ALTERNATIVE CREDIT COUNCIL
LENDING FOR GROWTH

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Sent by email to: yelena.mishkevich@aicpa-cima.com

Dear Yelena,

Working draft of the AICPA Accounting and Valuation Guide: Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies

The Alternative Credit Council (ACC)[1] is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 100 members that manage $350bn of private credit assets. The ACC is an affiliate of the Alternative Investment Management Association (AIMA)[2] and is governed by its own board which ultimately reports to the AIMA Council.

The ACC welcomes the opportunity to comment on this working draft of the AICPA Accounting and Valuation Guide *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies* (the 'Guide').

We believe that the Guide will be a useful document for our members and others involved in the accounting and valuation of portfolio company investments held by investment companies within the scope of FASB ASC 946.

Our detailed comments on the guidance proposed in part one of the Guide can be found in the annex to this letter. We would offer the following general comments on the Guide for your consideration:

[1] The ACC is a global body that represents asset management firms in the private credit and direct lending space. It currently represents over 100 members that manage $350bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy, providing finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business. The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

[2] The AIMA is the global representative of the alternative investment industry, with more than 1,900 corporate members in over 60 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than $2 trillion in assets.

- The Guide benefits from the illustrative examples and we consider it could be further improved by including more illustrative examples to the extent that this is applicable. For example, Chapter 11 has self-contained illustrative examples of the process and considerations whereas Chapter 6 does not.
- The concept of calibration is not explained in Chapter 5 but reference is made to the chapter on calibration (Chapter 10). We would suggest providing a brief introduction or definition when the concept "calibration" is first introduced in the valuation guide. This definition should then be referenced at the beginning of Chapter 10.
- Chapter 11 focuses on performing backtesting analysis on trades that occurred after the measurement date. Consideration should also include backtesting against future valuations to assist in improving the determination of fair value. While future valuations may not represent a valuation that was fair valued, they can provide a good directional indication and assist in defining and reviewing valuation policies and procedures.
- Chapter 11 also contains minimal reference or guidance in respect of debt investment valuations. As the retrospective reviews of debt investments can assist with the development of fair value measurements and methods, we would suggest that the Guide could be improved by incorporating illustrative examples of backtesting applied in respect of debt instruments.
- Chapter 1 refers to the duration of private equity fund life as between 10-12 years. Although the average duration has been increasing, we believe that 7-12 years would be more appropriate.

I hope that you find these comments helpful and thank you for considering these views.

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs

Annex
ACC comments on AICPA Accounting and Valuation Guide *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies* Working Draft

Please note that, where we have suggested amendments to the original text, these are marked as tracked changes. Where we have made comments on the proposed text, the areas being commented on are highlighted in yellow.

Chapter 1 : Overview of the PE and VC Industry and Its Investment Strategies	
1.02	*Private equity* is a term often used to refer to illiquid closed end investment funds which are offered only to sophisticated investors (for example, "accredited" or "qualified" investors, which are terms defined in SEC regulations; see the "Investor Base" section in paragraphs 1.28–.37 of this chapter for further discussion). *Venture capital* generally refers to a form of private equity investing focused on early stage and start-up companies, with early investments in these companies often occurring before they have revenues. Later stage private equity investing would include *pre-IPO, MBO, MBI, expansion capital, growth investing*, *roll-up strategies,* or *leveraged buyouts* of more mature companies. *It may be helpful to include these additional examples of later stage private equity investing.*
1.12	~~In addition, private equity and venture capital funds are market participants for other investments in private company interests. As a result,~~ Wwhen reviewing valuations of one private equity or venture capital fund, it is helpful to be knowledgeable about the private equity and venture capital industry, how it operates and what types of strategies are typically employed. If, for example, a venture capital fund has an early stage company in its portfolio that has had a successful product introduction but has reached the point where it needs a large amount of additional capital to build out its production, sales and distribution functions, such portfolio company may be of interest to a growth-oriented private equity fund. Understanding the perspective, mandate or edge of a private equity firm that may ~~actually invest~~have the appetite to invest in such a portfolio company may help to value it in a more specific manner. *The first sentence is unclear and does not appear necessary for the purposes of this paragraph. We have also suggested amendments to the last sentence where we believe these augment the point being made in this paragraph.*
1.17, 1.18, 1.60	1.17 As noted previously, venture capital funds typically pursue a strategy of investing in earlier stage enterprises (~~stages 1, 2, and 3~~angel, pre-series A, series A, series B). Early stage enterprises often invest heavily in product development with little to no offsetting revenue and, as a result, may generate significant negative cash flow (often referred to as *cash burn*). Early stage enterprises may also be subject to high risk of failure because the product or service is often unproven and subject to risk of successful development, regulatory approval, commercialization, and financial feasibility. A venture capital fund will often manage the risk of cash burn and high risk of failure by making investments in a particular portfolio company through multiple rounds of financing and investing along with several participants.

