

Jersey Funds Association Accounting for Private Equity Funds

Nick Silvester, PricewaterhouseCoopers

30 January 2007

Critical concepts, clear direction

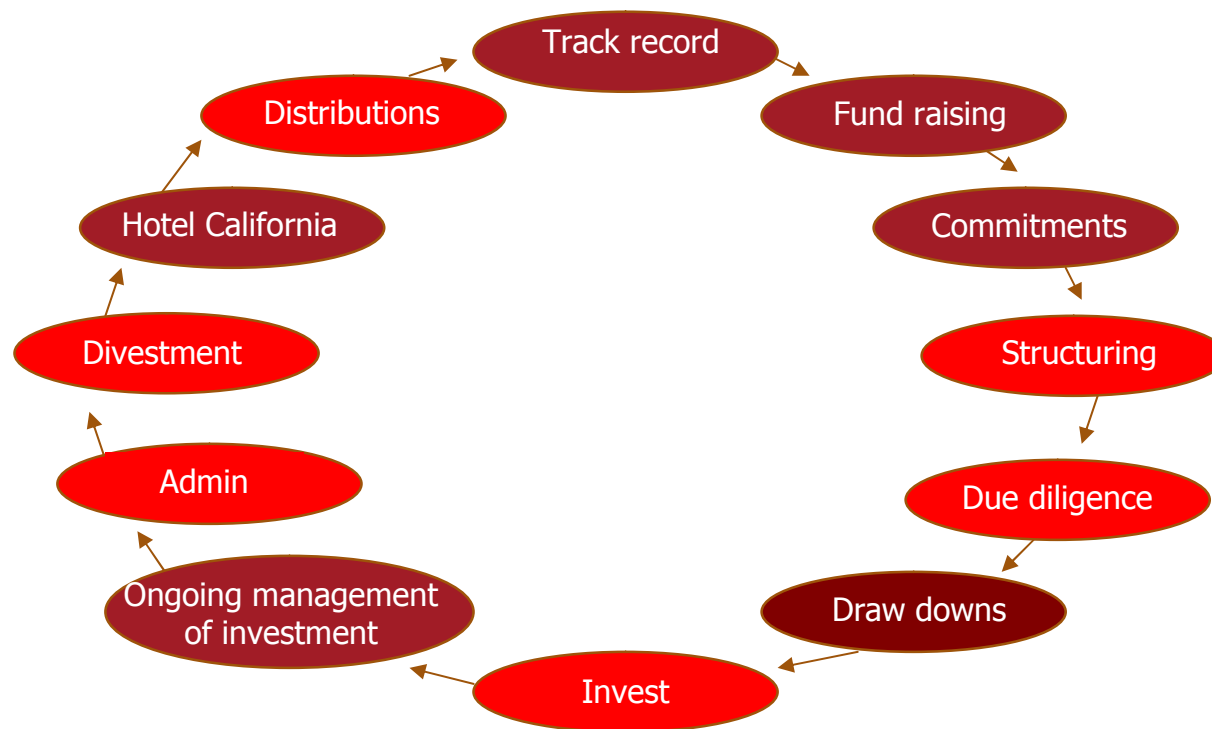


Agenda

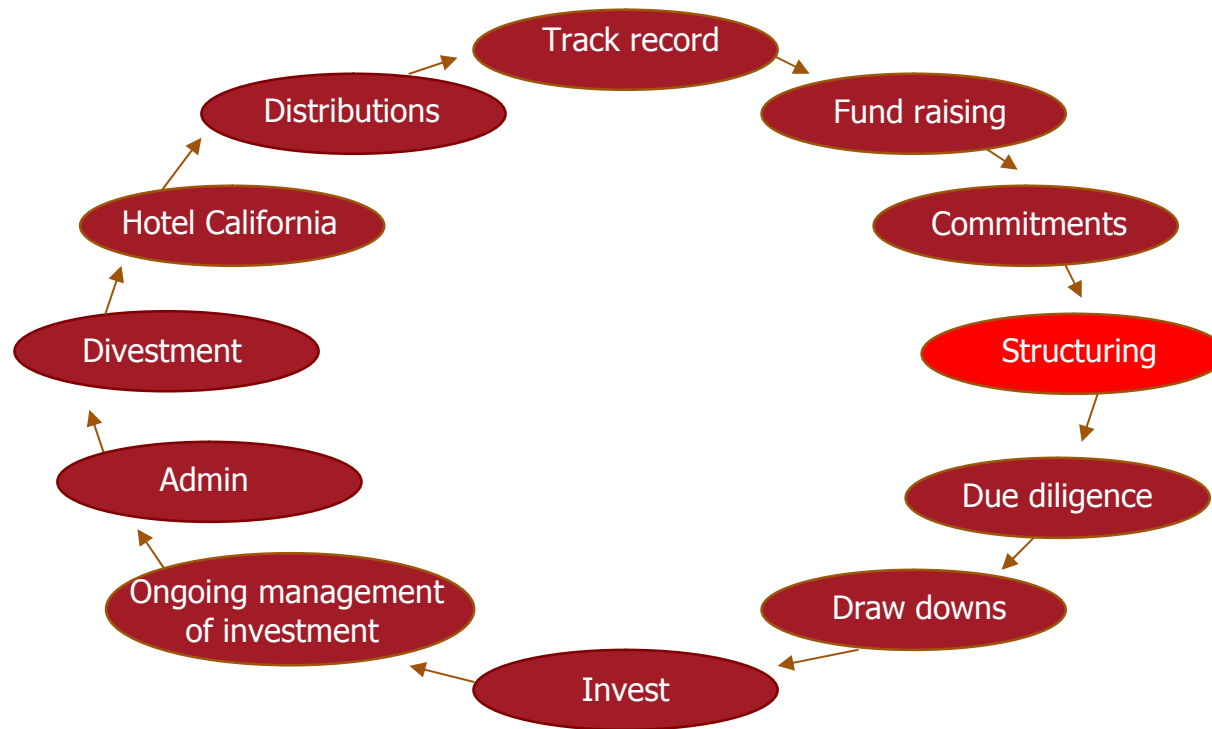
Consider Audit, Accounting and Admin implications of:

1. Structuring
2. Due Diligence
3. Investment
4. Ongoing Admin & Reporting
5. Divestment & Distribution
6. Some final thoughts

