



**Global Investment Performance Standards**

## **Guidance Statement on Private Equity**

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**[www.gipsstandards.org](http://www.gipsstandards.org)**

## **GIPS® Guidance Statement on Private Equity**

### **Introduction**

For purposes of compliance with the GIPS standards, private equity entails investment in nonpublic companies at various stages of development and encompasses venture capital, buyout, mezzanine, and some distressed securities investing. Private equity may also include investments in public companies with the intent of taking them private or investments directly in public companies through structures known as PIPEs (private investment in public equity).

Private equity investments can be made in virtually any industry or geographic sector. Venture capital investments normally take a minority equity position in a company while buyout funds will take a controlling position in or total ownership of a company. As the industry has evolved, it has become more specialized, providing prospective clients with investment opportunities outside of the investment categories popular even in the recent past.

The private equity industry has grown from being principally composed of primary fund vehicles investing into individual companies to a complex mix of primary fund vehicles, secondary fund vehicles, funds of funds, direct investments, co-investments, and sponsored primaries, among others. The industry has evolved to the extent that some investment strategies that were novel some years ago are now common. For example, investors in funds historically invested only in the funds themselves. It is now common for investors to invest directly in companies rather than only in funds. Private equity investments may overlap investments in sectors also invested in by other asset classes such as real estate. As a result, there has been increasing interest in how the overlap creates issues for harmonizing the provisions among the various asset classes.

Investments by private equity vehicles may include investments in individual companies, in other funds, in debt securities, and in infrastructure projects, among others. Technically, all of those investments are ultimately investments in securities as the investor takes some ownership position therefore these collectively will be termed “underlying investments” for purposes of this guidance.

### **Investment Vehicles**

Investments in private equity are made through a variety of investment vehicles. This is generally done either through fund vehicles that are referred to in these provisions as “primary funds” or through a “fund of funds.” *Primary Funds*

Primary funds are investment vehicles that make investments into individual companies which are typically termed “portfolio companies”. The strategy of the fund may be broad or may have a specific investment stage and/or geographic focus.

#### *Funds of Funds*

Funds of funds invest in primary funds rather than directly in portfolio companies (also see co-investment section below) with the fund of funds taking a position as a limited partner of the underlying primary funds.

#### *Secondary Funds*

Secondary investment funds, which themselves may be structured either as a primary fund or a fund of funds, acquire an interest in a private equity fund from one or more of the original investors before the end of the fund’s fixed life.

There are also specialized secondary funds which focus on acquiring portfolio companies from other private equity funds. These are typically seen as another type of primary fund and are not

synonymous with secondary funds that acquire interests in private equity funds and thus must be considered a primary fund for compliance purposes.

There is often confusion as to the difference between a secondary fund and a fund of funds since both have interests in other primary funds. The differentiation is that a fund of funds is typically an original investor in an underlying fund while a secondary fund acquires the interest from another investor. There are exceptions as a fund of funds may make an opportunistic secondary investment but its primary focus is to be an original investor.

### *Co-investment*

In some instances, a limited partner in a primary fund may invest directly into portfolio companies alongside the primary fund. A fund of funds may also invest directly into portfolio companies alongside its underlying funds. These are termed “co-investments.” To take advantage of this particular investment, there are now specialized funds that focus on co-investments.

### **Investment Flows**

When investing in private equity through a closed-end primary fund or closed-end fund of funds, an investor makes an initial commitment of capital that is then “called” or drawn down as the investment manager of the primary fund or the investment managers of the underlying funds in a fund of funds find investment opportunities. Capital is returned to the investor via distributions on the sale or recapitalization of individual portfolio companies by the private equity funds, although in some cases investors may also receive earnings-derived distributions.

Private equity investment vehicles typically have a limited life (i.e., they are not open-ended) and are generally illiquid. The ultimate return of the private equity investment vehicle is not known until the fund or partnership is finally liquidated. Because of the unique characteristics of this asset class, additional performance reporting requirements are needed. The GIPS standards, which are based on the principles of fair representation and full disclosure, seek to provide prospective clients with the critical pieces of information needed to evaluate the firm’s performance.

### **Compliance**

Compliance with the GIPS standards can only be achieved on a firm-wide basis and requires adherence to not only the private equity provisions but to all provisions of the GIPS standards in Section 0-5 in Chapter 1, unless otherwise noted.

The GIPS standards are primarily designed for presenting a firm’s performance to a prospective client rather than reporting performance to an existing client. While that does not preclude using the GIPS standards when reporting performance to existing clients or for internal reporting purposes, there is no requirement to do so.

### **Valuations**

Accounting standards up through the 1990s were driven in part by an overriding principle of prudence, seeking to protect investors and creditors from overstatements of asset values and profits. Traditional valuation methodologies, such as the use of historic cost, were easy to justify, thus placing a burden of proof on those seeking to deviate from conservative valuations. However, there are a number of shortcomings in historic cost methods which led to pressure for change. Although the precise tipping point for change from a historic cost basis differed by jurisdiction, it became apparent over various market cycles that in some cases conservatism can operate against the interests of some stakeholders.

For example, the historic cost approach has an outward appearance of being conservative and thus in the best interest of stakeholders. However, the use of historic cost can become a defense against the proper write down of impaired investments. Conversely, the true value of a company's assets may be materially understated, leading to a potential undervalued takeover bid. Furthermore, as valuation methodologies in public markets became more sophisticated by incorporating cash flows, brand values, the value of intellectual property, and earnings growth, traditional balance sheet conservatism became a less compelling approach.

### **Fair Value**

It has been the position of the GIPS Executive Committee (and previously the Investment Performance Council) for some time that fair value was the most appropriate way to view private equity valuations. It was recommended that a fair value basis be used to value private equity investments in the 2005 edition of the GIPS standards. As fair value is progressively adopted as the preferred industry practice, and is mandated by various accounting standards, the GIPS standards require the use of fair value for all investments, including private equity investments, as of 1 January 2011.

### **Scope**

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**The following are provisions that apply to the calculation and presentation of PRIVATE EQUITY investments made by fixed life, fixed commitment PRIVATE EQUITY investment vehicles including PRIMARY FUNDS and FUNDS OF FUNDS. These provisions also apply to fixed life, fixed commitment SECONDARY FUNDS, which MUST apply either the provisions applicable to PRIMARY FUNDS or the provisions applicable to FUNDS OF FUNDS depending on which form the SECONDARY FUND uses to make investments. PRIVATE EQUITY OPEN-END and EVERGREEN FUNDS MUST follow Sections 0–5 in Chapter I. REAL ESTATE CLOSED-END FUNDS MUST follow Section 6 in Chapter I.**

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### **Investment Structures**

#### *Closed-End Fund Vehicles (GIPS private equity provisions are applicable)*

The predominant vehicle in the global private equity industry is the independent, private, fixed-life, closed-end fund. These vehicles may be organized in a variety of legal forms (e.g., limited partnership, trust, unit trust) depending on the jurisdiction. A firm may have several funds in existence at any one time, each of which is independent from the others. These funds by and large have a defined “start date” and most often have a fixed life (typically 10 years) that can be extended by a pre-set number of defined periods (e.g., two one-year periods) upon agreement of the investors. This is termed a closed-end fund because the number of investors/shares is fixed for the life of the fund and closed to new investors, although ownership interest may be transferred (sold) to another investor under certain circumstances. This also means that the capital available for investment (capital commitments) is also fixed for the life of the fund.

An example of a closed-end fund vehicle is the limited partnership. A limited partnership is the most common structure used in the U.S. and is a fund of pooled interests managed by a general partner (generally an affiliated entity of the firm) who raises capital (i.e., committed capital) from outside investors (limited partners). The general partner charges an investment management fee, typically from one to three percent per annum, on the total committed capital. Most funds require at least a nominal one percent investment by the general partner. In addition, the general partner will take a profit split (known as the carried interest or simply the “carry”) of usually 20 percent of profits.

The general partner will “call” the capital from the limited partners in tranches as needed for investment into underlying companies. These capital calls are also termed “draw downs” or “takedowns”. The cumulative capital calls are known as paid-in capital. Another unique feature of this type of vehicle is that any proceeds from investments must be distributed to the limited partners; reinvestment is only permitted if allowed in the contract (known as a limited partnership agreement (LPA) or partnership agreement) between the general partner and the limited partners. In recent years there has been an increasing number of cases where (by agreement) distributions may be recalled for subsequent investment. In addition, committed capital in these vehicles cannot be withdrawn (“redeemed”), as is the case in other pooled investment vehicles such as hedge funds. In a typical private equity limited partnership, the cash flows are easy to enumerate as return is calculated on the basis of the cash flows between the partners (general and limited) and the fund. The investment management fee is generally charged on the total assets committed to the fund by the limited partners rather than on the value of the invested capital of the fund.

