Introduction

.01 The purpose of this guide is to provide guidance to investment companies and their advisers1 regarding the valuation of, and certain aspects of the accounting related to, their investments in both equity and debt instruments of privately held enterprises2 and certain enterprises with traded instruments. Such investments are subsequently collectively referred to as portfolio company investments. The guidance is intended to assist management and boards of directors of investment companies, valuation specialists, auditors, and other interested parties, such as limited partners. This guide is not intended to serve as a detailed "how to" guide but, rather, to provide investment companies that invest in equity and debt instruments of portfolio companies with (a) an overview and understanding of the valuation process and the roles and responsibilities of the parties to the process and (b) best practice recommendations for complying with FASB Accounting Standards Codification (ASC) 946, Financial Services—Investment Companies, and applying FASB ASC 820, Fair Value Measurement.

Background

.02 This guide is intended to assist various parties involved with investment company financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) in understanding and applying the principles of FASB ASC 820 to portfolio company investments. This guidance is intended to address the illiquid nature of the market for such investments and the significant subjectivity associated with determining their fair values.

.03 Throughout this guide, estimating fair value is discussed in two different contexts: valuation of investments in the equity and debt instruments of an enterprise and valuation of an enterprise. The ultimate objective of this guide is to provide guidance on valuation of investments in equity and debt instruments. However, many valuation methods (often referred to as top-down methods) involve first valuing the enterprise and then using that enterprise value as a basis for allocating the enterprise value among the enterprise’s classes of equity and debt instruments. Whenever valuation techniques3 for enterprise

---
1 For the purpose of this guide, investment company is defined as an entity that meets the assessment described in paragraphs 4–9 of FASB Accounting Standards Codification (ASC) 946-10-15. The investment company (a fund) may manage its investments using one or more investment advisers, who make investment decisions on behalf of the fund in exchange for a fee. The investment adviser, in turn, may be employed by multiple funds and, thus, may make the same investment decision for multiple funds. This guide uses the term fund to refer to an individual reporting entity. Each fund, in turn, will hold investments in one or more portfolio companies or other investment companies, which may be privately held or may have traded securities.

2 This guide uses the terms enterprise and company interchangeably.

3 FASB ASC 820, Fair Value Measurement, refers to valuation approaches and valuation techniques; however, VS section 100, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, in AICPA Professional Standards refers to valuation approaches and methods (not techniques). VS section 100 defines valuation method as "[w]ithin approaches, a specific way to determine value." This definition is consistent with the use of the term valuation technique in FASB ASC 820. Also, in practice, many valuation techniques are referred to as methods (for example, guideline public company method, guideline company transactions method, and discounted cash flow
valuation are discussed in this guide, it is important to understand that those valuation techniques are presented solely for the ultimate purpose of valuing investments in the enterprise’s equity and debt instruments consistent with the FASB ASC 820 requirement to consider market participant assumptions.

.04 This guide identifies what the PE/VC Task Force (task force) perceives as best practices for the valuation of, and certain aspects of the accounting related to, investments in equity and debt instruments.

.05 In the context of discussing accounting issues or concepts, the word should is used in this guide only if a particular statement is in accordance with GAAP. Phrases such as “the task force believes” or “the task force recommends” are used to indicate the task force’s opinion if a particular statement in this guide, although not in conflict with GAAP, relates to an issue for which guidance is not specifically prescribed by GAAP or if there are alternative treatments of the particular issue. In the context of discussing valuation issues or concepts, no specific valuation standards exist that address detailed aspects when valuing portfolio company investments of venture capital funds, private equity funds and other investment companies. (The concept of accepted valuation standards is discussed in paragraph 5.05.) As a result, in this context, the word should is generally used in this guide to indicate the task force’s opinion as a whole, although individual or firm positions may differ. This guide is not intended to set valuation standards or interpret any other valuation standards that exist in practice.