Investment cycle



Investment cycle - Structuring



Investment Cycle – Structuring

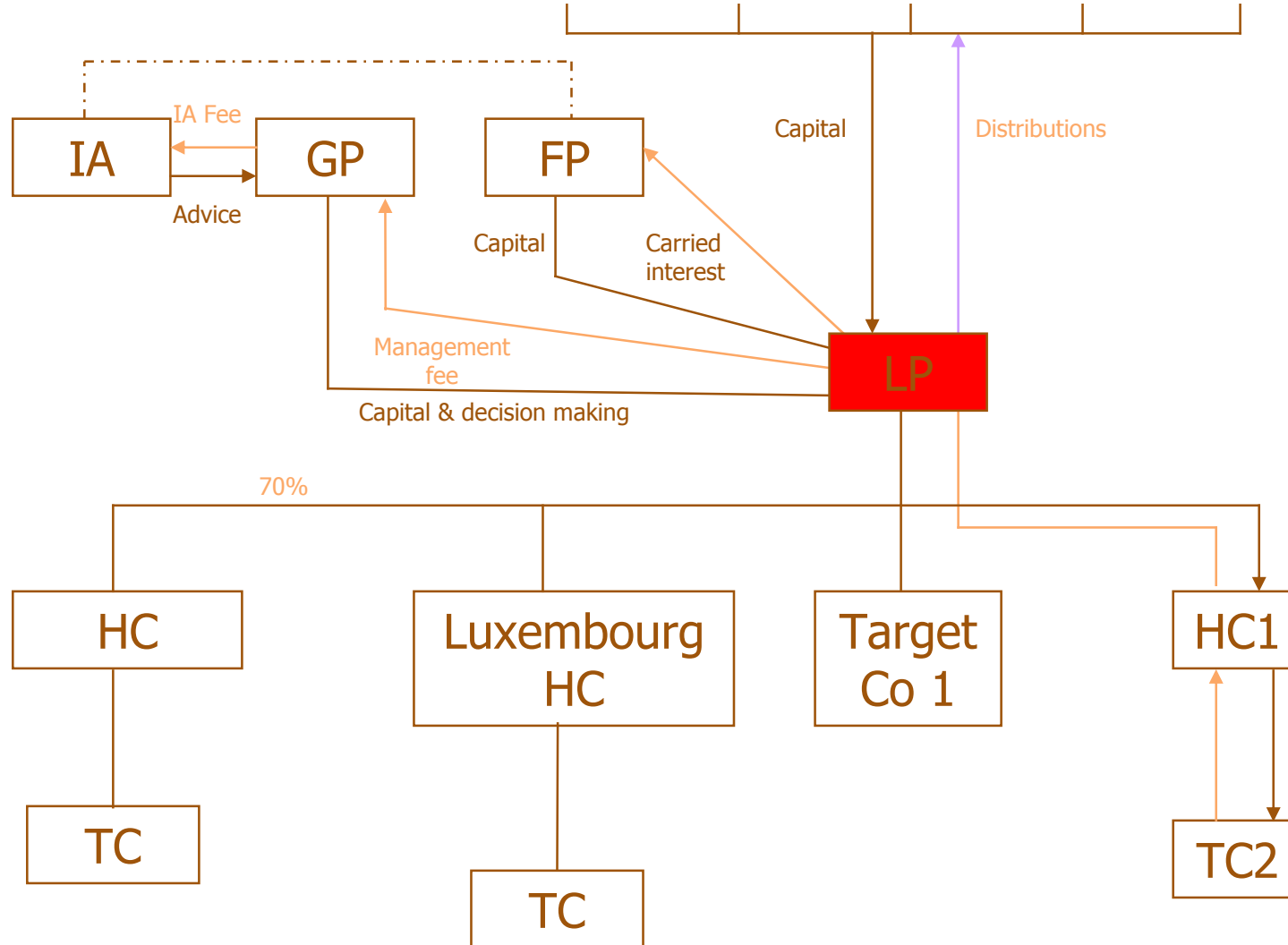
The Choice of Structure

- Generally driven by 4 factors:
 - The needs of the investors
 - The needs of the PE House
 - The Fund's investment strategy
 - The preferences of the Fund's advisors
- 3 levels to the structure
 - The management companies [Carried interest, transfer pricing, VAT]
 - The investment portfolios [Use of holding companies depend on investment strategy]
 - The Fund. Types of vehicles I have seen:
 - Jersey/Guernsey companies (Often for listed structures)
 - Delaware LLC (Limited liability & tax transparent)
 - Jersey/Guernsey/Delaware/Cayman/UK Limited Partnerships (Most flexible, limited liability for ordinary partners, tax transparent)

Investment Cycle – Structuring Limited Partnerships

- Majority of PE/VC Funds are constituted as Limited Partnerships
- Delaware, UK, Guernsey, Jersey, Cayman etc
- Tax transparent vehicles
- Investors/limited partners assessed to tax in own jurisdiction on apportioned share of gains/losses for the period
- Limited Partnership Agreement provides framework for fund's operations and reporting
- Maximum flexibility

LIMITED PARTNERS



Investment Cycle – Structuring

The Choice of Accounting Standards

The choice of accounting standards can significantly increase or reduce complexity in the accounting and reporting processes of the fund:

- Although accounting standards are said to be converging, key differences exist;
- Limited Partnership Agreements allow flexibility as to choice of policies
- Corporate vehicles generally require application of GAAP
- IFRS requires consolidation of investments ‘controlled’ by the fund
- US GAAP has standards tailored to the funds.

Investment Cycle – Structuring

The Choice of Accounting Standards

The choice of accounting standards can significantly increase or reduce complexity in the accounting and reporting processes of the fund...

Accounting Issue	UK GAAP	IFRS	US GAAP
Overall framework	Nothing fund specific	Nothing fund specific	AICPA Audit and Accounting Guide: Investment Companies
Presentation of financial statements	Driven by the requirements of multiple standards: <ul style="list-style-type: none"> • Profit and Loss Account • Balance Sheet • Cash Flow Statement [unless small' entity] • Statement of Total Recognised Gains and Losses • Notes to the Financial Statements 	Driven by the requirements of IAS 1: <ul style="list-style-type: none"> • Income Statement • Balance Sheet • Cash Flow Statement • Statement of Changes in Net Assets Attributable to Partners • Notes to the financial statements 	Drive by the requirements of Chapter 7 of the Audit and Accounting Guide: <ul style="list-style-type: none"> • Statement of Assets and Liabilities • Schedule of Investments • Statement of Operations • Cash Flow Statement • Notes to the financial statements • Financial Highlights (may be included in the notes)

Investment Cycle – Structuring

The Choice of Accounting Standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Consolidation – The Fund	<p>Ability to exercise dominant influence. But...</p> <ul style="list-style-type: none"> ▪ severe long term restrictions; ▪ held exclusively with a view to resale 	Requires consolidation of underlying investments where those structures are controlled.	<p>Does not require consolidation of underlying investments.</p> <p>One exception to this general principle is an investment in an operating company that provides services to the investment company.</p>
Consolidation – General Partner	<p>Ability to exercise dominant influence.</p> <p>Generally less likely to lead to consolidation.</p>	Requires consolidation of the Fund where the GP controls it under the provisions of IAS 27.	<p>Requires consolidation of the Fund where the GP:-</p> <ul style="list-style-type: none"> • Is the primary beneficiary of the Fund under FIN 46(R); or • Controls it under EITF 04-5.
Equity accounting	<p>Generally requires associates to be equity accounted for where the investor holds a participating interest and exercises significant influence.</p> <p>However, PE funds holding such investments as part of their portfolio are exempted.</p>	Requires associates to be equity accounted for except where they have been designated as fair value through profit or loss.	Does not require equity accounting for underlying investments unless those entities are investment companies themselves.