### *Funds of Funds (GIPS private equity provisions are applicable)*

A fund of funds is a special type of fund vehicle which makes investments in primary private equity funds rather than in individual portfolio companies. The private equity fund of funds operates much like a primary fund vehicle except that the underlying investments are funds rather than companies. Recognizing that funds of funds do not necessarily control the underlying funds in which they invest, it is not necessary for each underlying fund in a fund of funds to be in compliance with the GIPS standards in order for the fund of funds firm to be compliant. A closed-end fund of funds that invests in open ended vehicles would be required to follow the private equity provisions. Funds of funds must meet all relevant private equity requirements at the fund of funds level. Unless otherwise noted, each private equity provision applies to fund of funds vehicles.

### *Direct Investments and Co-investments (GIPS private equity provisions are applicable)*

Although an investment by a primary fund into a portfolio company is technically a “direct investment” because the investment is made directly into the company, the term is generally applied to separate investments in companies by investors outside of a primary fund. For example, an investor who invests directly in a company is said to be making a direct investment, rather than investing through a fund. Co-investments are a special case of direct investments where an investor in a fund makes a direct investment in a portfolio company along with the fund. This is generally allowed in a pre-established co-investment agreement. In many cases the direct investment or co-investment will have a different fee structure than a comparable investment in a fund. It is not uncommon for these co-investments to be “no-fee, no-carry” transactions. If a composite includes any non-fee paying portfolios, the firm must present, as of each period end, the percentage of the composite that is represented by non-fee paying portfolios.

### *Side-by-Side Vehicles (GIPS private equity provisions are applicable)*

There are instances in which parallel vehicles are created that invest alongside a primary fund for reasons such as individual client accommodation, jurisdictional or tax considerations, or other reasons. The vehicle itself usually invests on an equal basis with its affiliated primary fund. Best practice is for firms to disclose if there is a side-by-side vehicle associated with a fund. While the terms and conditions for the side-by-side vehicle may be significantly different from those of the primary fund, if the side-by-side vehicle has a similar strategy and the same vintage year as the primary fund, the side-by-side vehicle must be included in the same composite as the primary fund. In the case that a side-by-side vehicle is materially different in strategy, fee structure, or other characteristic from the primary fund, then the side-by-side vehicle should be included in a separate composite.

### *Evergreen funds (GIPS private equity provisions are not applicable)*

In contrast to the typical closed-end, fixed life limited partnership (described above) are those investment vehicles that are neither fixed-life nor fixed-commitment. They are often called open-end funds or evergreen funds. While they do not have the same structure as a limited partnership, they may make the same type of investments into venture capital, buyouts, distressed debt, and similar investments, and are usually also classified as private equity funds. However, the GIPS standards have excluded these from application of the private equity provisions even though they may make the same type of investments. The investment structure typically doesn't lend itself to the same type of treatment as the closed-end fixed-life fund.

To understand why the private equity provisions do not apply it should be understood that the basic metric and industry practice used in measuring performance in the private equity industry is the since-inception internal rate of return (SI-IRR). In the typical open-ended vehicle without a fixed amount of committed capital, an investment manager does not have control over the timing of the cash flows. While a SI-IRR can technically be calculated for such a cash flow stream, a time weighted return is more appropriate given the cash flow stream and the decision process being measured. For this reason, evergreen vehicles are not good candidates for using the SI-IRR but rather are best treated using a time weighted rate of return (TWRR) calculation. This implies that fair values of investment in such vehicles can be determined at the date of every large cash flow in order to calculate the TWRR in accordance with the GIPS standards. The GIPS standards require private equity investments to be valued in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II.

As a result, the private equity provisions exclude funds that have an evergreen structure and require that they comply with the provisions in Sections 0-5 in Chapter 1 of the GIPS standards. The exception is the special case of evergreen funds of funds where GIPS private equity provisions can be applied (see discussion below).

### *Captive and Semi-Captive Funds (GIPS private equity provisions are applicable if funds are closed-end)*

Some private equity vehicles are organized as captive vehicles or semi-captive vehicles. Captive refers to a fund that only invests for the interest of its owner organization (e.g., corporation, university, foundation). The salient feature is that the fund only invests its parent's capital - there are no outside investors. Corporate venture groups of technology companies are examples of this type of vehicle, although several insurance companies and investment banks also have similar vehicles. A captive or semi-captive vehicle that is closed-end would qualify for private equity provisions application.

A semi-captive vehicle is a vehicle that invests both parent entity capital as well as outside capital. These funds normally charge a management fee and carried interest to the outside investors and are usually closed-end, as the number of investors is fixed, although a number of evergreen semi-captive funds also exist. If a captive or semi-captive vehicle is a closed-end vehicle then the GIPS private equity provisions apply. If the vehicle is evergreen, the GIPS private equity provisions do not apply.

### *Open-End Funds (GIPS private equity provisions are not applicable)*

Another investment structure is an open-end investment vehicle that acts much like a publicly-quoted mutual fund. The fund is an investment vehicle that is traded on an exchange and priced daily. In addition there are open-ended vehicles that, although not traded on an exchange, may be "priced" monthly. In these open-end investment vehicles, where the investment manager does not have control of the timing of cash flows from its investors, the IRR calculation is not appropriate.

This type of open-end investment vehicle must adhere to the provisions in Section 0-5 in Chapter 1 of the GIPS standards, rather than the private equity provisions.

### *Special Case of Evergreen Funds of Funds (GIPS private equity provisions can be applied)*

The private equity provisions generally exclude evergreen open-ended vehicles. While not explicit in the provisions, there is one exception to the applicability of the private equity provisions. The private equity provisions of the 2010 edition of the GIPS standards provide funds of funds with the ability to define composites by vintage year of the funds of funds or by strategy. This flexibility accommodates a common type of structure used by funds of funds that have characteristics of an evergreen vehicle, but the terms and structure resemble a typical private equity investment. This particular vehicle has the following characteristics:

- It is an open-end fund of funds vehicle which is neither publicly traded nor available to the general public.
- It does not have a finite life and is in essence evergreen.
- It invests in private equity funds as is typical for a fund of funds as either a limited partner or investor. The fund of funds manager has full discretion regarding selection of the underlying funds. The underlying funds are managed by independent third-party managers/general partners. The fund of funds manager does not influence the investment decisions taken by those third-party managers. The fund of funds may also have other co-investments with the underlying funds.
- The fund of funds typically invests by strategy rather than by vintage year.
- The manager of the fund of funds charges a management fee to the investors.
- The timing and size of external cash-flows into/from the fund of funds are determined by the third-party managers managing the underlying funds as they call the capital to make use of the investment opportunities or make distributions.

A vehicle of this structure may, but is not required to, comply with the private equity provisions which apply to funds of funds. If an evergreen fund of funds vehicle meets the above criteria and chooses to apply the private equity provisions, it must also comply with all of the private equity requirements in Section 7 of Chapter I. Alternatively, these vehicles can apply the provisions in Sections 0-5 of Chapter I.

### **Determining the Non-GIPS-Compliant SI-IRR Performance Period for Private Equity Composites**

The private equity provisions require that private equity composites present the since inception internal rate of return (SI-IRR) of the composite through each annual period end in the compliant presentation. When coming into compliance, firms must initially present at least five years of performance (or for the period since the firm's inception or the composite inception date if the firm or the composite has been in existence less than five years) that meets the requirements of the GIPS standards. Each subsequent year, firms must present an additional year of performance. Furthermore, firms must not present a non-GIPS-compliant SI-IRR for periods ending on or after 1 January 2006. However, firms may present a non-GIPS-compliant SI-IRR for periods ending prior to 1 January 2006 provided that only GIPS-compliant performance is presented for periods ending on or after 1 January 2006. For any SI-IRR presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, firms must disclose the periods of non-compliance.

The period for a SI-IRR is from the inception date through the end of the period that is being reported. Unlike time-weighted rates of return, the beginning period for a SI-IRR remains constant and does not change. Therefore, it is necessary to use the period end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each subsequent annual period, starting with the period ending 31 December 2006. If the firm chooses to present the SI-IRR through periods ending prior to 1 January 2006, these performance periods must be disclosed as non-compliant.

