As the demand for transparency rises for private equity and hedge funds, the spotlight has been turned toward valuation practices. There are a number of reasons why the valuation process has become important, and they are essential for any fund manager to understand.

One of the heaviest pushes came from the broad-reaching Dodd-Frank legislation which has led to increased financial industry regulatory oversight. After deep investigation of factors which caused The Great Recession, the resulting regulations and guidelines were formalized under the Dodd-Frank Act. One of the resulting actions of this act was the reduction of the minimum threshold of assets under management (AUM) at which funds would be registered with the SEC, which resulted in a larger number of private registered funds. Being registered with the SEC requires the adherence to SEC reporting and corresponding disclosure requirements. The legislation also mandated an increase in the SEC review staff workforce to cover the increased number of registrants as well as enhance the level of reviews around SEC filings. The goal of this wave of regulation is a focus on instilling more transparent reporting and performance standards and more robust internal controls for monitoring and reporting of investment values. The underlying goal of the SEC is to create stricter investor protections. This is especially true for hedge fund and private equity funds that accept public monies, such as an investment from a public pension plan. With the increased attention, a key consideration for asset managers is the probability of an SEC audit and how a failure to comply may have a negative impact on the asset manager’s reputation. An important component of the SEC review is valuation. Asset managers – private equity firms, hedge funds, business development companies (BDCs) – need to prepare accurate valuations of their investment holdings with proper valuation policies and procedures in place in order to withstand an SEC inquiry.

The attention around valuation isn’t solely stemming from enhanced SEC regulation. In the post-Bernie Madoff era (where an unscrupulous fund manager was able to dupe investors out of millions or billions of dollars), limited partners (LPs), boards of directors and auditors are also demanding enhanced governance and more transparent documentation when it comes to valuations, especially those of illiquid investments. In addition to the heightened caution caused by fraudulent structures, another key catalyst to enhanced governance and transparency is the record flow of capital into alternative investments.

**Limited partners**, many of which are institutional investors such as insurance companies, endowments, and large corporate pension plans, are putting pressure on the general partners (GP) for increased transparency. In the past it was common for LPs to whole-heartedly accept GP reporting without any questions. However, a few bad actors took advantage of the trust which forced LPs to ask more questions and dig deeper. Investors have therefore demanded more transparency into valuation estimates and want more information on methodologies,
key market inputs, and valuation models. This topic is especially pressing for LPs/asset managers that focus heavily on non-traded, illiquid assets. These illiquid assets can be difficult to value and can have a material impact on reported figures. The major concerns of the LPs are that erroneous valuations can lead to overpayment of management fees, an inappropriate asset allocation mix, inaccurate performance measurements, and inaccurate prices. Performance measurement has been pushed to the forefront given the increased level of fundraising in the last several years to ensure returns have not been misstated. In addition, for hedge fund or mutual fund models, net asset value calculations need to be accurately determined on a frequent basis to set prices for investors buying into or exiting respective funds.

**Fund boards of directors**, given the highly publicized cases of board negligence around fund asset values, are much more involved in the fund valuation processes as they are ultimately responsible and held accountable for the final sign-off of the asset manager’s valuations. Directors are taking a greater interest in the valuation process and continue to strive for better information regarding valuation accuracy and processes. Indeed, there are potential legal consequences for the directors surrounding inadequate or fraudulent valuation practices. Ignorance around valuations is not an excuse for negligence.

**Auditors** are under a much higher level of scrutiny since the creation of the Public Company Accounting Oversight Board (PCAOB), created after the Arthur Anderson and Enron reporting scandals. Moreover, after the Madoff and Stamford Capital scandals, auditor scrutiny increased even further around asset managers. Auditors are requiring more detailed support of figures used in financial statements, including valuation estimates for a fund’s assets, as reported under Generally Accepted Accounting Principles (GAAP) ASC 820 fair value measurements and as was detailed in a November 2014 Staff Consultation Paper. Auditors are requiring a much higher level of diligence and documented support around asset manager valuations. Funds are finding that they need to spend a lot more time and effort providing this necessary support in order to receive signoff from their auditors on their asset values.