Investment Cycle – Structuring

The Choice of Accounting Standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Valuation of investments	<p>Entities required to apply FRS 26 - same as IFRS.</p> <p>Other entities - less prescriptive.</p> <p>May carry investments as cost less any provisions for impairment.</p>	<p>Requires investments (designated as 'fair value through profit or loss' or 'available for sale') to be stated at fair value.</p>	<p>Requires investments to be stated at fair value. A new Fair Value Standard issued in September 2006 will also require, amongst other things, new disclosures around the inputs used to determine fair value.</p>
Valuation of quoted securities	<p>Less prescriptive – general practice is to value at quoted prices.</p>	<p>Requires quoted securities in active markets to be stated at bid price multiplied by the number of shares. Marketability discounts are generally not permitted.</p>	<p>Requires quoted securities in active markets to be stated at end of day market prices. Where a legal, contractual or regulatory restriction exists then the market price should be adjusted for the effect of the restriction (requirement of new Fair Value Standard).</p>

Investment Cycle – Structuring

The Choice of Accounting Standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Treatment of Partners' Capital	Where the Fund has a finite life, partners' capital is generally treated as debt under FRS 25. Applicable to all entities (not just listed)	Where the Fund has a finite life, partners' capital is generally treated as debt under IAS 32.	Partners' capital is generally treated as equity unless there is an obligation to redeem the capital at a specific date at a specific amount.
Functional Currency	Entities required to apply FRS 26 – same requirements as IFRS. Other entities – not prescriptive.	IFRS and US GAAP requirements are substantially the same: An entity's functional currency is defined as the currency of the primary economic environment in which the entity operates.	
Derecognition of financial assets	Recognise and derecognise based on risks and rewards, focusing on substance rather than just legal form.	De-recognise financial assets based on risks and rewards first; control is secondary test.	Derecognise based on control. Requires legal isolation of assets.

Investment Cycle – Structuring

The Choice of Accounting Standards

Creating flexibility in the Limited Partnership Agreement

‘The financial statements shall be prepared in accordance with International Financial Reporting Standards as amended from time to time.’

‘The financial statements shall be prepared in accordance with International Financial Reporting Standards as amended from time to time provided that IAS 27 shall not apply.’

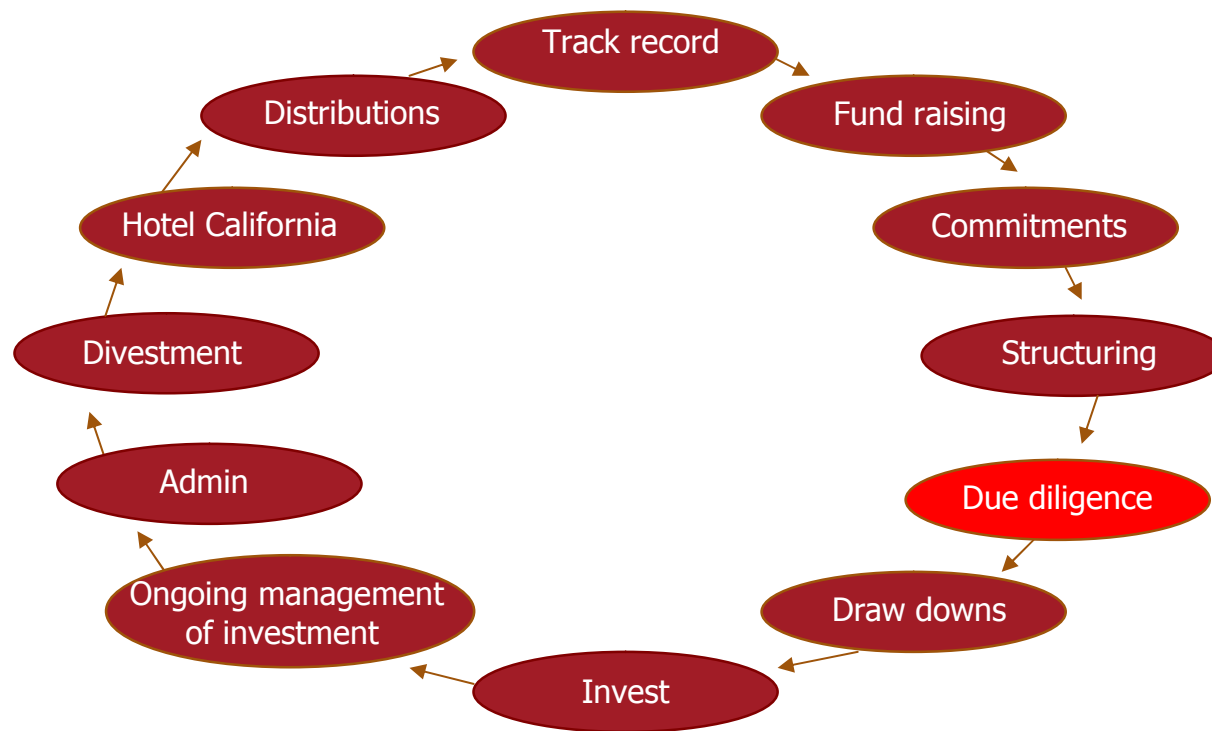
‘The financial statements shall be prepared in accordance with accounting policies determined by the General Partner.’