Scope

.06 The scope of this guide is limited to valuations and certain accounting matters associated with portfolio company investments held by investment companies within the scope of FASB ASC 946 (including private equity [PE] funds, venture capital [VC] funds, hedge funds, and business development companies). Entities that do not meet the definition of an investment company in FASB ASC 946, such as corporate VC groups or pension funds, may also make investments in similar types of portfolio companies and pursue similar strategies. Although this guide may contain some useful information, such as valuation techniques and best practices relevant to valuations of portfolio company investments held by noninvestment companies, the numerous and varied aspects of these other entities were not considered or contemplated in the preparation of this guide. The scope of this guide also does not address the value of investment company assets when the investment company is using the liquidation basis of accounting as described in FASB ASC 205, Presentation of Financial Statements. Furthermore, this guide does not address fair value disclosure considerations related to portfolio company investments held by investment companies.4

---

4 FASB ASC 820-10-50 provides extensive guidance regarding disclosure requirements on fair value measurements. As indicated in FASB ASC 820-10-50-2F, the disclosure requirements vary depending on whether the reporting entity is a public business entity or nonpublic entity.
Some funds that invest in industries such as real estate, oil and gas, infrastructure, and other specialized areas using investment vehicles, such as master limited partnerships, PE limited partnerships, and so on, meet the definition of an investment company under FASB ASC 946, and the valuation of their portfolio company investments is included within the scope of this guide. Other funds, such as those investing in income-producing assets, may not meet the definition of an investment company under FASB ASC 946.

PE funds investing in the real estate sector (sometimes referred to as real estate funds or opportunity funds) may invest in active real-estate-oriented businesses in a form similar to other PE or VC funds, but they may also invest in real estate development projects or income-producing real estate assets, or both. If these funds meet the definition of an investment company under FASB ASC 946, the concepts discussed in this guide would be applicable to their investments in real-estate-oriented businesses or projects — that is, to their investments in real-estate businesses that act as portfolio companies. Some actively traded real estate investment trusts (REITs) and some nontraded REITs that are not deemed investment companies under FASB ASC 946 are not within the scope of this guide; however, such entities may find certain aspects of this guide to be helpful in estimating fair value for disclosure and other purposes.

This guide is based on U.S. GAAP and does not specifically address International Financial Reporting Standards (IFRSs). Although FASB and the IASB have completed their efforts to converge U.S. GAAP and IFRSs in the area of fair value (FASB ASC 820 and IFRS 13, Fair Value Measurement), there is no direct equivalent to the FASB ASC 946 guidance for investment companies under IFRS. Therefore, even though this guide may contain some useful information, such as valuation techniques and best practices relevant to valuations of portfolio company investments held by investment entities reporting under IFRS, the numerous and varied aspects of IFRS requirements for investment entities were not considered or contemplated in the preparation of this guide. However, if an investment of an investment entity is measured at fair value in accordance with IFRS 13, the valuation principles illustrated in this guide may be useful in considering the application of IFRS 13 for these investments.

Information Included in This Guide

This guide provides the task force’s views regarding best practice considerations by investment companies and their advisers regarding the valuation of, and certain aspects of the accounting related to, their investments in both equity and debt instruments of privately held enterprises and certain enterprises with traded securities. In presenting various best practices for performing valuations for this industry, it is not the task force’s intention to be prescriptive, to unduly limit the range of acceptable alternative approaches, or to eliminate the need for management judgment. In particular, the guidance within this guide is not meant to be absolute but, rather, based on the specific facts and circumstances noted and should be considered within the confines of materiality.

- PE and VC funds typically seek to generate returns through longer-term appreciation from equity or debt investments in privately held and nonlisted publicly traded
companies, or both. PE and VC funds often obtain majority controlling interests or significant noncontrolling interests (also known as minority interests) that allow for active involvement in investee operations, restructuring, and merger and acquisition activity through board oversight positions.

There is generally a discrete period of time over which the funds invest and a realization period, which can often be extended because the funds’ investment strategy is to hold their investments long enough to allow management to execute on a business plan sufficient to capture value from the investment. Once it is accomplished, the fund generally exits the investment either by selling it to another company, another fund, or through a public offering. See chapter 1, “Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies.”

- Pursuant to FASB ASC 946-320-35-1, “An investment company shall measure investments in debt and equity securities subsequently at fair value.” FASB ASC 820 establishes a framework for measuring fair value and requires disclosures about fair value measurements. FASB ASC 820 is broad, principles-based guidance that applies to all entities, transactions, and instruments that require or permit fair value measurements. See chapter 2, “Fair Value and Related Concepts.”