### **Effective Date**

The effective date for this Guidance Statement is 1 January 2011. When bringing past performance into compliance, firms may comply with this version of the Guidance Statement or with the prior version in effect at the time. The prior version of this Guidance Statement is available on the GIPS standards website ([www.gipsstandards.org](http://www.gipsstandards.org)).

## **INPUT DATA – REQUIREMENTS**

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### **7.A.1 For periods ending on or after 1 January 2011, PRIVATE EQUITY investments MUST be valued in accordance with the definition of FAIR VALUE and the GIPS Valuation Principles in Chapter II.**

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**Discussion:** Performance reporting is of little value unless the underlying valuations are based on sound valuation principles. The GIPS Valuation Principles, including requirements and recommendations specific to private equity, establish a broad foundation for valuing investments. In order to create comparable valuations for consistent performance calculation and avoid incompatibility in return calculations before and after the effective date, for periods ending on or after 1 January 2011, private equity investments must be valued in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II. For periods ending prior to 1 January 2011, private equity investments must be valued according to either the GIPS Private Equity Valuation Principles in Appendix D of the 2005 edition of the GIPS standards or the GIPS Valuation Principles in Chapter II of the 2010 edition of the GIPS standards.

These broad principles can be supplemented with more detailed valuation guidelines such as the standardized methods used for valuing private equity investments presented in the International Private Equity and Venture Capital Valuation (IPEV) Guidelines.

#### *Fund Reporting and Valuation Considerations*

In some instances, the concept of fair value is misunderstood as being the same as “market value”. However, although related, they are not the same. At any point in time a private equity portfolio’s valuation may be different from market prices due to an inherent lag effect in the industry. In private equity reporting, there is typically a lag effect in valuation reporting because a private equity fund has to apply the firm’s valuation methodology to portfolio investments, accumulate its total portfolio valuations, and report this information to its investors. The reporting lag inherent in this process means that there can be a valuation lag of a quarter or, in some cases, even longer. Thus, a 31 March valuation may be what is termed a roll-forward valuation – i.e., a valuation based on 31 December of the prior year adjusted by interim cash flows between 1 January and 31 March. This has the added effect that valuations of private equity holdings may not be contemporaneous with marketable securities that can truly be “marked to market.”

If these roll-forward valuation estimates are used, firms must assess to what extent the estimated values or the final values should be used for GIPS compliance purposes and how it will fit within the composite-specific valuation policies and procedures. Two possible scenarios include, but are not limited to:

- a. The firm does not publish compliant presentations until the final valuations have been received and used in the creation of the compliant presentation. As a result, the compliant presentations may only become available to prospective clients with a significant time lag.
- b. The firm uses estimated values to determine fair value and produce the compliant presentation on a timely basis. If using estimated values provided by third parties, the firm should obtain an understanding of the process of determining estimated values and determine whether reliance can be placed on this process. After the final values have been determined, the firm must assess the differences between the estimated and final values and the impact on composite assets, total firm assets, and performance. If the final values and resulting performance are materially different, firms must determine whether the compliant presentation for that composite must be adjusted on a prospective basis and whether any additional disclosure of this adjustment may be required. Firms must also consider if the compliant presentation should be revised retroactively according to the composite-specific valuation policies and procedures. If composite valuations are revised retroactively, firms must consider the Guidance Statement on Error Correction and the firm's error correction policies.

It is important to remember the underlying principles of the GIPS standards: fair representation and full disclosure. If using estimated values to determine fair value, firms should consider disclosing this fact in compliant presentations to provide enough information for a prospective client to interpret the performance record. The GIPS standards state that firms must not present performance or performance-related information that is false or misleading.

### *Portfolio Company Reporting Considerations*

Given the subjective methods used in private equity valuation, it should be noted that two funds invested in the same company may agree on a valuation on the date of initial or subsequent investment but at other times it may be possible, and is likely, that valuations may diverge as there is no market price and each firm invested in the portfolio company can use their own valuation methodologies to value those investments.

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### **7.A.2 PRIVATE EQUITY investments MUST be valued at least annually.**

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**Discussion:** In Sections 0-5 in Chapter 1 of the GIPS standards, portfolios are required to be valued monthly for periods beginning on or after 1 January 2001, and portfolios must be valued at the time of all large cash flows for periods beginning on or after 1 January 2010. In a calculation where time-weighted returns are used, valuations at key cash flow events and at period end are needed as those valuations become terminal values in the time-weighted return. In a true time-weighted return calculation, sub-period returns are calculated between each valuation and geometrically linked together to derive a return for the period.

The GIPS standards require a SI-IRR rather than a TWRR for private equity portfolios. In a SI-IRR, valuations are only needed at the end of the period being measured. Valuations in private equity investments are generally performed on a less frequent basis as they are not liquid securities. More often than not, valuations are reported on a quarterly basis rather than monthly or

daily. The GIPS standards require private equity investments to be valued at least annually in accordance with the definition of fair value and the GIPS Valuation Principles in Chapter II. Quarterly valuations are recommended. In addition, firms must value portfolios as of the calendar year-end or the last business day of the year for periods ending on or after 1 January 2006.

The practical implication of this is that private equity portfolios typically have quarterly valuations but must be valued at least once in a 12 month period. Most private equity firms have annual audits for their funds, meaning that this year end valuation will most likely be the valuation used for compliance with the GIPS standards. More frequent valuations are generally required for client reporting purposes and are considered good business practice thus the GIPS standards recommend quarterly valuation for private equity.

## CALCULATION METHODOLOGY – REQUIREMENTS

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### 7.A.3 FIRMS MUST calculate annualized SINCE INCEPTION INTERNAL RATES OF RETURN (SI-IRR).

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**Discussion:** An investment manager should neither be rewarded nor penalized for investment decisions outside of his or her control. In an open-end fund, the timing of cash flows in and out of the fund is usually not at the discretion of the investment manager. As a result, the time-weighted rate of return, which adjusts for the effect of the timing of the cash flows in the portfolio, is required for open-end funds.

On the other hand, in an independent, fixed-life private equity fund, the decisions to raise money, take money in the form of capital calls, and distribute proceeds are all at the discretion of the private equity manager. The timing of cash flows is part of the investment decision process. The private equity manager should be rewarded or penalized for the results of those timing decisions and thus the IRR is required.

In general, the IRR is the rate of return that equates the present value of a series of inflows cash flows with the present value of a series of outflows. The SI-IRR is a specific version of the IRR where the measurement period covers the entire investment period since inception.

The annualized IRR is calculated as follows:

$$V_E = \left[ V_B \times (1 + r_{IRR})^{\frac{TD}{365}} \right] + \sum_{i=1}^I \left[ CF_i \times (1 + r_{IRR})^{\frac{t_i}{365}} \right],$$

where

$V_B$  = value of the investment at the beginning of the measurement period

$V_E$  = value of the investment at the end of the measurement period

$CF_i$  = cash flow  $i$  (positive values for inflows and negative values for outflows)

$i$  = number of cash flows (1, 2... $I$ ) during the measurement period

$r_{IRR}$  = annualized internal rate of return

$t_i$  = number of calendar days from the day when the cash flow  $i$  occurred to the end of the measurement period

$TD$  = total number of calendar days within the measurement period

Firms must calculate and present the annualized since inception internal rates of return. If the period is less than a full year, firms must present the non-annualized SI-IRR. The non-annualized SI-IRR is calculated as follows:

$$R_{IRR} = \left[ (1 + r_{IRR})^{\frac{TD}{365}} \right] - 1,$$

where

$R_{IRR}$  = non-annualized internal rate of return

$r_{IRR}$  = annualized internal rate of return

$TD$  = total number of calendar days within the measurement period

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**7.A.4 For periods ending on or after 1 January 2011, the SI-IRR MUST be calculated using daily cash flows. Stock DISTRIBUTIONS MUST be included as cash flows and MUST be valued at the time of DISTRIBUTION.**

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**Discussion:** Calculating performance using daily cash flows provides the most accuracy in all performance calculations, including the SI-IRR. For private equity investments, the GIPS standards require daily cash flows for periods after 1 January 2011 and recommend daily cash flows for periods prior to 1 January 2011. For periods prior to 1 January 2011, the SI-IRR must be calculated using either daily or monthly cash flows.