Investment Cycle – Structuring

Other key areas of the LPA/Prospectus

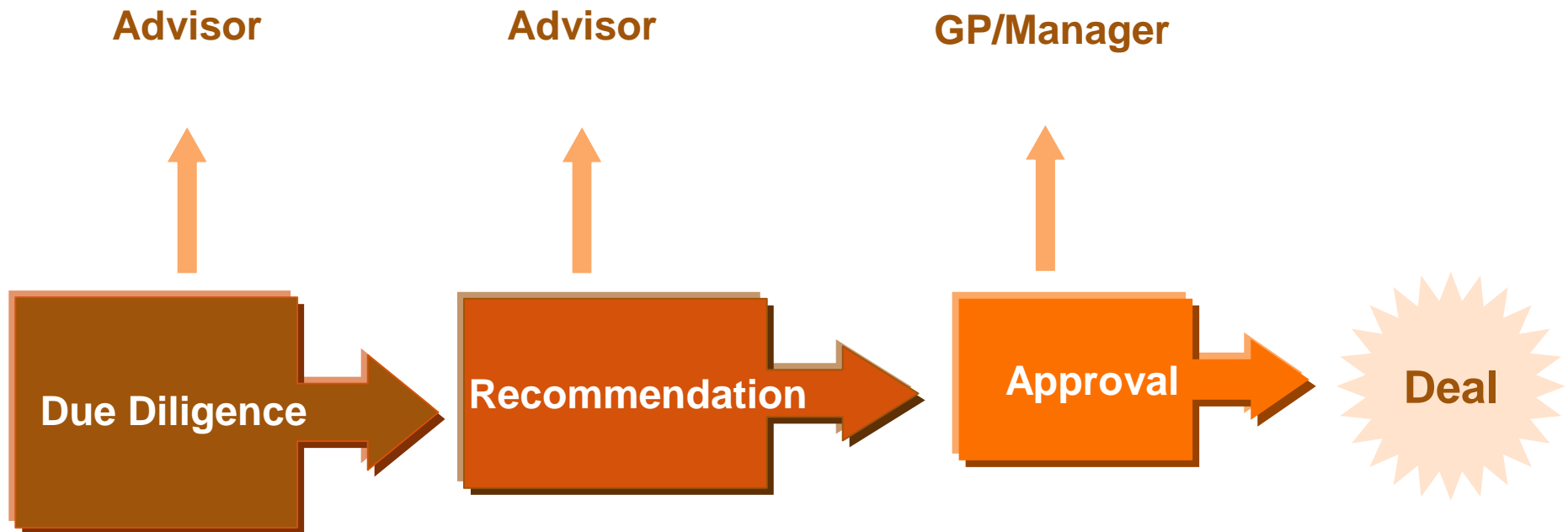
- Capital Contributions → Consider controls over standing data
Don't forget the GP contributions
- Capital Account Allocations → Excel or Accounting Package?
Excel based allocations need careful review processes
Investor transfers need careful review/approval processes
- Distributions → Excel based allocations need careful review
In LP's, consider the nature of the distribution (income, gain, capital)
Monitoring of 'catch-up' and 'carried interest' stage is important
- Management Fees → Is the fee a flat % of commitments/NAV
If other fees received by the advisor are 'offset' these need careful monitoring
- GP/Manager Kick-Out Rights → Under most GAAP's, a lack of substantive kick-out rights may lead to a consolidation requirement for the GP
- Fund winding-up procedures → Winding-up procedures may include 'claw-back' provisions of carried interest/performance fee paid to the GP/Management Company.
- Fund valuation → Important to ensure that the prospectus/LPA does not include valuation requirements that are not GAAP compliant.

Investment cycle – Due Diligence



Investment Cycle – Due Diligence

The Decision making process



Investment Cycle – Due Diligence Points for the Administrator

Themes

- Demonstrating Management & Control
- Retention of documentation
- Accuracy of recording

Actions

- Demonstrate appropriate consideration of transactions
- Documentation should be accurately and timely
- Retain copies of transaction documentation in the relevant jurisdiction
- Maintain control processes that checks the accuracy of the transaction documentation and accounting records

Investment Cycle – Due Diligence Points for the Administrator

Typical Points Arising from Documentation Reviews

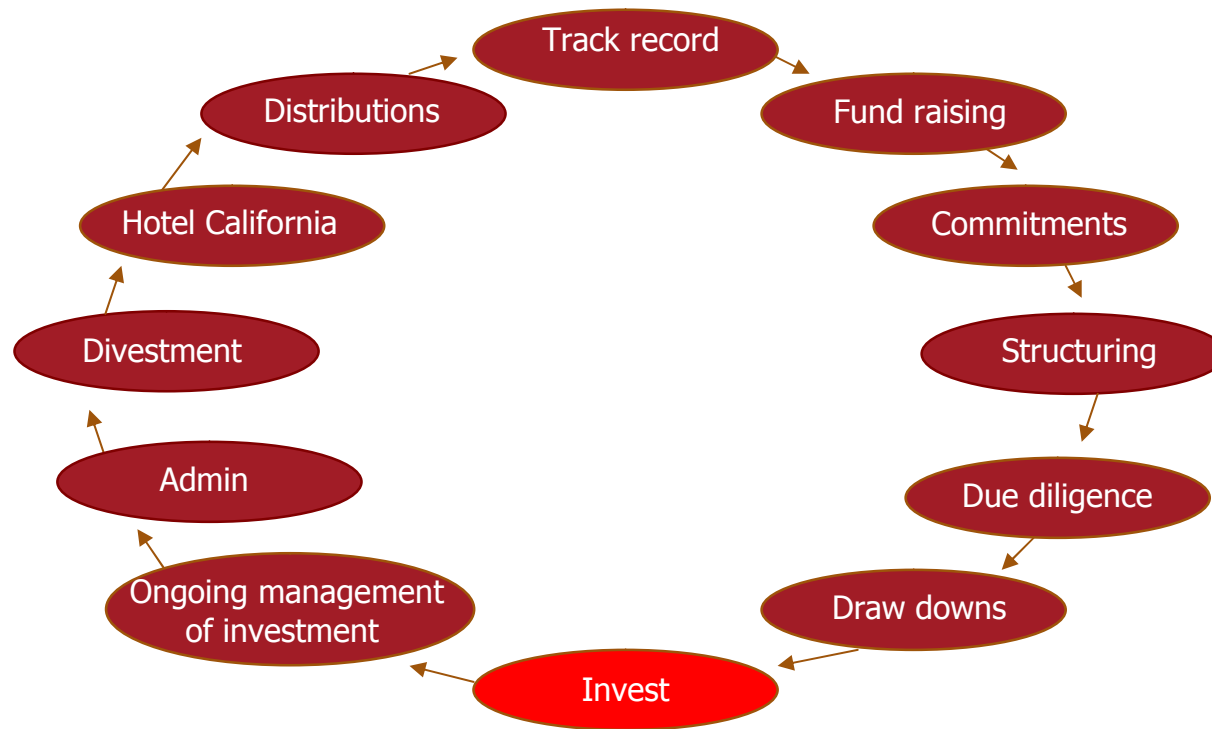
- Time taken for the board to consider investment decisions too short
- Incomplete documentation retained in investment files
- Final signed documentation (eg loan agreements) is inaccurate
- Consideration of revisions to investment decisions are not properly documented
- Where advance board packs are issued, evidence of this should be recorded