	1.18 The venture capital funding model rarely involves a portfolio company raising enough money in the very early stages to fund the business fully until profitability. Investing through multiple rounds allows the venture capital fund to manage the cash burn risk by ideally providing just enough funds to allow the portfolio company to operate through a targeted milestone or stage of development. The portfolio company will seek to invest these funds in product development, marketing or other activities, such that value will be created equal to or in excess of the investment. The venture capital fund will monitor the portfolio company's progress. At the time of the next financing round, the venture capital fund is able to reassess the portfolio company's progress, the feasibility of the business plan, and the prospects for successful exit. Based on this assessment, the venture capital fund can then decide whether to continue investing. Managing the cash burn is important because the venture capital fund will want to avoid a situation in which the portfolio company runs out of cash before achieving the targeted milestones or stage of development and next round of financing. In addition, the venture capital fund will have the opportunity to negotiate terms based on the perceived change in value since the last round. Often the investors in each round will be different and the rounds will be negotiated independently. 1.60 As a result, the venture capital funding model rarely involves a portfolio company raising enough money in the very early stages to fund the business fully until profitability. Instead, venture capital funding typically involves several rounds of financing, providing the portfolio company with enough money to reach another milestone and giving investors the opportunity to see how the portfolio company and the related market develop over time. This approach helps to minimize the amount of money investors stand to lose if the portfolio company does not make sufficient progress or the market develops differently from initial expectations. The ultimate decision regarding whether to invest is based on assessing the portfolio company's development prospects over a long period of time and what it may ultimately be worth. The more immediate assessment is to identify the portfolio company's future milestones and determine the probabilities of it achieving these milestones. The achievement of past milestones, probabilities of meeting future milestones, and cash needs are key factors that investors evaluate in combination with the overall outlook for the portfolio company in negotiating the pricing and aggregate level of investment for each round of financing. *There is repetition of cash burn risk management in these paragraphs. The approach of multiple funding rounds is then again touched upon in 1.60. It may be more appropriate for this discussion be moved to one place in the Risk tolerance section and for these references to be removed from section 1.60.*
1.27	Understanding the terms of the fund and the relative performance of the fund can be helpful in understanding the financial incentives of the fund manager and general partner. The fund manager's revenues usually depend on its success in raising capital, and the fund manager will typically invite the limited partners in the current fund to participate in the next fund. In many cases, limited partners evaluate the fund manager based on the internal rate of return (IRR) of the fund manager's prior funds, as well as the multiples of invested capital generated by the fund. The IRR calculation for unrealized investments would generally assume that the remaining investments were sold at fair value on the date through which the IRR is calculated. The general partner's distributions usually depend directly on the performance of the fund. For funds with a hurdle rate or a preferred return, the IRR calculation against which the fund is measured usually is also used to determine whether the general partner has satisfied the fund's waterfall criteria in order to receive carried interest distributions.

	This explanation of multiples of invested capital is not entirely clear and would benefit from further elaboration.
1.28 – 1.37	*We would suggest reorganising this section to group the investor base into institutional and non-institutional investors, move FoFs to before HNW and FOs, and to include insurance companies and development finance organizations (e.g. World Bank, IFC, ADB, etc.).*
1.37	Funds of funds are investment companies that invest in other investment companies. A fund of funds manager raises capital from investors to invest in one or more underlying funds. These investments provide a vehicle for investors who are looking for exposure to private equity and venture capital funds but might otherwise be unable to access some managers (who might be quite selective in who they allow to participate in their funds). In addition, investors can rely on the fund of funds manager to identify and select managers and provide diversification to their portfolio, which would not be as readily attainable from a direct investment in private equity and venture capital funds due to the high minimum investment level. The fund of funds managers also tend to have well established due diligence procedures and portfolio monitoring processes, and handle the negotiations with the private equity or venture capital fund manager over fund terms, rights to information and reporting and so on. Some fund of funds managers may have related businesses that invest in private equity and venture capital "secondary fund" interests, which are existing fund interests acquired from other limited partners. Some funds of funds may also co-invest (invest directly in an underlying portfolio company) side by side with the fund making a direct investment. *This is true for a number of the investor types mentioned, not only for FoFs.*
1.38 – 1.44	Suggest moving *Investment horizon and return considerations* to before *Investor base* as this would make it clearer why certain investors such as pension funds, family offices etc. would want to allocate their funds into PE/VC because of their need for more long-term investments.
Planning for "Exits"	*It would seem more natural for this section to be the last part of the chapter.*
1.65	It is important to understand the portfolio company's strategy and positioning. An investor might start with understanding the portfolio company's mission and the details of its business plan, the metrics it will use to measure its own success and the progress it is making towards achieving its goals. The investor may also assess the technological feasibility and the uniqueness of the portfolio company's planned solution, as well as the potential size of the market and the portfolio company's strategy to penetrate the market. Finally, the investor would consider how much money the portfolio company would need to spend to develop and commercialize the product or service. That is, how much investment will be required to develop a viable solution and then to reach the market – for example, will the product ultimately be licensed or sold through independent distributors or is the portfolio company planning to build its own sales organization? Taken together, these factors determine the potential return on the investment. *Suggest moving this to the section on market opportunity.*