The date of the incoming cash flow (paid-in capital) is intended to reflect the date the investment manager obtains control of the capital from the investor, which is not necessarily the date the capital is invested in underlying companies (in the case of a primary fund) or funds (in the case of a fund of funds). For practical purposes this should be the date of the capital call, as there may be a day or so lag in between the date of the capital call and the date the investor actually delivers the capital. Similarly, the date of the distribution is the date the distribution is returned to the investor which is not necessarily the date the fund manager receives the proceeds from the underlying investment, as there may be a lag between the date of the distribution notice to investors and the date the investor actually receives the proceeds.

There has been confusion as to what daily cash flows mean and how to reconcile daily cash flows with historical results based on cash flows with a different frequency. Using daily cash flows means that the cash flows are dated on the date the cash flows occur, for example, the date of the capital call or the date of the distribution. Due to the administrative burden, historically cash flows were accounted for on a less frequent basis. For some funds in the 1980's, cash flow data was aggregated on a quarterly basis or even, in some cases, on an annual basis. The same is still true in some emerging markets today. Since cash flows were usually reported on a quarterly basis (or, in some cases on an annual basis), there was little reason to calculate returns with cash flows on a more frequent basis, even if available.

There were practical reasons for this aside from the administrative burden. Before the advent of the modern financial calculator, it was very difficult to calculate a SI-IRR. There were approximations and formulas for calculating both the TWRR and the IRR, such as Dietz and the Modified Dietz methods. Some methods attempted to approximate daily cash flows. However, these methods were still not as accurate as a daily cash flows stream incorporating the actual dates of the cash flows.

Even with the introduction of spreadsheets, the ability to create a spreadsheet that used daily cash flows meant creating extremely large and cumbersome spreadsheets as these tools typically needed an entry for every date from beginning to end even if the date didn't have a cash flow.

Software products addressed this issue and certain spreadsheets and performance systems only require dates on which cash flows actually occurred. However, monthly cash flow streams are still often used. In some cases, whole businesses have been created in order to consolidate cash flows into monthly streams in order to accommodate legacy performance measurement systems. Daily cash flow conventions are now the norm and are not difficult to produce with systems now available.

The principal issue is dealing with legacy cash flows streams that might be dated monthly for periods prior to 1 January 2011. While it may not be as accurate as requiring reconstruction of a daily cash flow stream historically, the administrative burden and cost of reconstruction would be difficult to reconcile given the benefit gained. Thus, a cash flow dated with a month-end convention can be part of a full cash flow stream that uses daily cash flows and still be compliant as long as the same compounding period is used. While the resultant SI-IRR is not as precise as retroactively reconstructing the daily cash flows, the difficulty of daily cash flow reconstruction means that combining the monthly and daily cash flow streams is a reasonable accommodation. If monthly cash flows are used with daily cash flows in the same cash flow stream, the IRR formula must use a daily compounding convention for the entire cash flow stream, even if there are also monthly cash flows in the same cash flow stream. Thus, a firm that dates cash flows at month end prior to 1 January 2011 and then uses daily cash flows after 1 January 2011 would compound the entire stream daily to be in compliance with the GIPS standards.

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### **7.A.5 All returns MUST be calculated after the deduction of actual TRANSACTION EXPENSES incurred during the period.**

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**Discussion:** Firms are required to deduct actual transaction expenses when calculating both gross-of-fees and net-of-fees returns. Transaction expenses include all legal, financial, advisory, and investment banking fees related to buying, selling, restructuring, and/or recapitalizing portfolio investments as well as trading expenses, if any.

Transaction expenses that are allowable as a capitalized cost can vary depending on local accounting standards. As a result, good practice should include disclosure of the treatment of organizational or other costs to derive the returns being reported.

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### **7.A.6 NET-OF-FEES returns MUST be net of actual INVESTMENT MANAGEMENT FEES (including CARRIED INTEREST).**

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**Discussion:** For both primary funds and funds of funds, private equity investment management fees include two components: a commitment-based or fixed asset management fee that is paid on an ongoing basis, and a performance-based fee, known as carried interest, that is accrued and paid as typically agreed in the limited partnership agreement. Collectively these fees are referred to as investment management fees. Firms are required to deduct these actual investment management fees when calculating net-of-fees returns. Carried interest can often have a greater impact than the commitment-based or fixed asset management fees.

When calculating net-of-fees returns, the terminal value should be net of investment management fees (which include carried interest) that have been accrued but not yet paid. The intent is to provide an estimate of what the limited partner would receive if the portfolio were liquidated, unrealized gains and losses were realized, and the fund's assets were distributed at the date of the performance calculation.

When calculating both gross-of-fees and net-of-fees returns, a firm may reflect the deduction of other expenses incurred at the primary fund or fund of funds level, such as administrative expenses, but it is not required to do so. In the case of an investment management firm that manages a fund of funds, the firm must calculate all returns that reflect the deduction of all of the underlying funds' investment management fees and other expenses. The firm must also deduct the fund of fund's investment management fees when calculating the net-of-fees return. The firm may also deduct other expenses from the fund of funds' net-of-fees return to arrive at what is generally referred to as a "net-net" return. Deducting this added layer of fees reflects the true return to the ultimate investor.

In constructing cash flows for calculating gross-of-fees performance, investment management fees must be recognized as cash flows dated at the actual date when such investment management fees are paid. This is in contrast to the occasional practice in which a firm simply adds back paid investment management fees to the residual value used in calculating performance rather than dating them at the actual cash flow date. This treatment does not allow for a proper gross-of-fees SI-IRR calculation.

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### **7.A.7 For FUNDS OF FUNDS, all returns MUST be net of all underlying partnership and/or fund fees and expenses, including CARRIED INTEREST.**

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**Discussion:** For funds of funds, all returns must be calculated after the deduction of actual transaction expenses incurred during the period. In addition, all expenses related to investments in underlying funds, whether or not reflected in the valuations of the underlying funds, must reduce both the gross-of-fees and net-of-fees SI-IRR. Note that this requirement also applies to the carried interest and investment management fees of the underlying funds. Such expenses might include management fees billed in addition to or outside of the limited partners' capital commitment, or limited partner clawback expenses (e.g., portfolio company litigation) charged directly to the fund of funds. It is typically not possible to allocate the fund of funds level fees to the underlying portfolio investments individually as those fees are a joint cost and it would be arbitrary to allocate them down to the individual portfolio investments.

In addition to investment management fees and transaction expenses, fund of funds expenses used in calculating "net-net" returns to investors may include, but are not limited to: legal, auditing, consulting, accounting, and custodian fees and expenses; out-of-pocket expenses incurred in connection with transactions not consummated; expenses of the advisory board and annual meetings; premiums for insurance obtained by the fund of funds to protect it; taxes, fees, or other governmental charges levied against the fund of funds; organizational expenses up to a specified limit; expenses incurred in connection with the distribution of marketable securities; advertising and public notice costs; and costs of dissolving and liquidating the partnership.

### **COMPOSITE CONSTRUCTION – REQUIREMENTS**

The GIPS standards are structured around the concept of composites. A composite is an aggregation of one or more portfolios managed according to a similar investment mandate, objective or strategy. In addition, primary funds must be grouped by vintage year such that funds with different vintage years are in different composites.

Firms must remember that the GIPS standards have requirements and recommendations regarding composite construction, which can be found in Section 3 in Chapter 1 of the GIPS standards as well as the *Guidance Statement on Composite Definition*. Most importantly, firms are required to include *all* fee-paying discretionary portfolios, including funds and partnerships, in at least one

composite that is managed according to a particular investment mandate, objective, or strategy. Creating meaningful composites is critical to the fair presentation, consistency, and comparability of performance results over time and among firms. Firms must understand that the GIPS standards require a firm-wide level of compliance and not for just selected composites or funds.

Firms should realize that all provisions and guidance related to composites apply to funds and partnerships if the fund or partnership is a single portfolio composite. For example, when the GIPS standards state that the annualized SI-IRR (since inception internal rate of return) must be presented for the composite, because each composite will typically contain only one fund or partnership, this will be the same as the annualized SI-IRR for the fund or partnership.