Investment Cycle – Due Diligence Audit Risk

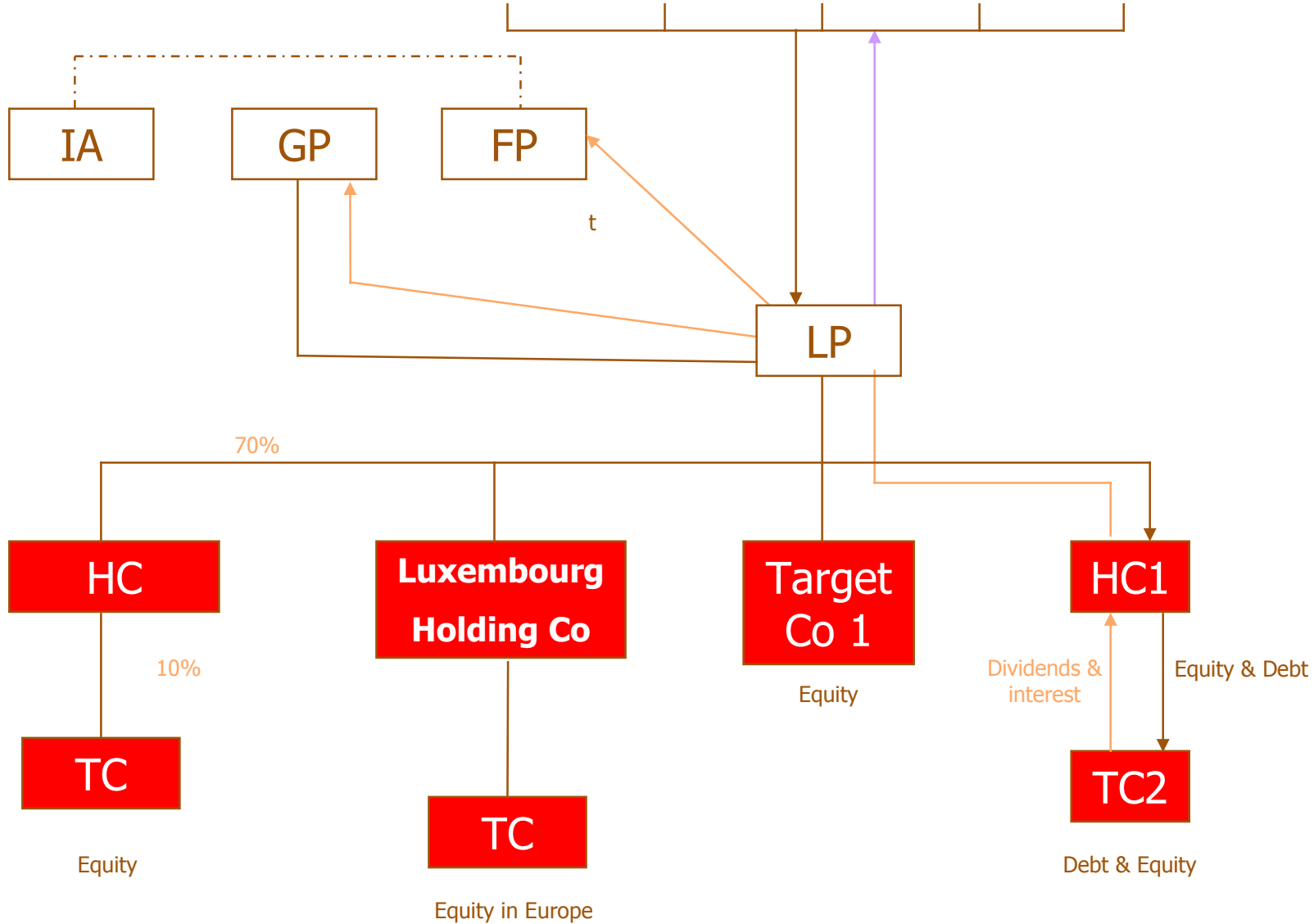
Our audit review will typically include testing of 100% of investment transactions. The testing will include reference to:

- Investment Advisors' Recommendations
- Minutes of General Partner/Manager Approvals
- Transaction documentation
 - What instruments are being bought and sold
 - The price of the transaction
 - Any ongoing commitments or contingencies
- Consistency of all the above with the Fund's accounting records

Investment cycle – Invest



LIMITED PARTNERS



Investment Cycle – Invest Structuring the deal

- Legal and tax advice considering
 - Tax efficiency
 - Exit right mechanisms
 - Who the other investors are
 - Level of control taken
- Accurate implementation of advice
- Ongoing monitoring to ensure that structure is still appropriate
- Update legal and tax advice for each exit event

Investment Cycle – Invest Instruments

- The main instrument is EQUITY
- About three levels of investment
 - Control → 50-75%
 - Influential minority → 20-49%
 - Minority → 5-15%
- Different issues are associated with each level

Consolidation issues under IFRS

Investment Cycle – Invest

Class of instrument

Type	Description
Senior Debt	Highest ranking debt
Subordinated Debt	Typically carries a higher interest rate than senior debt as it has a lower ranking
Preferred Equity	Ranks above ordinary equity – may pay coupon
Ordinary Equity	Lowest ranking common shares

Choice of investment instrument drives the nature of the returns received by the Fund.

Investment Cycle – Invest

Implications of Deal Structuring

- **Admin**
 - Need to ensure that shares are issued/loan agreements are signed
 - Also be careful to accurately process any changes that may occur down the line
 - Relevant minutes and records of each holding company need to be maintained
 - Demonstration of substance/management of control needs to be monitored closely since a mistake may invalidate the structure.

- **Accounting**
 - Transactions at the holding company level need to be considered at the fund level [Valuation of investments, unrecorded liabilities, disclosures]
 - The capital structure of the holding company will affect the nature of the returns received by the Fund. (eg if the Fund has provided debt only to the holding company then returns will be income or return of capital)

Investment Cycle – Invest

Audit risk: Investments - Existence

- Often test 100% of investments held by the fund
- Need to consider holding companies/SPV's used in each investment structure [and confirm existence with each party involved]
- What are the other considerations for the confirmation process
 - Type of security held by the fund
 - Derivatives issued that may dilute the value of the fund's holding
 - Related party disclosures
 - Fees received by the GP that are offset off the management fee
 - Dividends and interest declared/paid but not recorded at the fund level

Investment Cycle – Invest Consolidation

Accounting Standards	Control eg 50-75%	Influential minority eg 20-49%
UK GAAP	Consolidation can be avoided (see exclusions).	Equity accounting can be avoided if held within a 'basket of investments'.
IFRS	Consolidation required.	Equity accounting not required for 'venture capital organisations' who fair value through P&L .
US GAAP	Consolidation not required.	Equity accounting not required.