Market opportunity	*We would suggest making this a main heading, and with the following market-related headings sub-headings (e.g. product adoption and customer behaviour, competitive landscape and presence of a first-to-market advantage etc.)* *We would suggest that this section begins with commentary around the competitive landscape. Possibly structure around Porters five forces?*
1.72	In addition to evaluating the ~~subjective~~ idiosyncratic factors described previously specifically relevant to a given investment fund, investors in early stage portfolio companies will typically also perform an overall assessment of the potential IPO or strategic exit market for that particular company. The potential exit market for early stage portfolio companies differs by sector and strategy. For example, consider an early stage, pre-revenue company developing a drug that may have a very large potential market. Even though the potential market is large, the high failure rate of companies developing and commercializing new drugs may have a significant negative effect on this company's value. Therefore, the IPO or strategic investors may place a judgmental cap on this company's value at a level significantly below the ultimate value that may be realized. *It is unclear what this is referring to.* *We would suggest that section 1.72* Macro Investment Environment for the Particular Early Stage Portfolio Company *is moved to the new 'overall market' heading and not after discussing 'Executive Management and Their Track Records'.*
Chapter 5 : Overview of Valuation Approaches	
5.04	Footnote 2 in this section states that: For purposes of this guide, *enterprise value* is defined as the value of equity plus interest-bearing debt. In broader valuation practice, the term *enterprise value* is sometimes used to refer to the value of equity, plus interest-bearing debt, less all cash and equivalents; however, for this guide, the PE/VC Task Force (task force) defines *enterprise value* to include cash and cash equivalents. For purposes of this guide, *equity value* is defined as the enterprise value less the value of debt ~~a market participant would use to determine the value of equity~~, measured considering the investors' risk-adjusted expected returns from their investment~~.~~ *This seems to apply circular reasoning.*
5.07	Two commonly used valuation methods for valuing a portfolio company within the market approach are the *guideline public company method* and the *guideline company transactions method*. *These are new concepts that have not been defined before and should be accompanied by a brief introduction or definition.*
5.08	5.08 Calibration also may be used to infer the equity value for the company from a transaction involving the company's own instruments6 (the results of which may require adjustment for the nature of the instruments or any unstated benefits derived; see paragraphs 5.52–.55 and 10.31). The resulting calibrated equity value may be used as an input into the valuation of the fund's interests, similar to the way that the equity value derived from other approaches are used in valuing the fund's interests, and can be used to calibrate the assumptions used in other forms

	of the market approach or in the income approach to support valuations at subsequent measurement dates. Calibration provides an indication of the way that market participants would value the investment as of the transaction date given the differences between the portfolio company and the selected guideline public companies or transactions. These initial assumptions may then be adjusted to take into account changes in the portfolio company and the market between the transaction date and each subsequent measurement date. See chapter 10, "Calibration." *This sentence is a bit unclear to us.* Calibrating to any recent transactions in the company's own instruments requires considering the rights and preferences of each class of equity and solving for the total equity value that is consistent with a recent transaction in the company's own instruments~~, considering the rights and preferences of each class of equity~~. See chapter 8, "Valuation of Equity Interests in Complex Capital Structures," for additional discussion of how to value equity interests within a complex capital structure, and chapter 10, "Calibration," for additional discussion of calibration. *Unnecessary repetition of the same phrase.*
5.09	5.09 The market approach may also be used to value the interests in a portfolio company directly, based on transactions in the company's own instruments. See paragraphs 10.31–.43, "Inferring Value From Transactions in a Portfolio Company's Instruments." *It is unclear whether this is different to what is stated in 5.06.*