The following hierarchy may be helpful as firms consider how to define private equity composites:

*Vintage Year*

*Strategy* (e.g., venture, buyout, generalist, mezzanine, fund-of-funds, other private equity)

*Sub-strategy* (e.g., size of fund, stage, geography)

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### **7.A.8 COMPOSITE DEFINITIONS MUST remain consistent throughout the life of the COMPOSITE.**

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**Discussion:** The GIPS standards require that vintage year and investment mandate, objective, or strategy remain consistent through the life of the composite. Thus, a fund cannot change from being classified as a generalist private equity composite to a venture focused composite even though it may have invested in more venture deals as the fund evolved. There are two methods of classifying funds by vintage year: the year of the investment vehicle's first drawdown or capital call from its investors or the year when the first committed capital from outside investors is closed and legally binding. The vintage year selected for the composite must be consistent through the life of the fund to avoid gaming. In most cases, a composite will contain only one fund/partnership. If a firm has multiple funds/partnerships (including side-by-side vehicles) with the same vintage year and strategy, they must be combined into a single composite. Side by side investment vehicles and co-investments in underlying portfolio companies must be included in the same composite as the related primary fund if the side by side investment vehicle or co-investment meets the primary fund's composite definition.

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### **7.A.9 PRIMARY FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR and investment mandate, objective, or strategy.**

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**Discussion:** The introduction outlined the features of the three most prevalent fund structures: the primary fund, the secondary fund and the fund of funds. To review, a primary fund invests directly in portfolio companies or other underlying private equity investments. A fund of funds invests in primary fund vehicles rather than making direct investments in portfolio companies. A secondary fund buys partnership interests from other investors and may be organized as a primary fund or as a fund of funds. The private equity provisions apply to all of the above structures as long as they are fixed-life, fixed-commitment vehicles or evergreen fund of funds structures. Composite construction may be impacted by the investment vehicles' structure so it's important to note which composite construction requirements apply. A primary fund's composite definition will be a combination of vintage year and investment mandate, objective, or strategy. A secondary fund's composite inclusion will depend on whether it has structured itself as a primary fund (7.A.9 applies) or as a fund of funds (7.A.9 does not apply).

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**7.A.10 FUNDS OF FUNDS MUST be included in at least one COMPOSITE defined by VINTAGE YEAR of the FUND OF FUNDS and/or investment mandate, objective, or strategy.**

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**Discussion:** A fund of funds is a vehicle that invests in private equity funds as a limited partner. These underlying fund investments are not typically in the same vintage year and do not necessarily share the same investment mandate, objective, or strategy. Thus, a fund of funds might include investments in a 1998 venture fund, a 2003 buyout fund, a 2004 buyout fund and a 2006 distressed fund. In addition, a fund of funds firm may have separately managed accounts that follow this same investment style but with different vintage years and strategies.

Requiring a firm to create fund of funds composites based on both vintage year AND investment mandate, objective, or strategy requirement was found to be impractical and not consistent with the information that prospective clients require for their fund of funds investments. Therefore, a firm may create fund of funds composites based on either vintage year of the fund of funds or investment mandate, objective, or strategy, or may choose to create a composite that considers both. In either case, all discretionary funds of funds must be included in at least one of the composites discussed above. For examples of how a fund of funds firm could present composite performance, refer to Appendix A: Sample Presentations in the GIPS standards.

Funds of Funds have to be careful in their use of the term “vintage year”. In a fund of funds context, the generic term “vintage year” can refer to the vintage year of the fund of funds itself or the vintage year of the underlying fund vehicles in which it invests. In addition, a firm may have separately managed accounts that have a “subscription year” which denotes the year an investor signed their investment agreement with the fund of funds. This is often also termed “vintage year”.

When the term “vintage year” is used to create a fund of funds composite, the term refers to the vintage year of the fund of funds vehicle itself. It does not refer to the vintage year of the underlying fund investments. However, provision 7.A.22 does require that if a fund of funds composite is defined by strategy only, the firm must also provide performance of the underlying fund investments aggregated by the vintage year of the underlying investments. It is only in this context that the underlying fund investments’ vintage year is considered.

**DISCLOSURES – REQUIREMENTS**

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**7.A.11 FIRMS MUST disclose the VINTAGE YEAR of the COMPOSITE and how the VINTAGE YEAR is defined.**

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**Discussion:** The disclosure of the vintage year increases transparency and comparability by allowing prospective clients to understand the time frame when the fund was initiated or locked up.

The concept of the vintage year is to set a starting date so that funds started in the same year can be equitably compared on an equal basis. While there may be several ways that start date could be determined, for compliance with the GIPS standards the relevant start date is the vintage year of the fund. In practice, the private equity industry determines vintage years in two ways - the date of first close and the date of first capital call. First close is the date when the firm has signed subscription agreements with investors and has the right to call capital from an investor. First capital call is the date when the firm actually has received investors’ capital. The GIPS standards require vintage year to be determined based on either first close or first call.

Historically, the vintage year was determined by the date of the first close of a fund. This date typically also coincided with the fund's first capital call for investments. As the industry evolved, there were more and more cases where the first close did not coincide with actual capital calls but instead were "dry closes" where the fund closed its first commitments but drew no capital because it had no investments to make. Thus another method evolved in which vintage year was defined by the date of the first capital call, whether for investment or management fees, rather than the first close.

These two methods are both legitimate methods of defining vintage year. The GIPS standards require disclosure of the vintage year and how the vintage year is defined for the composite. The vintage year chosen must be the same for the entire life of the composite.

It is important to note that the calculation of the SI-IRR relies on the first cash flow. The definition of vintage year does not impact the SI-IRR calculation but it will have an impact on the benchmark that is chosen. The benchmark chosen to compare performance of the composite must reflect the same vintage year used for the composite.

*Sample Disclosure:* The vintage year of the Venture Capital Composite is 2001 and was determined by the year of the first drawdown of capital.

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### **7.A.12 FIRMS MUST disclose the FINAL LIQUIDATION DATE for liquidated COMPOSITES.**

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**Discussion:** While most private equity funds generally have a ten year life, it is common to have multiple extensions whereby some funds may have lives as long as 17 or 18 years. The residual value of the investments may be de minimis at that final liquidation date, but the longer the life, the lower the fund's SI-IRR will be, all other things being equal. At some point the fund is finally liquidated either by disposing of the remaining investments or writing off any remaining investments. It is important to know the final liquidation date in order to evaluate how the extensions have affected the performance calculations.

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### **7.A.13 FIRMS MUST disclose the valuation methodologies used to value PRIVATE EQUITY investments for the most recent period.**

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**Discussion:** Given the subjective nature of the judgments that are required in valuing private equity investments, it is important that the latest valuation methodologies used be disclosed. Portfolios must be valued in accordance with the definition of fair value and the GIPS Valuation Principles as of 1 January 2011. Any key assumptions and subjective judgments made should be disclosed.

*Sample Disclosure:* Accounting convention is U.S. GAAP. Partnership fund investments are carried at fair value as determined by the General Partner at its discretion. The Partnership's fund investments are generally carried at the valuations provided by the general partners or managers of such investments. The valuations provided by the general partners or managers of the underlying funds reflect the fair value of the Partnership's capital account balance of each fund investment, including unrealized gains and losses, and reflect the values as reported in the audited financial statements of the respective fund at the fund's fiscal year end. The valuations used were based upon the fund managers' valuations as at [date] or at the latest available date. In reviewing these underlying valuations, the General Partner is advised by the Investment Advisor, who reviews the capital account balances and may adjust the value of each fund investment. The General Partner uses the market approach to estimate the fair value of private equity investments. The market approach utilizes prices and other relevant information generated by market

transactions including the type of security, size of the position, degree of liquidity, restrictions on the disposition, data from the latest round of financing, and current financial position and operating results, among other factors. In circumstances where fair values are not provided in respect of any of the partnership's fund investments, the Investment Advisor will seek to determine the fair value of such investments based upon information provided by the general partners or managers of such funds or from other sources. Notwithstanding the above, the variety of valuation bases adopted and quality of management data of the ultimate underlying Investee companies means that there are inherent difficulties in determining the value of these investments. Amounts realised on the sale of these investments may differ from the values used to calculate returns and other fund measures used to prepare this composite presentation and the difference could be significant.

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**7.A.14 For periods ending on or after 1 January 2011, FIRMS MUST disclose material changes to valuation policies and/or methodologies.**

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**Discussion:** Consistent with the recognition that valuations are a significant input into the performance equation and that the valuation of private equity investments involves the use of subjective estimates, for periods ending on or after 1 January 2011, firms are required to disclose any changes in valuation policies or methodologies which might affect performance results or make historical comparability of performance results difficult. This includes any changes to international guidelines which have had an impact on valuation practices, or adoption of different accounting principles valuation policies or industry guidelines. Some examples of a material change include but are not limited to:

- new valuation principles adopted by a local accounting standards board,
- adoption of new international standards in lieu of local standards,
- change of economic criteria used to value investments, and/or
- change from discounted cash flows basis to a comparables basis.