- According to FASB ASC 820-10-35-9, fair value should be estimated “using the assumptions that market participants would use in pricing the asset or liability, assuming that market participants act in their economic best interest.” Market participants are defined in FASB ASC Master Glossary as

  Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

  a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms

  b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary

  c. They are able to enter into a transaction for the asset or liability

  d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

The market participants that are relevant for portfolio company investments and the way that those market participants would evaluate portfolio company investments together establish a framework for fair value measurement. See chapter 3, “Market Participant Assumptions.”
Generally, investment companies or other market participants for similar assets do not exit a position before they have had time for their investment strategies to resolve. Under FASB ASC 820, however, the basis for estimating fair value is an assumed transaction for the asset on the measurement date. This discrepancy can create unique challenges for measuring fair value by such investment companies.

The FASB ASC Master Glossary defines the *unit of account* as “[t]he level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes.” For purposes of identifying what to measure at fair value, FASB ASC 820-10-35-2E states that “The unit of account for the asset or liability shall be determined in accordance with the Topic that requires or permits the fair value measurement, except as provided in this Topic.”

Defining the unit of account for investment companies is challenging. FASB ASC 946 does not provide explicit unit of account guidance. Further, many investment companies hold significant positions in the companies in their portfolios, giving them the ability to influence the direction of these companies. In addition, an investment company may hold multiple types of investments within an entity (for example, common stock, various classes of preferred stock, or various classes of debt in a private entity).

In defining the unit of account for investment companies, this guide attempts to answer the following questions, as discussed in chapter 4, “Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments”:

— Does the assumed transaction for FASB ASC 820, considering market participant perspectives, contemplate only the sale or transfer of the specific investment held by the fund in a given portfolio company, or the sale or transfer of a larger grouping of assets?

— Is it appropriate for investment companies to group assets (for example, equity and debt investments held in the same fund) for the purpose of measuring fair value considering their economic best interest and, if so, how?

— How does the requirement under FASB ASC 820 to measure fair value based on an assumed sale or transfer of the fund’s investment on the measurement date consider market participant assumptions regarding the investment strategy and the way that value is expected to be realized from the investment?

• The three approaches to estimating the value of an enterprise and interests in the enterprise are the market, income, and asset approaches, as discussed in chapter 5,

---

5 FASB ASC 820 describes three valuation approaches: market, income, and cost. The concepts underlying FASB market, income, and cost approaches apply broadly to the valuation of discrete assets and business enterprises. Within FASB’s *cost approach* concept, practitioners distinguish valuations of individual assets and business enterprises by using different terminology. The cost approach is said to have been applied when valuing individual assets, and the asset approach is said to have been applied when valuing business enterprises. The *International Glossary of Business Valuation Terms*, which has been adopted by a number of professional societies and organizations, including the AICPA, and is included in appendix B of VS section 100, defines *asset approach* as "[a] general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value
“Overview of Valuation Approaches.” A valuation analysis will generally consider more than one valuation technique, relying on the technique or techniques that are appropriate for the circumstances. It is common for the results of one valuation technique to be used to corroborate or otherwise be used in conjunction with one or more other valuation techniques:

— The *market approach* bases the value measurement on market data (for example, valuing an enterprise based on values for comparable public companies or similar transactions or valuing interests based on transactions in similar instruments). Another method for valuing an enterprise within the market approach is to derive an indication of the total *equity value* from a recent transaction involving the company’s own instruments (for example, a recent financing round).

— The *income approach* seeks to convert future economic benefits into a present value for the enterprise or the interests in the enterprise.

— The *asset approach* estimates the value of an enterprise or the interests in the enterprise based on the principle that the equity value is equivalent to the values of its individual assets net of its liabilities.

Chapters 6–8 explore the application of these broad techniques in greater detail as it pertains to the valuation of debt instruments as well as equity interests in the context of both simple and complex capital structures, whereas chapter 13, “Special Topics,” addresses special topics relevant to specific valuation matters.

• In standard valuation theory, value may be measured on a controlling or minority-interest basis and a marketable or nonmarketable basis. Adjustments to the value may be needed when estimating the fair value of an interest on a specified basis. The appropriate *basis of valuation* varies depending on the objective of the analysis. See chapter 9, “Control and Marketability.”