5.12	5.12 When identifying guideline public companies to be used in a market approach, it is helpful to consider what makes a company comparable to the subject portfolio company Operational and financial characteristics are considered to be factors of comparability and help determine those companies that have the most similar earnings capacity and relative levels of investment risk. Many sources7 of public company data are searchable by these key factors that can aid in identifying potential guideline public companies. Factors of comparability can include the following (note that this list is not intended to be an exhaustive list):
	
	• Similar operational characteristics, such as
	  ○ same industry or sector (the North American Industry Classification System or the Standard Industrial Classification code);
	  ○ similar lines of business;
	  ○ geographic reach (for example, domestic versus international versus multinational);
	  ○ similar customers and distribution channels;
	  ○ contractual versus non-contractual sales;
	  ○ seasonality of the business;
	  ○ similarity of business cycle (for example, short cycle characterized by ever-changing technology versus long cycle driven by changes in commodity pricing);
	  ○ similar stage of business life cycle (start up, high growth, mature, and so forth); or
	  ○ similar operating constraints (for example, reliance or dependence on key customers or government regulations).
	• Similar financial characteristics, such as
	  ○ similar size (for example, revenues, assets, or market capitalization, if subject is public);

	○ similar profitability (for example, earnings before interest, taxes, depreciation, and amortization [EBITDA], operating margin, contribution margin); ○ similar anticipated future growth in revenues and profits; ○ similar asset-base (for example, manufacturing versus service business); or ○ similar pattern of owning versus leasing real properties, machinery, and equipment (for example, an entity that owns its manufacturing operations versus one that leases the building and machinery used for its operations). *Suggest amending or removing the reference as peers could be international and hence would have differing domestic markets. Possibly also add any permits or licenses from the related government authority as an operating characteristic.*
5.14	Not all of the factors listed in paragraph 5.12 will be applicable in every circumstance, and there may be many other important factors to consider, some of which may be industry specific. When performing the analysis, the factors of comparability are determined and public company data is screened to identify the best set of guideline public companies, if any, that meet these criteria. *This paragraph should follow directly after 5.12.*
5.22	These multiples can be calculated on a historical basis or a forward looking basis. The selection of historical versus forward looking multiples requires judgment about which measure(s) are most indicative of a normalized level of operations going forward. In many cases, both historical and forward looking multiples may be considered, with adjustments to account for expected growth and other factors. If the portfolio company has generated historical revenues or profits, most market participants will consider the historical multiples as one input, since historical data is more easily available and more likely to be reliable. However, if available, forward multiples are likely to provide more relevant information, especially for high growth businesses. See the following paragraphs, especially paragraph 5.38, for additional discussion. *It would be helpful to specify more clearly which paragraphs.*
5.28	There may be situations in which adjustments to a guideline public company for nonoperating assets are necessary for significant identifiable items, such as investments in an unconsolidated subsidiary or joint venture accounted for under the equity method, unused land adjacent to plant or facility, or corporate headquarters located in an area where the price of real estate is high. The objective for making these adjustments is to enhance the comparability between the guideline public companies and the subject portfolio company. *This should be moved to the adjustments section (5.32 and onwards).*
5.32	Footnote 11 Another consideration is that not all companies within an industry have similar operations. For example, some hotel companies purchase their properties, whereas others lease them. Companies with different operating models will likely trade at different multiples of various financial metrics, so it is important to consider these factors when estimating appropriate multiples for the company to be valued. It may also be necessary to make pro forma adjustments to the financial statements for selected guideline public companies or for the company to be valued to take into account factors such as favorable or unfavorable contracts