*Sample Disclosure:* Effective [date] our valuation policy was changed from a discounted cash flow methodology to a market comparable basis. The reason for this change is that market comparables are more reflective of the value of the investments given the changes in the sectors we have invested in over the last few years. The new methodology is consistent with the definition of fair value and the GIPS Valuation Principles and the International Private Equity Valuation principles, policies and recommended methodologies.

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**7.A.15 If the FIRM adheres to any industry valuation guidelines in addition to the GIPS Valuation Principles, the FIRM MUST disclose which guidelines have been applied.**

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**Discussion:** Since the early 1990s, there have been several local, national and international valuations principles adopted which have specifically addressed private equity. Almost every major national industry association has developed their own valuations guidelines. Many of the valuation standards across the globe have been subsumed into the International Private Equity and Venture Capital (IPEV) Valuation Guidelines which have broad global representation. The U.S. industry's attempt to codify standards have been subsumed into FAS 157/ ASC Topic 820. It is not uncommon for the GIPS Valuation Principles to be supplemented by other local or international standards as other standards may be more stringent in their requirements.

The disclosure of which jurisdiction's valuation guidelines have been used in addition to the GIPS Valuation Principles will help readers to determine the comparability of compliant presentations from different firms and/or jurisdictions.

*Sample Disclosure:* The Global Diversified Distressed Composite adheres to the XYZ Venture Capital Association's valuation guidelines as well as the GIPS Valuation Principles. The XYZ valuation standards are based on fair value but provide more prescriptive advice in terms of how to value specific investments such as secondary investments and distressed debt investments.

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**7.A.16 FIRMS MUST disclose the calculation methodology used for the BENCHMARK. If FIRMS present the PUBLIC MARKET EQUIVALENT of a COMPOSITE as a BENCHMARK, FIRMS MUST disclose the index used to calculate the PUBLIC MARKET EQUIVALENT.**

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**Discussion:** The benchmark selected must be appropriate to comparing the performance of the composite. However, unlike those for publicly traded securities, industry benchmarks for private equity are not as widely available or are only available through certain commercial vendors. Firms may use public market indices as a benchmark, but the public market indices by themselves are not directly comparable to the SI-IRR as the market indices typically use a time-weighted return. The public market equivalent (PME) is a method where a public market index is used to create a comparable SI-IRR from a series of cash flows that replicate those of the composite and which can be compared to the SI-IRR of the private equity composite.

The GIPS standards require that the calculation methodology for the benchmark be disclosed. This provides transparency as to the comparability of the performance of the composite and the benchmark. The disclosure includes the calculation method itself (e.g., is the benchmark a net IRR, compounded on a particular basis, the method by which the vintage year is determined for the benchmark, as well as the metric or statistic being used for comparison.) For example, the metric for a benchmark could be an average, median, upper quartile, or other percentile. It is expected that the benchmark description includes the name or source of the benchmark as well as the metric being used. If a PME is used as a benchmark, the firm must disclose which public market index is used to create the PME.

*Sample Disclosure:* The benchmark is the 2008 vintage year (determined by the date of first capital call) pooled SI-IRR for U.S. venture capital funds, published by ACME advisory.

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**7.A.17 FIRMS MUST disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011.**

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**Discussion:** The SI-IRR calculation is sensitive to the relative timing of cash flows. In some cases, especially early in the life of a fund, using a quarterly cash flow dating convention (only allowed for periods prior to 1 January 2006) can have a much different outcome from using a monthly or daily convention due to the compounding effect of the SI-IRR. Accordingly, firms are required to disclose the frequency of cash flows used in the SI-IRR calculation if daily cash flows are not used for periods prior to 1 January 2011. Daily cash flows must be used for periods after 1 January 2011.

*Sample Disclosure:* The SI-IRR calculation incorporates monthly cash flows for periods prior to 31 December 2009 and daily cash flows thereafter.

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**7.A.18 For GROSS-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the TRANSACTION EXPENSES.**

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**Discussion:** In order to assist prospective clients better understand the gross-of-fees return calculation, firms must disclose if any other fees are deducted in addition to actual transaction expenses. For example, a closed-end fund's gross-of-fees return might reflect the deduction of

administrative expenses such as custodian and fund accounting fees. The same is true for a fund of funds. While fund of funds gross-of-fees returns must be reduced by all fees and expenses of the underlying funds, including carried interest, such returns could also reflect the deduction of other expenses at the fund of funds level. Firms are required to disclose if other fees have been deducted to derive the gross-of-fees return.

*Sample Disclosure:* Gross returns reflect the deduction of administrative expenses at the fund of funds level but do not reflect the deduction of ABC Fund of Funds Manager's investment management fees.

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**7.A.19 For NET-OF-FEES returns, FIRMS MUST disclose if any other fees are deducted in addition to the INVESTMENT MANAGEMENT FEES and TRANSACTION EXPENSES.**

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**Discussion:** When presenting private equity performance, firms are required to present both gross-of-fees and net-of-fees returns. Net-of-fees returns must be net of actual investment management fees and transaction expenses. Net returns may reflect the deduction of other expenses such as administrative expenses. Expenses in addition to the investment management fees and transaction expenses that are reflected in net returns must be disclosed.

*Sample Disclosure:* Net returns are net of transaction expenses, administrative expenses, management fees, and carried interest.

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**7.A.20 For any performance presented for periods ending prior to 1 January 2006 that does not comply with the GIPS standards, FIRMS MUST disclose the periods of non-compliance.**

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**Discussion:** Recognizing that firms may not be able to gather historical valuations and/or records for transactions of private equity investments for periods prior to 1 January 2006, a firm may present non-compliant performance, but must disclose the periods of non-compliance with the GIPS standards. Note that the SI-IRR and other private equity performance measures are "since-inception" measures. The period for a SI-IRR is from the inception date through the end of the period that is being reported. Unlike time-weighted rates of return, the beginning period for a SI-IRR remains constant and does not change. Therefore, it is necessary to use the period end date of the SI-IRR to determine the non-compliant time period. For example, if a firm claims compliance with the GIPS standards beginning 1 January 2006 and the private equity fund composite history begins 1 January 2003, the SI-IRR is required to be presented from 1 January 2003 (inception) through each annual period starting with the period ending 31 December 2006. In cases where a firm presents the SI-IRR through periods ending prior to 1 January 2006, any non-compliant performance periods must be disclosed.

*Sample Disclosure:* Fund IV was formed in 1996. During 1996 and 1997, cash flows were dated to the end of the quarter. Cash flows beginning January 1, 1997 are all dated as of the end of the month, while cash flows beginning January 1, 2003 are all dated as of the actual cash flow date. Therefore, performance for periods ended 31 December 1996 and 31 December 1997 is not compliant with the GIPS standards.

**PRESENTATIONS AND REPORTING - REQUIREMENTS**

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**7.A.21 The following items MUST be presented in each COMPLIANT PRESENTATION:**

- a. **FIRMS MUST present both the NET-OF-FEES and GROSS-OF-FEES SI-IRR of the COMPOSITE through each annual period end. FIRMS MUST initially present at least five years of performance (or for the period since the FIRM'S inception or the COMPOSITE INCEPTION DATE if the FIRM or the COMPOSITE has been in existence less than five years) that meets the REQUIREMENTS of the GIPS standards. Each subsequent year, FIRMS MUST present an additional year of performance. COMPOSITE returns MUST be clearly identified as GROSS-OF-FEES or NET-OF-FEES.**
- b. **For periods beginning on or after 1 January 2011, when the initial period is less than a full year, FIRMS MUST present the non-annualized NET-OF-FEES and GROSS-OF-FEES SI-IRR through the initial annual period end.**
- c. **For periods ending on or after 1 January 2011, FIRMS MUST present the NET-OF-FEES and GROSS-OF-FEES SI-IRR through the COMPOSITE FINAL LIQUIDATION DATE.**

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**Discussion:**

- a. The five year reporting requirement is most relevant for asset classes reporting performance on a periodic time-weighted basis. For example, a non-private equity investment firm that is first coming into compliance with the GIPS standards and has a ten year track record can report performance on the last five years of their track record. These results will be independent of any performance preceding those five years. In the case of private equity returns that are based on since inception basis, the current performance is dependent on all transactions historically. If a fund has been in existence less than five years, it must present performance through each annual period end from inception.