• Many of the valuation techniques that are used to estimate the fair value of portfolio company investments require significant *unobservable inputs* (level 3 inputs). Although it is possible to use market data from similar traded securities to provide an indication of the range that might apply for each input, selecting specific reasonable assumptions for valuing an investment can be challenging. Therefore, when using a valuation technique that requires unobservable inputs, it is important to calibrate these inputs to any observed transactions in the investment itself, providing an initial set of assumptions that are consistent with the transaction price when the transaction price represents fair value.
Calibration is required when the initial transaction is at fair value. As indicated in FASB ASC 820-10-35-24C

If the transaction price is fair value at initial recognition and a valuation technique that uses unobservable inputs will be used to measure fair value in subsequent periods, the valuation technique shall be calibrated so that at initial recognition the result of the valuation technique equals the transaction price. Calibration ensures that the valuation technique reflects current market conditions, and it helps a reporting entity to determine whether an adjustment to the valuation technique is necessary (for example, there might be a characteristic of the asset or liability that is not captured by the valuation technique). After initial recognition, when measuring fair value using a valuation technique or techniques that use unobservable inputs, a reporting entity shall ensure that those valuation techniques reflect observable market data (for example, the price for a similar asset or liability) at the measurement date.

See chapter 10, “Calibration.”

- Investment companies often find it beneficial to perform periodic (for example, quarterly) backtesting on investments that have had subsequent realizations or liquidity events, comparing the implied value from the transaction to the fair value estimate from the most recent analysis as well as valuations from other prior periods that may be deemed relevant. Backtesting provides ongoing feedback that could enhance the rigor and controls around the valuation processes for periodic fair value estimates. Chapter 11, “Backtesting,” discusses the benefits and limitations of backtesting.

- When a transaction has recently been completed or is expected to close within a short timeframe, consideration of uncertainties and contingencies surrounding the transaction can provide meaningful information in estimating fair value. Furthermore, there is specific guidance under GAAP regarding the treatment of transaction costs. These concepts are discussed in chapter 12, “Factors to Consider at or Near a Transaction Date.”

- The guide also includes the following other information that is designed to provide insights and tools that will benefit various users of this guide, including financial statement preparers, auditors, and investors:
  - Chapter 14 includes “Frequently Asked Questions” that provide additional discussion of certain issues in a question and answer format.
  - The appendixes include information on best practices pertaining to the valuation process, a valuation toolkit that provides certain calculations and research that may be useful in estimating fair values, and several case studies that illustrate different investment situations, the way these situations evolved over time, and what factors may be considered in arriving at a fair value measurement at each measurement date consistent with the guidance in FASB ASC 820.
Guide to the Guide

.11 The task force has organized the guide with chapters, topics, and case studies identified to help direct users of the guide to areas that might be of most interest to them. Given the broad scope of the guide, some users may be more interested in some sections than others. The following discussion highlights the sections that may be most relevant as a resource for various users. To derive the most benefit from this guide, users are encouraged to read this guide in its entirety for an overview of the key concepts before reviewing specific areas of interest in more detail.

- **Investment company managers** may wish to focus on the case studies, reviewing the list in appendix C to identify the situations that are most similar to their funds’ investment styles. They may also wish to consider the implications for their funds of the guidance in chapter 10, “Calibration,” chapter 11, “Backtesting,” chapter 12, “Factors to Consider at or Near a Transaction Date,” and appendix A, “Valuation Process and Documentation Considerations.”

- **VC fund managers** may wish to focus on case studies 9–13 in appendix C, which present examples of investments in early-stage companies and companies with complex capital structures. They may also wish to consider the guidance in chapter 8, “Valuation of Equity Interests in Complex Capital Structures,” and paragraphs 13.39–.43 regarding the valuation of early-stage company investments when there has been no recent round of financing.

- In addition to the suggested points of focus noted previously for investment company managers, **accountants and auditors** may also wish to focus on chapter 4, “Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments,” as well as reviewing the background on the industry in chapter 1, “Overview of the Private Equity and Venture Capital Industry and Its Investment Strategies,” chapter 2, “Fair Value and Related Concepts,” and chapter 3, “Market Participant Assumptions.”

- **Valuation specialists** may benefit from the background on the industry in chapter 1 and may also want to consider chapters 5–9 on valuation (especially the discussion on premiums and discounts and calibration in chapter 9, “Control and Marketability”), and chapter 10, “Calibration.” In addition, the material in chapter 4, “Determining the Unit of Account and the Assumed Transaction for Measuring the Fair Value of Investments,” sets the context for the valuation and provides examples.

- **All users** of the guide may want to review chapter 13, which addresses special topics, and frequently asked questions in chapter 14 to identify those topics and responses that are applicable to their situations.