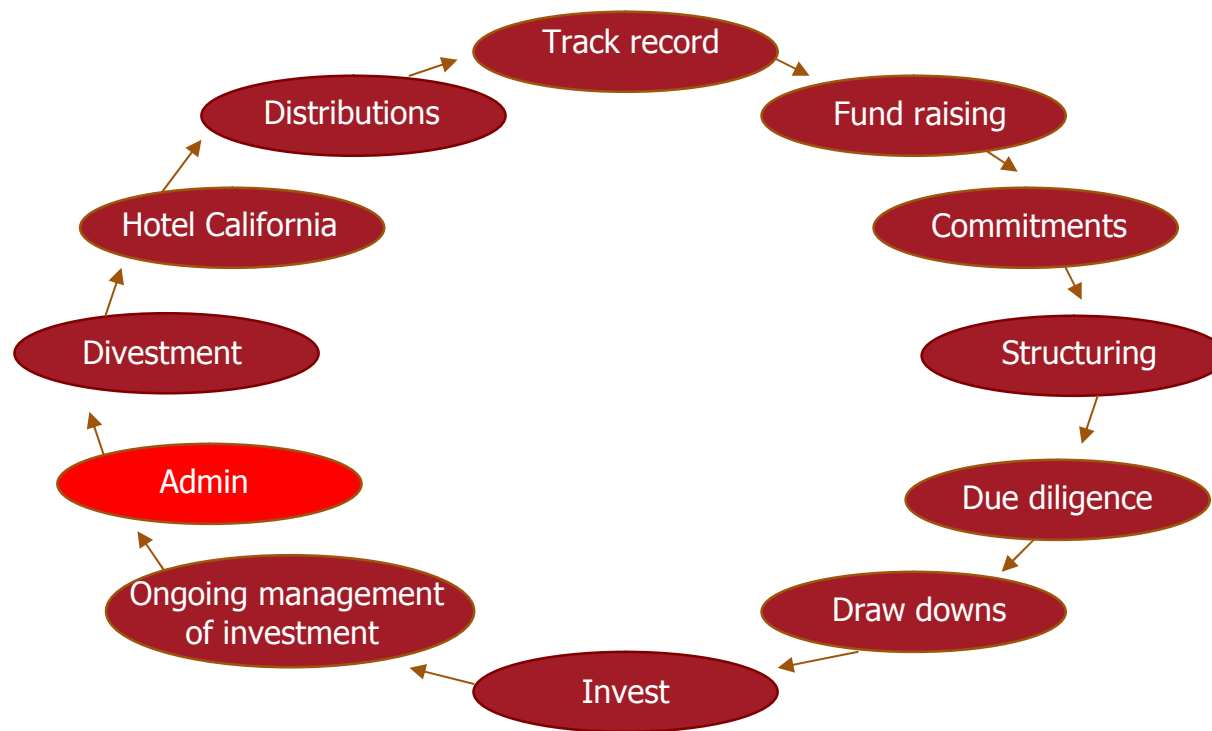
Investment Cycle – Invest

Tax Risk

Tax is a big issue....for all of us

- Private Equity Funds often enter into transactions involving complex investment structures designed to be tax efficient.
- There is a risk that a structure put in place:
 - Does not reflect the advice given by the lawyers and tax advisers
 - Reflects an untested interpretation of tax legislation in a particular country
 - Is not updated for changing legislation or interpretations
- Our approach is therefore to:
 - Consult with our tax department on the level of risk associated with a particular fund structure
 - Discuss processes and controls in place at the client surrounding tax risk
 - Assess the adequacy of processes and controls in place
 - Obtain representations from management

Investment cycle – Admin & Reporting



Investment Cycle – Admin & Reporting Administration

High quality ongoing administration is obviously important but where have mistakes been found in the past?

- Resolutions not signed
- Share registers and directors' registers not kept up to date
- Permit conditions regarding filing of financial statements with the regulator not complied with
- AGM's of GP's and SPV's not held
- Annual financial statements of SPV's not prepared
- No evidence of investors reports being sent to investors

Investment Cycle – Admin & Reporting

Investor reporting

A growing set of standards driving consistent reporting:

- EVCA Investor Reporting Guidelines
 - Fund reporting
 - Portfolio reporting
 - Capital accounts
 - Fees and carried interest

Updates to these guidelines are expected.

- International Private Equity and Venture Capital Valuation Guidelines
- PEIGG Guidelines
- US GAAP/UK GAAP/IFRS

Investment Cycle – Admin & Reporting

Reporting fair value

- Ultimately investors are concerned about **realised** value;
- The advisor needs to be able to measure **unrealised** value for two important reasons:
 - It is an important part of his own internal monitoring mechanisms
 - Market practice is now to report at fair value in the financial statements

Investment Cycle – Admin & Reporting

International Private Equity & Venture Capital Valuation Guidelines

FRS 26/IAS 39/ AICPA Accounting and Audit Guide all....

- Require fair value accounting
- Very little guidance on how to reach fair value

The International Private Equity and Venture Capital Valuation Guidelines were developed by the British, European and French Venture Capital Associations.

The guidelines are intended to provide a framework for arriving at a fair value for private equity and venture capital investments. They guidelines define fair value as:

‘the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction.’

This is consistent with the definition contained within accounting standards.

Investment Cycle – Admin & Reporting

Valuation methodologies unquoted companies

‘The Valuer should exercise his or her judgement to select the methodology that is the most appropriate for a particular investment’:

- Price of recent [within one year] investment - consider the background to the transaction
- Earnings multiple - an established investment with maintainable earnings
- Net Assets – value derived from assets rather than earnings [eg property holding or investment business]
- Discounted Cash Flow – flexible but subjective since many assumptions are used. Useful as a cross-check.
- Industry Valuation Benchmarks - limited situations. Useful as a cross-check.

Investment Cycle – Admin & Reporting

Valuation methodologies quoted companies

Use of Bid-Prices

‘Instruments quoted on a stock market should be valued at the bid prices on the reporting date....although the use of the mid-market price will not usually result in a material overstatement of value’.

NB. This is consistent with IFRS which requires the use of bid prices. The new US standard on fair valuation permits the use of prices within the bid-offer spread where appropriate.