Most investors will want to see the entire track record of annual SI-IRR's in order to gauge the effect of the "j-curve" in the early years of the fund's life. The "j-curve" is the plot of the cumulative since-inception net cash flows or since inception returns of a fund. It is typical that early returns or net cash flows will be negative in the early years and will then likely turn positive. The early negative results are the result of the fact that in some funds, like venture funds, it will take time before distributions outpace paid-in capital. In addition, in the early cash flows, the cash flows called for management fees may be larger than the cash flows made for investment. As a result, it is recognized that the early years of a fund are not indicative of long-term performance. This is especially true for venture capital funds as the early capital calls for management fees and length of time for investment development and growth means that early returns will usually be highly negative until the fund recovers from the j-curve. However, the j-curve effect should be minimized in the gross-of-fees return as management fees are not deducted in the gross-of-fees calculation.

- b. Firms are required to present any partial year performance for the initial reporting period, on a non-annualized basis, for composites that begin on or after 1 January 2011. For example, a fund that began on 30 November 2011 and has a one month initial return through 31 December 2011 of 3% would be required to present that 3% as the partial year's performance. The annualized return of 42.6% must not be presented. Many spreadsheet and software applications automatically annualize all returns and firms are reminded that for periods of less than a year, the firm must "de-annualize" any annualized returns that are calculated.

The method chosen to de-annualize is at the discretion of the firm. For example, the firm may de-annualize the return from the bottom up by compounding daily cash flows for the investment period or by taking the implied annual return and calculating the equivalent return for the investment period. In the situation above, the 42.6% implied annualized return could be de-annualized by formula  $((1+.426)^{(1/12))-1)*100$  or as  $((1+.426)^{(31/365))-1)*100$  both resulting in a de-annualized one month return of 3%.

- c. Funds typically have an initial ten year life that can be extended through either prior or current agreement for a stipulated number of years. Many times, a fund may have one or two portfolio companies that have not been liquidated and continue to be held in the fund. On a since inception basis, the returns do not vary much during those extension periods unless the remaining investments have some major events that cause significant revaluation. In the end, the investments are liquidated by some means and the fund eventually is also liquidated. A firm must report performance through that final liquidation date in order to capture the residual value, either good or bad, in the last stages of the fund's existence.

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**7.A.22 For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy, FIRMS MUST also present the SI-IRR of the underlying investments aggregated by VINTAGE YEAR as well as other measures as REQUIRED in 7.A.23. These measures MUST be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES and MUST be presented as of the most recent annual period end.**

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**Discussion:** Each fund of funds manager determines the strategies to invest in and the vintage years over which to invest. These distinguishing characteristics are routinely described in detail in the limited partnership agreement. Fund of funds firms differentiate themselves from each other by offering narrow or broad strategies, offering regional or global geographical focuses, investing in primary or secondary markets, and the usage of direct investments or co-investments. These investment mandates are generally employed over 2-5 consecutive vintage years although this can vary widely.

One of the significant changes in the 2010 edition of the GIPS standards is in how fund of funds composites can be defined. In the 2005 edition of the GIPS standards, all private equity funds, including funds of funds, were required to be included in composites that were defined by vintage year AND investment mandate, objective, or strategy. Given how funds of funds structure their investment portfolios, this often led to a tremendous number of composites, many of which were irrelevant to prospective clients. The 2010 edition of the GIPS standards allows fund of funds firms to create composites that are defined by vintage year and/or investment mandate, objective, or strategy. Following the 2005 edition of the GIPS standards, a fund of funds firm with five funds, each of which had the same strategy but different vintage year, would create five composites. Following the 2010 edition of the GIPS standards, the same firm could choose to define composites either by vintage year (five composites) or investment mandate, objective, or strategy (one composite).

If the firm chooses to create a fund of funds composite defined only by investment mandate, objective, or strategy, the firm is required to present the SI-IRR of the underlying investments that have been aggregated by vintage year as of the most recent annual period end. The firm must also present, as of the most recent annual period end, all of the metrics required by provision 7.A.23 by vintage year as well. See Appendix A of the GIPS standards for examples.

Presenting the underlying investments by vintage years has the added benefit of increased comparability with benchmarks. Because of the numerous variations and structures of funds of funds, fund of funds composites may have underlying investments that span a number of vintage years. Since the number of vintage years of the underlying investments varies significantly, fund of funds composites are not usually comparable with vintage year benchmarks or with other funds of funds. By stratifying the fund of funds composites by the vintage year of the underlying investments, additional analysis of the composite can be performed. This allows for analysis by vintage year of all investments made by the fund of funds by comparing them directly to an appropriate vintage year benchmark.

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**7.A.23 FIRMS MUST present as of each annual period end:**

- a. COMPOSITE SINCE INCEPTION PAID-IN CAPITAL;**
  - b. COMPOSITE SINCE INCEPTION DISTRIBUTIONS;**
  - c. COMPOSITE cumulative COMMITTED CAPITAL;**
  - d. TOTAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (INVESTMENT MULTIPLE or TVPI);**
  - e. SINCE INCEPTION DISTRIBUTIONS to SINCE INCEPTION PAID-IN CAPITAL (REALIZATION MULTIPLE or DPI);**
  - f. SINCE INCEPTION PAID-IN CAPITAL to cumulative COMMITTED CAPITAL (PIC MULTIPLE); and**
  - g. RESIDUAL VALUE to SINCE INCEPTION PAID-IN CAPITAL (UNREALIZED MULTIPLE or RVPI).**
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**Discussion:** While the since inception IRR is the basic metric used to report performance for private equity investments, it is not the only useful metric used to gauge performance. Other measures are also useful to provide additional insight. The IRR by its nature is sensitive to early cash flow events and the IRR calculation assumes that the residual value of a composite is totally liquid whereas, in reality, the residual value is the unrealized (and often illiquid) portion of the composite. As a result, other metrics have been developed that allow a prospective client to examine aspects of performance other than simply a rate of return.

The SI-IRR uses four components – three cash flow components and one non-cash flow component. The three cash flow items are: 1) since inception paid-in capital; 2) since inception distributions; and 3) expenses that have been paid. The paid-in capital consists of all capital inflows to an investment vehicle from the limited partners while the distributions include all cash and stock distributed to limited partners. Expenses paid by the fund are also cash flows. The one non-cash flow item in the SI-IRR calculation is the residual value. The residual value is the value of remaining equity that the general partner and limited partners have in an investment vehicle at the end of the reporting period. This is often referred to as the net asset value. In addition to these components, a second non-cash component, cumulative committed capital, is also required for certain other performance metrics. The committed capital represents the total pledges of capital to an investment vehicle by the limited partners. These five components can be used to calculate the performance metrics, as well as the since inception IRR which assumes that the residual value is treated as the terminal cash flow.

Unlike the SI-IRR, the following are simple multiples that do not incorporate the time-value of money into their calculation:

- the realization multiple (since inception distributions to paid-in capital or DPI) whose purpose is to attribute how much of the total return has actually been returned to investors and is calculated as:

$$\text{DPI} = (\text{cumulative distributions since inception}) / (\text{cumulative paid-in capital since inception})$$

- the unrealized multiple (residual value to paid-in capital or RVPI) whose purpose is to attribute how much of the total return is comprised of investments yet realized and is calculated as:

$$\text{RVPI} = (\text{residual value at period end}) / (\text{cumulative paid-in capital from inception to date of residual value in numerator})$$

- the investment multiple (total value to since inception paid-in capital or TVPI) is calculated as:

$$\text{TVPI} = \text{DPI} + \text{RVPI} \text{ or } (\text{cumulative distributions} + \text{period ending residual value}) / \text{Cumulative paid-in capital}$$

- the PIC multiple (since inception paid-in capital to cumulative committed capital) whose purpose is to determine how much committed capital is left to be called is calculated as:

$$\text{PIC} = (\text{cumulative paid-in capital}) / (\text{Total committed capital})$$

#### *Recycling/Reinvestment and recallable cash flows*

Private equity vehicles are usually characterized by the prohibition (unless stipulated by agreement) to reinvest proceeds or allow redemptions. This means that unless otherwise agreed to, private equity funds must distribute proceeds from investments to limited partners and cannot reinvest that capital. In some cases, distributions are “recallable”, that is, after the fund distributes proceeds to its investors, it can draw down the same capital again, which makes it possible for the fund to draw capital in excess of its total committed capital.