	(for example, a below-market lease or a low rate on a technology licensing agreement), recent or pending acquisitions, or one-time events. *This footnote does not discuss IFRS vs. GAAP considerations. It may be more appropriate for this to be included as commentary in the guidance.*
5.33	In performing valuations of early-stage enterprises under the market approach, not only is it assumed that the industry, size of enterprise, marketability of the products or services, and management teams are comparable but also that the portfolio company's stage of development is comparable. This last assumption often renders the market approach impractical for early-stage portfolio companies because pricing data for such enterprises is difficult, if not impossible, to find. Furthermore, even if pricing data can be found, until product or service feasibility is achieved, comparability among early-stage enterprises is difficult to achieve. *This paragraph is in the adjustment section but does not discuss adjustments.*
5.52-55	*It may be more appropriate for these paragraphs be moved to Chapter 10 on Calibration.*
5.62	It is important to note that FASB ASC 820, *Fair Value Measurement*, does not limit the use of present value techniques to measure fair value to these three choices. Many elements of risk may be handled by adjusting either the level of expected cash flows or the discount rate or both. *It may be helpful to list the three choices in this paragraph.* *The final reference to 'or both' does is inconsistent with section 5.61 which states that one or the other need be adjusted, not both.*
5.63	In selecting a discount rate in the discounted cash flow method, it is important to consider not only the various inputs typically used to estimate the cost of capital, but also the differences between the portfolio company and the selected guideline public companies used in estimating these other inputs, which might indicate that a higher or lower cost of capital is appropriate. Calibration provides an indication of the way that market participants would value the investment as of the transaction date given the differences between the portfolio company and the selected guideline public companies. These initial assumptions can then be adjusted to take into account changes in the portfolio company and the market between the transaction date and each subsequent measurement date. See chapter 10, "Calibration." *It would be helpful to clarify which ones or list examples.*
5.65	Although it may be difficult to forecast future cash flows beyond a certain point, it does not mean that the portfolio company will not have such cash flows. Those cash flows also will be periodic cash flows unless the ownership of the portfolio company is changed or transferred as a result of a liquidity event. In many cases, such an event will result in a single cash flow, which represents the value of the portfolio company expected to be realized at that point in time. In other cases, the liquidity event may result in multiple future cash flows, which need to be discounted to estimate terminal value. In all cases, the terminal value should be estimated and incorporated into the DCF calculation of value.19 *This sentence appears to be missing the word cash twice.*

5.66	The cash flows for the portfolio company as a going concern also provide a basis for reasonably estimating a terminal value. That estimate generally is made as of the date the portfolio company is expected to begin a period of stable cash flow generation. That period may be one of growth at some assumed constant rate or one of no growth. See appendix B, paragraphs B.05.01–.05.04, "Table of Capitalization Multiples," for a discussion of capitalization multiples that may be applied to the stable annual cash flow in estimating a terminal value. Whether terminal value is estimated by the use of a capitalization multiple or other means, the terminal value is the fund's best estimate of the present value of those future cash flows, consistent with market participant assumptions. That terminal value is incorporated into the DCF calculation of value by further discounting the terminal value to a present value. *This is not entirely clear.*
5.74	The quality of the PFI and its relevance for purposes of measuring fair value depends upon many factors, which are often interrelated. One useful tool for addressing these factors is the AICPA Guide, *Prospective Financial Information* (the PFI Guide), which, among other things, is intended to assist third-party specialists who are engaged to compile or examine client company PFI. It sets forth conditions that such specialists should follow before associating themselves with PFI that could be relied upon by third-party users. These conditions presume certain factors: • The third-party specialist will have appropriate access to management • The responsible party should have a reasonably objective basis for its forecast • Sufficiently objective assumptions can be developed for each key factor The PFI Guide defines *responsible party* as "[t]he person or persons who are responsible for the assumptions underlying the prospective financial information. The responsible party usually is management, but it can be persons outside the entity who currently do not have the authority to direct operations (for example, a party considering acquiring the entity)." *Please clarify what 'key factor' refers to above.*
5.76	The task force believes that market participant assumptions should be taken into account when considering the level of detail used in assessing PFI. In some cases, there may be extensive support for PFI, in other cases there may be very limited support. The level of underlying support for PFI will vary based on the individual facts and circumstances. *This is not entirely clear to us.*
5.78	*Discount rate adjustment technique (conditional)* *It is not clear what '(conditional)' refers to.*
5.79	Expected present value-based PFI come in many forms. For example, the PFI may be disaggregated into multiple success and failure scenarios, weighted by probabilities of occurrence. This would be a more detailed way of addressing unresolved risks such as the ultimate success of a single product or service. Another format would be a single scenario PFI that represents a weighted set of outcomes. In both of these cases, the PFI still contains risky assumptions concerning revenues, margins, growth, and other factors that require the

