fair value of illiquid assets has never been more difficult. Many LPs are wondering “What am I supposed to do about fair value reporting?” This article details some of the best practices in fair value reporting LPs have implemented.

## The Evolution of LP Fair Value Reporting

From the moment LPs started investing in private investment, they wrestled with how to incorporate the value of illiquid investments into their financial reporting. Most LPs met their reporting requirements by accepting the fund’s reported net asset value (NAV), on a one-quarter lag and rolling it forward (rollforward value) for any capital calls and distributions between the fund’s reporting date and their reporting date, thus not reflecting changes in fair value due to market changes for the interim period. Although imperfect, this practice seemed to stand the test of time.

FOCUS ON FAS 157

**What is FAS 157?**

FASB Statement No. 157, Fair Value Measurements (FAS 157), was issued in September 2006 to provide a single definition and framework for fair value measurements to ensure consistency of application.

**What does it do?**

- Defines fair value
- Establishes a framework for measuring fair value in accordance with generally accepted accounting principles (GAAP)
- Establishes a three-level hierarchy for fair value measurements, based on transparency of inputs to the valuation of an asset or liability as of the measurement date
- Expands disclosures about fair value measurements

**Who does it impact?**

- Mutual funds
- Hedge funds
- Private equity funds
- Pension funds

Over the years leading up to FASB Statement No. 157, ***Fair Value Measurements*** (FAS 157), auditors generally accepted rollforward values as good practice, but increasingly have requested more information While LPs struggled to meet auditor's expanding demands. After all, LPs were invested in private investment funds and didn't have any way to actually value the underlying assets. LPs didn't have access to the data they needed to perform those valuations, nor the resources to do the analysis.

Progressive LPs quickly began to evolve and develop a new set of industry best practices on what to do to satisfy these new requirements for fair value—all the while still considering a stable market. They began to demand fair value reporting from all their private investment funds. Some of the longest-standing fund managers, who had raised many past funds under tax-basis reporting, found themselves raising their 2008 vintages using fair value GAAP reporting because of investor pressure. This was clearly a step in the right direction. It is noteworthy that prior to 2008, it is estimated that as many as 25% of private investment funds were still reporting non-GAAP financials.

At the same time, LPs realized it is equally crucial to understand the valuation policies and practices of their external fund managers. So as part of the operational due diligence on new managers, and ongoing monitoring of existing managers, LPs started asking for written copies of fund's valuation policies and procedures. For the LPs outsourcing their administration to J.P. Morgan, this meant a change in their service level. To help our clients better understand the valuations they received, J.P. Morgan began to gather and store the valuation policies for all fund managers in an LP's portfolio.

Even with this additional detail on the funds' NAV calculations, LPs were still unsure if rollforward values were sufficient, and many auditors shared the same uncertainty. As LPs continued to analyze what was possible given the data they had, best practices continued to evolve. LPs started deviating from the reported NAV for some of their funds, which led to more new best practices.

LPs who had direct investments had to start identifying assets held in a fund that they also held directly. In these cases, they now had better data to perform their own objective and independent valuation on their direct holding and use it as a proxy for the fund's value of the same asset.

Leveraging this principle, the question arose, "What if I looked across and into my whole portfolio at underlying assets?" No two valuations will be the same, but outliers should be followed up on. If one fund holds an asset at cost in a tax-basis report, and the same asset was held at three times cost in an audited GAAP report, there would be cause for follow-up. This best practice suggested LPs replace the fair value for an asset versus the tax basis value in their reporting. Upon the request of our LP clients, J.P. Morgan can identify the cross-holdings in underlying assets or underlying funds across our client's entire portfolio, facilitating the needed drill-down by clients.

Another best practice emerged for LPs invested in both a private investment fund and also invested in a fund of funds with the same fund holding. The fund is on a one-quarter lag in its reporting, but the fund of funds is on a two-quarter lag. LPs began to use the most recent fund reporting as a proxy for the fund of funds position.

Similarly, in response to LPs' need for timely market data, J.P. Morgan began to source updated publicly available prices for any public securities held in a private investment fund.

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## New Challenges in Fair Value Reporting

The aforementioned best practices didn't take into consideration a financial crisis of such proportions. The most challenging realization for many LPs was that a one-quarter lag was too long of a time frame, given the current market conditions. Too much had happened in the last 90 days of 2008 to simply accept that it was industry standard practice to rely on a rollforward value. At this point, some LPs started to panic.

- Do they take a reserve?
- Do they engage their own valuators?
- Do they hold off on their financial reporting until they get 100% of their fund's reports?

Almost all LPs eventually realized that the answer to the above questions was a practical "No". But they did have to do something. Most started a dialogue with each of their fund managers throughout the fourth quarter of 2008 and into the first quarter of 2009. They looked at each fund on a case-by-case basis, and assessed what each fund manager was doing in the current economic climate to retain value, as well as to measure the value of their portfolio in the interim period. Many LPs moved away from rollforward values, accounting for some market effect best qualified through discussions with their fund managers. Upon clients providing us their adjusted values, we facilitated tracking their updated accounting and performance reporting.

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A new debate has recently emerged during this crisis. Traditionally, LPs have valued their assets at their intrinsic value. Any artificial price created by a distressed seller or a strategic buyer on the secondary market was considered a temporary price, and the asset would revert to being valued at its intrinsic value following the transaction. This practice seemed acceptable, as secondary transactions represented a small fraction of the total industry transactions. These past few months have seen record-breaking numbers of secondary transactions, leading to a debate over the fair value of the assets. Some believe the intrinsic value still prevails, while others are claiming that the abundance of secondary transactions flooding the markets has created a permanent impairment in value. This debate will perhaps continue well into 2009, but for now the general consensus is that you should consider all known data points in determining the value at which you choose to carry your assets, and that the true fair value likely lies somewhere in between.

One of the obvious benefits of this crisis was the increased dialogue, awareness, and transparency that came from funds as a result of LPs needing to adapt their reporting practices. The only certainty in this asset class is that LPs will have to continually adapt and will be challenged to continuously rethink fair value reporting.

In these uncertain times, it has become even more critical that LPs partner with a trusted, experienced portfolio administrator whose service offering matches LPs' evolving fair value reporting needs.

**For more information on J.P. Morgan's alternative investment portfolio administration, and fair value best practices for LPs, please contact Leroy Wall at +1-212-552-4030.**