Marketability Discounts

‘Marketability discounts should generally not be applied to prices quoted on an active market, unless there is some contractual, governmental or other legally enforceable restrictions preventing realisation at the reporting date.....

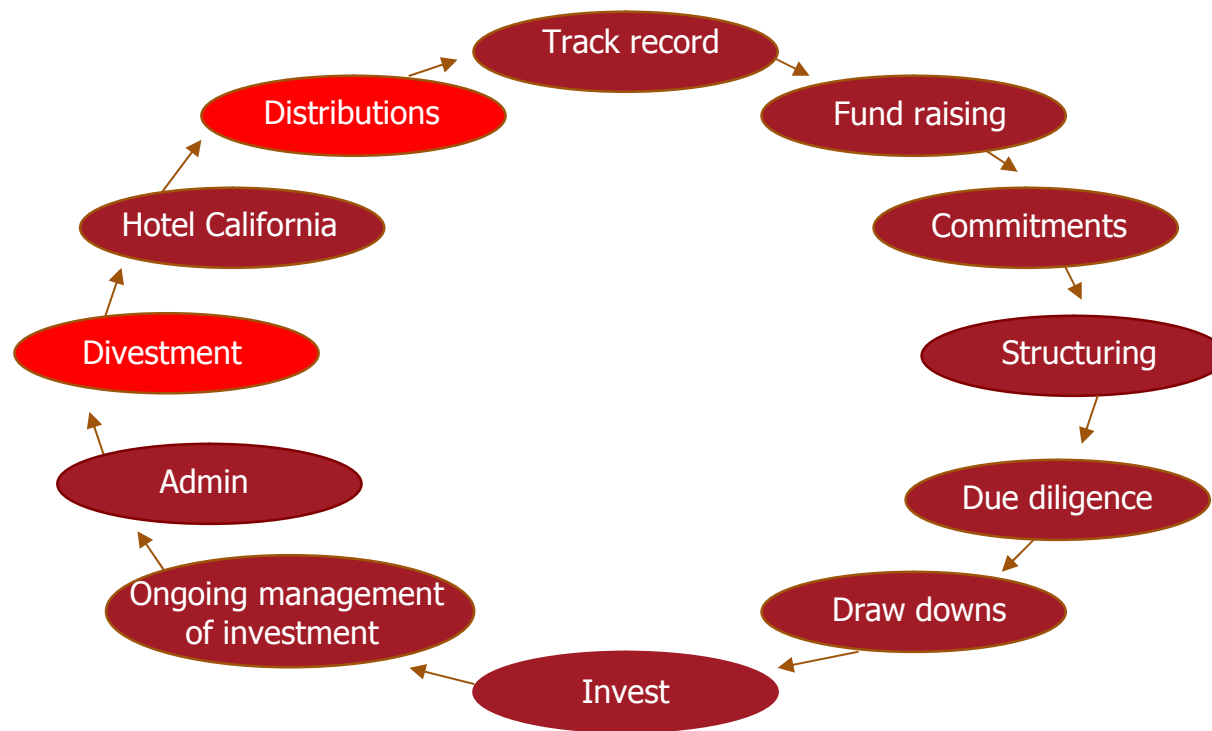
In the case of a six-month lock-up period, in practice a discount of 20% to the market price is often used at the beginning of the period, reducing to zero at the end of the period.’

Investment Cycle – Admin & Reporting

Investments – Valuation and audit process

- Broad concepts of valuation already discussed.
- As auditors we focus on:
 - Understanding the procedures and controls surrounding valuation
 - The assumptions used by the GP
 - The supporting documentation explaining why the methodologies and assumptions used are appropriate (particularly where changes have taken place).
 - The audit evidence available to support the GP's representations (eg sale agreements, entity financial statements, valuation reports)
 - Whether we need a valuation specialist to help us with our work.