	application of a risky discount rate such as a WACC- or CAPM-based rate. In general, such a rate would be lower than the conditional rate discussed previously, because the expected cash flow or other metric would already be de-risked for conditional events/milestones via the probability-weighting process. *Please specify where this was discussed previously.* *It may be easier to follow if all sections discussing Method 2 come after the sections discussing Method 1.*
5.82	When the unit of analysis is a specific tranche of preferred equity, for example, and the PFI has been adjusted to focus on the cash stream available to this specific level of investment, further adjustments to the discount rate should be considered. For example, stock that is preferred with regard to liquidation rights, etc. is less risky than common stock in many scenarios, and may be less risky than the entity's aggregate equity. As discussed in chapter 8, "Valuation of Equity Interests in Complex Capital Structures": *This sentence appears to be missing the word equity.*
5.92	In corporate finance theory, it is generally accepted that when discounting a risky future cash flow, the discount rate should include (a) the time value of money, often at a risk-free rate; (b) a market risk premium; and (c) other adjustments to account for risks not captured in (a) and (b). The PFI may represent a conditional scenario that assumes, e.g., that a new product will be successfully completed and gain market acceptance. The discount rate would need to be adjusted to capture such additional risks. *We would suggest moving this part to the introduction of the chapter as this is not specific to Milestone driven valuation but more generic.*
5.94	This final technique does not require the application of arbitrary assumptions such as ignoring the passage of time or making adjustments to discount rates that are not supported by changes in the market or at the portfolio company. However, in the absence of the resolution of significant risks/achievement of milestones, all three techniques will produce similar estimates of fair value. *Suggest reminding the reader of the three approaches.*
5.99	Footnote 27 Robert F. Reilly and Robert P. Schweihs, *Valuing Intangible Assets* (New York: McGraw-Hill, 1998). *This is the first source mentioned, should there be others mentioned as well, e.g. the Brealey & Myers example on page 134?*
Chapter 6 : Valuation of Debt Instruments	
6.02- 6.03	6.02 The fair value of debt reflects the price at which the debt instrument would transact between market participants transacting in the debt, in an orderly transaction at the measurement date. This value would consider the contractual terms of the debt instrument (e.g. coupon rate, contractual maturity, amortization and other pre-payment features, change of control provisions, conversion rights if any), the historical and projected financial

	performance of the company, the information that market participants transacting in the debt would have regarding the plans of the portfolio company that issued the debt (e.g. expected time horizon), and the expected cash flows and market yield considering the risk of the instrument and current market conditions. *Fair value should simply be what a hypothetical buyer is willing to pay (in the case of debt it is what yield expectation market participants are willing to accept for a set of contractual future cash flows – taking into account the risk of the issuer defaulting on those cash flows – notwithstanding the face value of the instrument).* 6.03 The value of debt for the purpose of valuing equity (that is, used as an input in valuing the equity interests in a portfolio company), reflects the value of the liability that market participants transacting in the equity interests would subtract from the total enterprise value to establish a price for the equity interests in an orderly transaction at the measurement date. This value similarly would consider the contractual terms of the debt instrument (for example, coupon rate, contractual maturity, amortization and other pre-payment features, change of control provisions, conversion rights if any), the historical and projected financial performance of the company, the information that market participants transacting in the equity would have regarding the plans of the portfolio company that issued the debt (e.g. expected time horizon), and the expected cash flows and market yield considering the risk of the instrument and current market conditions. See paragraphs 6.19–.31 for further discussion. *It is unclear whether this repetition is necessary.*
6.04	Several other measures of the value of debt instruments are often used as proxies for the fair value of debt or the value of debt for the purpose of valuing equity in some circumstances. These measures do not necessarily reflect the fair value of debt nor the value of debt for the purpose of valuing equity: • Par value – the notional value of the debt • Face value – the par value of the debt plus any accrued (paid-in-kind, or PIK) interest • Book value – the value of the debt used for financial reporting purposes, typically measured as par less any original issue discount (OID), inclusive of debt issuance costs if any, accreting toward par over the maturity as defined by the financial reporting guidance • Payoff amount – the value of the debt that would be owed upon repayment at the measurement date, which may include a pre-payment penalty and thus be higher than face value • Traded prices, matrix prices or indicative broker quotes – the price for the debt reported from trades or various pricing services or provided by one or more brokers, which may or may not reflect the fair value as of the measurement date and may or may not reflect a binding offer to transact. *We would welcome additional guidance on the potential scenarios or circumstances, including examples, under which the proxies for the fair value of debt identified in 6.04 might be adopted to estimate fair value.*
6.05	The fair value of debt ~~may not~~is unlikely to be the same as its face value. A fair value of debt lower than face value reflects the cost to the debt holders of being locked into the investment at a below-market interest rate. This situation can arise either due to overall market conditions or company-specific credit issues. For example, if Company A issued debt on June 30, 2X08, at London Interbank Offered Rate (LIBOR) + 300 basis points (bps) with a 5-year maturity but as of