Distributions include both recallable and non-recallable distributions. This means that a recallable distribution must be treated as an actual distribution and, if and when that distribution is called again, it must be treated as additional paid-in capital but must not reduce unfunded commitments or change cumulative committed capital.

It should be noted that recallable distributions have an impact on the metric calculations. For example, this recallable feature means that cumulative paid-in capital can be higher than cumulative committed capital. It also means that, all other things being equal, the DPI, RVPI, and TVPI multiples will be lower for funds with recallable distributions as the denominator will be increased. It also means that the PIC multiple (paid-in capital to cumulative committed capital) will be higher for funds with recallable distributions, all other things being equal.

While there is neither a requirement nor recommendation to disclose the fact that certain distributions are recallable, it would be prudent practice to disclose the fact if there is material distortion to the PIC or DPI multiples.

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#### **7.A.24 FIRMS MUST present the SI-IRR for the BENCHMARK through each annual period end. The BENCHMARK MUST:**

- a. **Reflect the investment mandate, objective, or strategy of the COMPOSITE;**
  - b. **Be presented for the same time periods as presented for the COMPOSITE; and**
  - c. **Be the same VINTAGE YEAR as the COMPOSITE.**
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**Discussion:** Firms are required to present the annualized SI-IRR of a benchmark that reflects the same investment mandate, objective, or strategy of the composite that corresponds to the same time periods as presented for the composite, and has the same vintage year as the composite. Firms must disclose the calculation methodology of the benchmark and, if a custom benchmark or multiple benchmarks is used, how that benchmark is constructed, including the benchmark components, weights, and rebalancing process. If the firm determines no appropriate benchmark for the composite exists, the firm must disclose why no benchmark is presented.

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**7.A.25 For FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by investment mandate, objective, or strategy and a BENCHMARK is presented for the underlying investments, the BENCHMARK MUST be the same VINTAGE YEAR and investment mandate, objective, or strategy as the underlying investments.**

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**Discussion:** A variety of appropriate benchmarks can be used for direct comparison or opportunity cost comparison. A fund of funds is composed of underlying funds of various vintage years. If a firm chooses to present a benchmark for the underlying investments, an appropriate benchmark is one that mirrors the exact vintage year of the underlying funds for direct comparison. If the benchmark is presented for the underlying investments that span a number of vintage years, a corresponding benchmark including multiple vintage years should be used. For example, for a fund of funds composite with underlying buyout funds with 2004, 2006 and 2008 vintage years, the benchmark should be composed of buyout funds with 2004, 2006 and 2008 vintage years as this is the direct peer comparison to those who invested in the same years.

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**7.A.26 For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.**

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**Discussion:** Direct investments (or co-investments) by a fund of funds may augment the strategy used in the investment in underlying fund vehicles. Direct investments may have different terms and conditions that might change the return characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the returns of the fund of funds composite. If no assets are invested in direct investments, no disclosure is required.

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**7.A.27 For periods ending on or after 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS MUST present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.**

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**Discussion:** Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending on or after 1 January 2011, firms must disclose, for primary fund composites, the

percentage of the composite that is invested in other funds as of each annual period end, if any. If no assets are invested in other funds, no disclosure is required.

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**7.A.28 FIRMS MUST NOT present non-GIPS-compliant performance for periods ending on or after 1 January 2006. For periods ending prior to 1 January 2006, FIRMS may present non-GIPS-compliant performance.**

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**Discussion:** As discussed in 7.A.20, there may be legitimate reasons for which reported performance may not be compliant prior to 1 January 2006. Given the fact that performance for private equity is always reported on a since inception basis, the past is always incorporated into the IRR as contrasted with a TWRR which does not incorporate since-inception results. It could be argued that the since-inception basis of private equity reporting would mean that any period of historical non-compliance could legitimately mean the current period would also be non-compliant because the current calculation may depend on inputs that were not in compliance with the GIPS standards. However, this is not the case—a firm may present prior non-compliant performance while claiming compliance even if the prior non-compliant period’s inputs are used in current period reporting. The early use of quarterly cash flows or the inability to value portfolios in accordance with private equity valuation standards for investments prior to 1 January 2006 does not invalidate current compliance with the GIPS standards.

**PRIVATE EQUITY – RECOMMENDATIONS**

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**7.B.1 PRIVATE EQUITY investments SHOULD be valued at least quarterly.**

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**Discussion:** There was a time when private equity valuations were only available annually but the industry has evolved to the point where quarterly valuation reporting is a standard industry practice. The use of quarterly valuations is recommended as it provides prospective clients with earlier notification of any significant movements and allows more effective tracking and comparative analysis of investments.

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**7.B.2 For periods ending prior to 1 January 2011, the SI-IRR SHOULD be calculated using daily cash flows.**

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**Discussion:** Daily cash flows improve the accuracy of the return calculations, including the SI-IRR required by the GIPS standards for private equity investments. Firms should therefore use daily cash flows for periods prior to 1 January 2011, and are required to use daily cash flows for periods after 1 January 2011.

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**7.B.3 FIRMS SHOULD explain and disclose material differences between the valuations used in performance reporting and the valuations used in financial reporting as of each annual period end.**

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**Discussion:** Valuations used for financial and performance reporting purposes should be consistent. This helps to ensure that performance reported to current investors is no different from that presented to prospective clients. However, in some cases, valuations are retrospectively updated (for instance, as a result of a financial statement audit). This could lead to different valuations being used in performance reporting compared to those used in financial reporting. If these differences are material, they should be disclosed.

*Sample Disclosure:* “There was a material change in the value of the fund XX caused by a significant write-down of an investment in the portfolio in the fourth quarter of 2012. Due to a time lag in reporting, this valuation is not reflected in the 2012 year-end financial report but was

recognized in the 2013 report. However, our compliant presentations reflect this decrease in valuation as of 31 December 2012. In the opinion of the GP, this represents a material difference between the valuations used in financial reporting versus performance reporting.”

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**7.B.4 For periods prior to 1 January 2011, FIRMS SHOULD disclose material changes to valuation policies and/or methodologies.**

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**Discussion:** A firm must disclose material changes to valuation policies and/or methodologies used to value private equity investments for periods ending on or after 1 January 2011. Firms are recommended to disclose material changes to valuation policies and/or methodologies for periods ending prior to 1 January 2011.

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**7.B.5 For periods ending on or after 1 January 2011, for FUND OF FUNDS COMPOSITES, if the COMPOSITE is defined only by VINTAGE YEAR of the FUND OF FUNDS, FIRMS SHOULD also present the SI-IRR of the underlying investments aggregated by investment mandate, objective, or strategy and other measures as listed in 7.A.23. These measures SHOULD be presented gross of the FUND OF FUNDS INVESTMENT MANAGEMENT FEES.**

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**Discussion:** As a corollary to provision 7.A.22, where a fund of funds firm is required to provide summary statistics by vintage year if the firm chooses to create composites by investment mandate, objective or strategy, 7.B.5 recommends that if a fund of funds composite is defined by vintage year, the firm should also provide summary statistics by strategy.

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**7.B.6 For periods ending prior to 1 January 2011, for FUND OF FUNDS COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in DIRECT INVESTMENTS (rather than in fund investment vehicles) as of each annual period end.**

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**Discussion:** Direct investments (or co-investments) by a fund of funds may augment the strategy used in the investment in underlying fund vehicles. Direct investments may have different terms and conditions that might change the performance characteristics of the fund of funds. By providing the percentage of investments dedicated to direct investments, the fund of funds firm is displaying additional transparency and allowing the prospective client to factor in additional criteria when analyzing the performance of the fund of funds composite.

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**7.B.7 For periods ending prior to 1 January 2011, for PRIMARY FUND COMPOSITES, FIRMS SHOULD present the percentage, if any, of COMPOSITE assets that is invested in fund investment vehicles (rather than in DIRECT INVESTMENTS) as of each annual period end.**

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**Discussion:** Portfolios of direct investments in companies may or may not have the same risk/return profile or fee schedule as portfolios of investments in other funds. Accordingly, for periods ending prior to 1 January 2011, firms should disclose, for primary fund composites, the percentage of the composites that is invested in other funds as of each annual period end.