Investment cycle – Divestment & Distribution

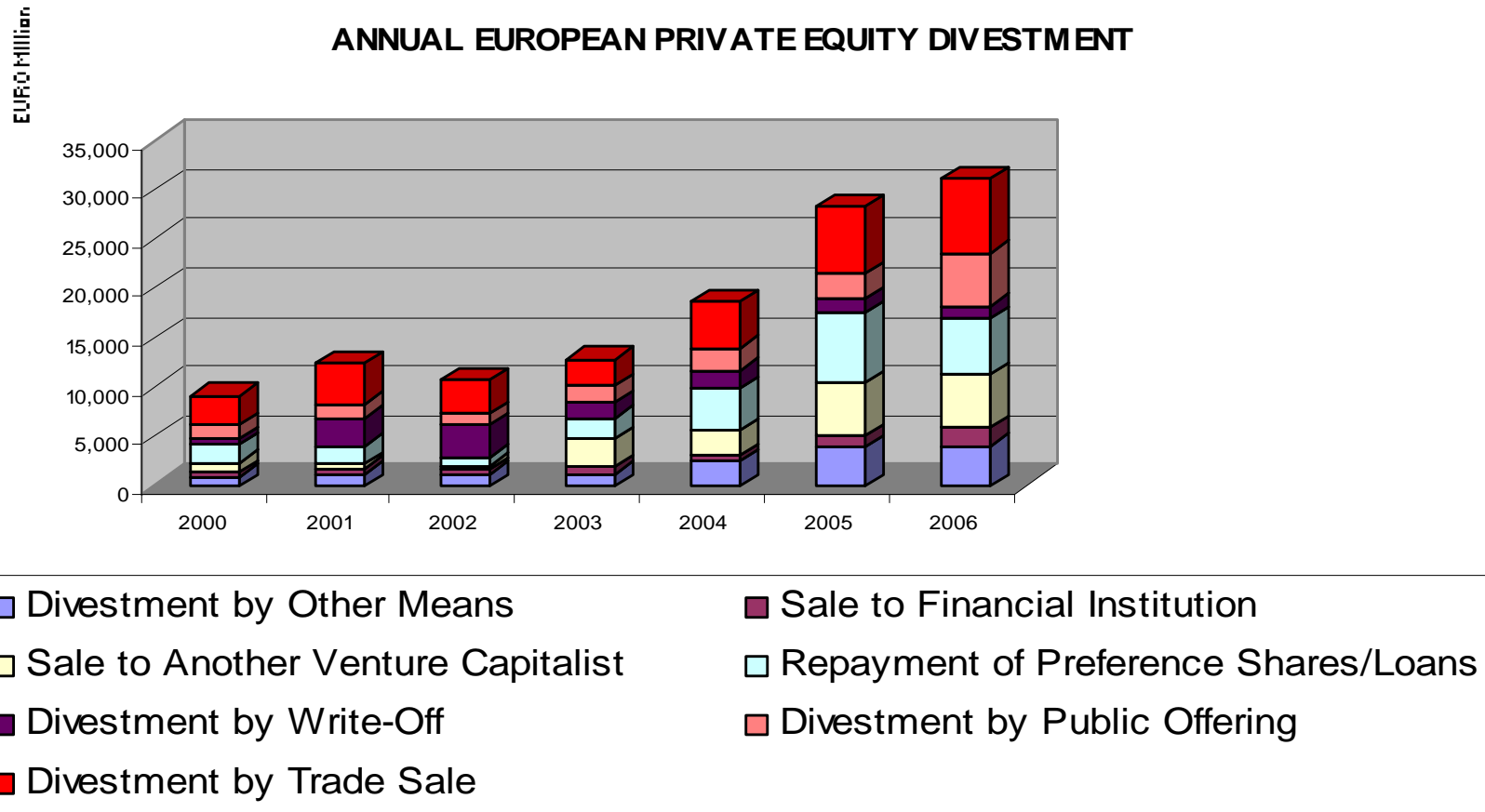


Investment Cycle – Divestment & Distribution Exit Strategy

- Initial view must be taken on investment
- Remain flexible throughout ownership period
- Typical exit options are:
 - IPO
 - “The Holy Grail”
 - Beware of Lock-ins
 - Not common
- Trade sale
 - Most common
 - Must be business synergies to make it work
- MBO/MBI
 - Current management team (MBO) or
 - External management team (MBI)
- Secondary Fund
 - Not common at an investment level

Investment Cycle – Divestment & Distribution

EVCA Statistics



Investment Cycle – Divestment & Distribution

Things to think about on distribution

- Order defined in LPA/Articles of Association
- A typical waterfall may be as follows:
 - Return of Capital to investors
 - Payment of a Preferred Return of 8% to investors
 - A 'Catch Up' payment of 80% to the GP; 20% to the investors until 20% of profits paid to GP; then
 - 20% paid to GP and 80% to investors.
- Classification as income/capital is important to investor. Consider:
 - The nature of the instrument paying the returns;
 - The accuracy of the interest calculations for debt instruments;
 - Whether the instrument has changed since the initial investment;
 - The accuracy of the information transferred to the distribution notice from the underlying calculations.

Investment Cycle – Divestment & Distribution

Things to think about on distribution

Admin Processes & Controls

- Recording and updating of standing data
- Accurate recording of the disposal transaction [Cost, income, gain]
- Accurate allocation of proceeds available for distribution amongst the partners
- Focus on calculations for preferred return and carried interest
- Accurate cash payments to investors/general partner

Audit Approach

- Testing of disposal to transaction documentation
- Verification of allocation methodology in accordance with the LPA/Prospectus
- Verification of the preferred return and carried interest calculations
- Sample testing of cash payments

Accounting thoughts

- Should the Fund make a provision for carried interest on unrealised gains? - Yes
- How should carried interest be accounted for in the fund? – A topic for debate
- Should the manager/GP recognise the carried interest in its accounts? - Maybe

Some Final Thoughts on Audit and Accounting Our Audit Engagement

- Our audit work is designed to assess the compliance of the financial statements with either accounting standards or the Limited Partnership Agreement or both;
- International Standards on Auditing require us to assess which areas of the financial statement are subject to the highest risk of material misstatement.

Some Final Thoughts on Audit and Accounting Our Audit Engagement

Significant audit risks for a private equity fund in my view are:

- Valuation of Investments
- Existence of Investments
- Accurate recording of investment transactions
- Accurate execution and recording of distributions

Some Final Thoughts on Audit and Accounting

IFRS 7 / FRS 29 Financial Instruments: Disclosures

Overview:

- New disclosures in addition to those currently required by IAS 32/FRS 25.
- Replaces IAS 30 – “Disclosures in the Financial Statements of Banks and Similar Financial Instruments”
- All financial instruments disclosures are placed together in this standard. The remaining requirements of IAS 32 deal with presentation matters and remain unchanged.

There are two main categories of disclosure:

- i) Significance of financial instruments for an entity’s financial position and performance – incorporating many of the existing IAS 32 requirements
 - Balance sheet disclosures
 - Income statement and equity disclosures
 - Disclosures on accounting policies, hedge accounting and fair value.

Some Final Thoughts on Audit and Accounting

IFRS 7 / FRS 29 Financial Instruments: Disclosures

- ii) Nature and extent of risks arising from financial instruments including both qualitative and quantitative information.
 - Qualitative; Exposure to risks, how they arise and the entity's objectives, policies, processes and methods used for managing and measuring the risks.
 - Quantitative; the level of detail in the disclosures should be based on the information provided internally to the key decision makers of the entity. There are minimum requirements for credit risk, liquidity risk and market risk.

Entities reporting under International Financial Reporting Standards ('IFRS') are required to apply IFRS 7 for annual periods beginning on or after 1st January 2007.

Some Final Thoughts on Audit and Accounting FASB: Uncertain tax positions (FIN 48)

In July 2006, the FASB released an Interpretation that is intended to reduce diversity:

Accounting for Uncertainty in Income Taxes (FIN 48) Under the interpretation, companies' financial statements will reflect expected future tax consequences of uncertain tax positions.

It appears that investment companies will need to:

- List all tax positions that they currently have within their structures
- Assume that they are going to be audited by the relevant tax authorities - would the position be sustained?

Following the recent announcement from the FASB, FIN 48 will become effective for non-public entities for periods beginning after 15 December 2007.

Other entities should already have adopted the standard.

Some Final Thoughts on Audit and Accounting

FASB: Fair value measurements (FAS 157)

Approved by the FASB on 15 September 2006 and effective for financial statements issued for fiscal years beginning after November 15, 2007.

Valuation techniques

FAS 157 describes three main approaches to fair value: the market approach, the income approach and the cost approach.

The objective is to use the valuation technique or combination of valuation techniques that provide the best estimate of fair value in the circumstances. The PEIGG guidelines advocates the market approach as the most appropriate for private equity funds.

Fair value hierarchy

The standard establishes a fair value hierarchy to prioritise the inputs used in the valuation techniques.

Final, final thoughts....

- Think about accounting issues at the set up of the Fund (give the auditors a call)
- Accurate documentation is key
- Ensure that board meetings are effectively structured and documented
- Discuss the audit process with the audit team so that you understand their priorities and are well prepared

© <YEAR HERE> PricewaterhouseCoopers. All rights reserved. "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity. *connectedthinking is a trademark of PricewaterhouseCoopers LLP (US).