	June 30, 2X11, would have to pay LIBOR + 700 bps to refinance the debt for the remaining 2 years to maturity, the debt holders will not receive a market rate of return for the remaining 2 years. *Regarding the opening statement that the fair value of debt "may not" be its face value: this sentence could be misconstrued as conceptually linking face value as a fair value indicator.*
6.08	The portfolio company may have several classes of debt outstanding, including first lien and second lien loans, other senior secured debt, senior unsecured debt, subordinated debt, convertible notes, or other debt and debt-like instruments. If the debt instrument that the fund holds in the portfolio company is traded, the traded price as of the measurement date may be the best estimate of fair value, assuming the transaction is determined to be orderly. Most "traded" debt is traded through brokers or market makers where trades may be sparse. However, if the identical debt instrument is traded in an active market, then the fair value would be measured as P*Q (where P is the price of traded instrument, and Q is the quantity)
6.09	When a traded price as of the measurement date is not available or is deemed to not be determinative of fair value, the typical valuation technique to estimate the fair value of the debt is to use a discounted cash flow analysis, estimating the expected cash flows for the debt instrument (including any expected prepayments [for example, if prepayment is required upon a liquidity event]) and then discounting them at the market yield. This valuation technique is referred to as the yield method. *Consider adding ancillary cost incurred in prepayment event, and if the debt instrument is a convertible bond, the cash flow from conversion.*
6.12	One method for assessing the credit risk of a portfolio company is to perform a synthetic credit rating analysis. A synthetic credit rating is a quantitative analysis that compares selected financial ratios for the portfolio company to public companies with rated debt, using these metrics to estimate the rating for the portfolio company. This process considers the same types of metrics as those used by the major credit rating agencies, such as: • natural logarithm (total assets) [company size] • debt / total assets [leverage] • EBIT / net debt [solvency] • return on assets [operating performance] • EBIT / revenues [operating margin] • EBIT / average capital [return on capital] • Etc. *If synthetic credit rating analysis is used in the preparation of comparators / establishing an appropriate discount rate then the framework for defining rating equivalency should be both quantitative and qualitative. All factors and considerations should also be tailored to meet the needs of the underlying sector. While a rating for the purpose of valuation is somewhat less developed than the needs of a public rating performed by a CRA, the high level thought processes should be similar. As well as indicators of creditworthiness collated from financial statements one should also seek to incorporate qualitative risk factors not limited to: management and ownership structures, sector performance, cyclicity, outlook, country and economic risks which relate to the firms operating environment.* *Debt service coverage ratio (DSCR) should be included as one of the solvency or debt servicing*

	indicators.
6.13	Most synthetic credit rating algorithms use a variety of metrics (e.g. five to seven selected metrics that have been shown to be predictive of ratings, while avoiding overlap), and compare these metrics across a pool of all relevant public companies with rated debt (e.g. public companies in the US and Canada or other relevant markets with rated debt, excluding industries that have significantly different characteristics such as financial services and utilities, and in some cases, oil & gas) using some form of regression 145 analysis. To estimate the range of spreads for a given credit rating, the same population of public companies would be considered, using the option-adjusted spreads (OAS) reported for each outstanding bonds for these companies and filtering to find bonds with similar maturities. *Populations to determine synthetic ratings should be extensive in nature whereby and populations used to establish discount rates will often be, by comparison, much more limited. This should not be discouraged as the primary purpose of comparator selection for use in valuation should be solving for a bespoke beta that best serves the Fair Value process / synthetic ratings' primary purpose should be used to narrow the frame of reference for asset valuation (in this context).*
6.15	In addition, a synthetic credit rating is designed to estimate the corporate family rating (CFR) for the portfolio company, which typically also reflects the rating that would be expected for a senior unsecured bond issued by the portfolio company. Secured bonds typically are rated one notch better than the CFR (e.g. BB+ instead of BB), while subordinated bonds may be two to three notches below the CFR. However, these are not prescriptive thresholds and as with any valuation, the assumptions should be properly supported. Other methods for adjusting for seniority consider the relative expected recovery rates upon default, especially when the portfolio company has a recent debt issuance for another debt instrument or has traded debt that can be used to infer the spreads for the debt investment held by the fund. It is important to consider the seniority of the debt instrument when estimating the credit risk. *This section introduces the concept of a corporate family rating. This should be defined to provide context to this section.*
6.18	If the debt has prepayment features (such as call or put rights), it may be necessary to consider the optimal timing of repayment for the issuer (call features) and the holder (put features), given the future evolution in market yields. For example, if the debt is prepayable with decreasing levels of prepayment penalties as time progresses, it may be optimal for the issuer to prepay at a later date rather than prepaying immediately. ~~Typically, d~~Debt instruments with such features may be valued using a one-factor stochastic model such as a Black-Derman-Toy (BDT) model. *The word typically should be removed as this overstates Black-Dermont-Toy use. The term scenario analysis is used elsewhere in the document and this would be more fitting than specifying Black-Dermont-Toy.*
6.27	In a few situations, it may not be possible to estimate the market yield from public debt data. For example, in some leveraged buy-out situations, the debt may have much higher leverage than is observable in the public debt markets. In these situations, the debt will behave more like equity, and the value may be estimated by allocating the total enterprise value directly. For PIK debt, one approach would be to allocate the enterprise value using a payoff amount for the debt equal to its face value, plus accrued interest through the liquidity event, plus any prepayment penalty. For debt with cash interest, one approach would be to subtract the

	present value of the cash interest from the enterprise value and then allocate the residual value using a payoff amount for the debt equal to its face value plus any prepayment penalty. When estimating the value of debt by allocating the total enterprise value directly, it is a best practice to also calculate the yield implied by the analysis and assess whether it is reasonable, given the leverage and terms of the debt. *The reference to value should specify whether this refers to debt or equity?* *"allocating the total enterprise value directly" – what is meant by this?* *Suggest separating the discussion on PIK debt and debt with cash interest with bullet points as in 6.25.*
6.29	In situations where the portfolio company is not highly levered and the fair value of debt is close to its book value or payoff amount, many market participants use the book value of debt or payoff amount as the value of debt for valuing equity. Using the book value reflects the value of debt as originally negotiated, updated for accretion toward maturity. Using the payoff amount reflects the value of debt that would be due upon a repayment at the company's option, if the debt is prepayable, or that would be due upon a change of control. These approaches may provide a reasonable approximation for valuing equity when the change in the value of the debt would have only limited impact on the equity value. • If the credit quality of the company has not changed and credit markets have been reasonably stable, the fair value of debt is likely to be relatively close to its book value. For example, for debt that was funded at par, an increase in market yields of 50 or 100 bps over a five to seven year term to maturity would indicate a fair value of debt of approximately 94 to 99 percent of par. At thirty percent leverage (debt to TIC), using a value of debt for the purpose of valuing equity of 95 percent of par would increase the estimated equity value by less than two percent of TIC. • Alternatively, if the company's credit quality has improved or market yields have declined, it might be optimal for the company to pay off the debt, and thus, it would be reasonable to measure the value of equity using the payoff amount for the debt. If the debt has a pre-payment penalty, the payoff amount for the debt would be above par. At thirty percent leverage (debt to TIC), using a value of debt for the purpose of valuing equity of 102 percent of par would decrease the estimated equity value by less than one percent of TIC. • When the credit quality of the company has declined or the market yields have increased significantly, the value of debt for the purpose of valuing equity may be significantly below par, and furthermore, the leverage for the company may be higher as TIC may also have declined. At fifty percent leverage (debt to TIC), using a value of debt for the purpose of valuing equity of 70 percent of par would increase the estimated equity value by around twenty percent of TIC. *This acronym should be spelled out and defined at first use.*

13.25 to 13.28	13.25 It is common for funds investing in debt instruments and other infrequently traded instruments to use third-party sources such as pricing services and quotes from brokers or dealers to assist in their fair value estimation process. Funds investing in debt instruments may also obtain indicative offers from brokers or dealers or other potential buyers. 13.26 FASB ASC 820-10-35-54K indicates that the use of quoted prices provided by third parties, such as pricing services or brokers and dealers, is permitted if the reporting entity has determined that the quoted prices provided by those parties are developed in accordance with the fair value standard. Therefore, reporting entities that use pricing services need to understand how the pricing information is developed and obtain sufficient information to determine where instruments fall within the fair value hierarchy. 13.27 Dealer quotes can be binding or nonbinding dependent on whether the dealer stands ready and willing to transact at that price. Brokers, on the other hand, report what they see in the market but usually are not ready and willing to transact at that price. *While this may be current common practice, it is likely that this will change in light of market discussions around the standard of evidence that will be deemed acceptable when determining whether broker quotes are reflective of underlying transaction activity. Although section 13.26 adds a caveat about validating the methodology it may help to future proof the Guide by adding more detail here about determining the standard of evidence. Additionally, the statement in section 13.27 (perhaps rightly) undermines the use of broker quotes, unless it can be definitively established that the broker quote represents transaction activity.* *Section 13.28 identifies "Matrix Pricing" and "Consensus Pricing" as two potential methods for valuing debt instruments for which trading activity cannot be readily determined. We believe that the AICPA guide should add a caveat around the application of Matrix Pricing and Consensus pricing given the challenges inherent in valuing level 3 instruments.* *Overall, we believe the Guide would benefit from expanding sections 13.25 to 13.28 to provide more robust guidance with respect to the steps that the valuer should take to test and validate whether the indications of fair value coming from brokers, dealers, or pricing services are representative of actual transaction activity between market participants.* *AIMA's "Guide to Sound Practices for the Valuation of Investments – 2018 Edition" provides a comprehensive overview on the topics covered above and it may help for the Guide to cross reference this document. We would be happy to provide a copy of this for your review.*