**IMPLEMENTING BEST PRACTICES**
To avoid unnecessary investor, auditor, or regulatory scrutiny around valuations, we recommend hedge funds and private equity funds follow several best practices to improve processes, increase transparency, and create accountability for valuation oversight.

1. Create a sound valuation policy and procedures.
2. Assign appropriate compliance or legal personnel to document, monitor and update the valuation policy as necessary.
3. Establish dedicated personnel separate from the investment teams to monitor and carry out the valuations.
4. Establish documentation procedures for the ongoing valuation process such as investment monitoring slides and repositories to store all investment and new recurring information received on the investments. This may also include compilation of external industry or securities market data that supports the valuations.
5. Develop valuation models and processes that follow industry best practice, are consistent amongst homogeneous investments, and can be replicated for subsequent periodic valuations.
6. Prepare internally or externally robust valuation reports that can withstand regulatory, investor or auditor scrutiny.
7. If an external valuator is used, it is still important for the asset manager to have sound documentation of its own internal value corroboration to support its final fair value recommendation.
8. Establish a valuation review committee to periodically review and approve all valuations before sending to the Board of Directors for final approval of fair value estimates.
In addition to independence, consistency is very important with regard to application of the valuation policies, procedures, techniques, and methodologies.”

One key component is to establish a formal policy that details their valuation guidelines. This policy should be formally retained with the fund’s compliance department, and if public, should be referenced in their public filings. Furthermore, it is important to formally establish employee responsibilities around the carrying out of the policy, to obtain buy-in from all personnel of the Fund, and to actually follow the established policy guidelines. In addition, the policy should be reviewed and updated as necessary on a periodic basis. The regulatory landscape is littered with examples of funds that have no guidelines in place or have guidelines in place, but ultimately do not follow them.

Once a policy is created, a governance mechanism should be established. Many firms establish independent valuation committees to segregate the investment, valuation and accounting/financial reporting functions for heightened independence. Sometimes the investment committee and valuation committee members can overlap which can create actual biases and a perceived conflict of interest. For example, it may be hard for an investment professional to mark down an investment that he/she originated when that person is deeply ingrained in the original investment decision and judged on the performance of such security. It is best practice to create a middle office of individuals responsible for determining valuations and net asset values that serves as a liaison between the fund’s internal accounting, compliance, and investment professionals as well as any outside administrative and valuation professional serving as fund consultants, and the fund’s investors. A valuation committee can be separately established, which can serve as the direct link to the fund’s board of directors.

In addition to independence, consistency is very important with regard to application of the valuation policies, procedures, techniques, and methodologies. This includes, but is not limited to, policies on which investments to value and how often, what methodologies to employ and whether to perform the valuation internally, externally or both simultaneously. For example, a firm may hire an independent valuato perform valuations for all of their investments and then have their internal valuations committee review the results. Alternatively, they may perform internal valuation and also contract to have external valuations completed of the same investments, and have the valuation committee compare the results. Either way, appropriate monitoring and in-place compliance personnel should be assigned to ensure that the valuation process is not only being carried out, but to make sure that it is consistently applied across investments and from review period to review period.

Although based on proven financial theories and models, quality valuations are not simply an application of black box models, but require the synthesis of many variables and ultimately require a level of sound judgment. This is why many people state that valuations are more an art than a science. Essentially there really is no single ‘correct’ valuation answer, but valuations may vary within a reasonable, supportable band. As long as a valuation is supported by observable data, is based on sound financial theories and rationale, and follows a rigorous, thoughtful
process that is consistently applied and well documented, it will be difficult for anyone to claim that a specific valuation is incorrect. In our experience, key third party reviewers of our valuation work such as the SEC or audit firms are less interested in the actual conclusion reached and more interested in observing a well-documented report that outlines the observable data and support used to synthesize to the valuation conclusion, and for recurring valuations, that the valuation processes and methodologies are consistently applied across reports. Scant documentation and undocumented changes in assumptions or methodologies will be red flags that will cause deeper inspection that may turn your routine exam into a disruptive interrogation.

Reviewers of the work often scrutinize decisions to switch assumptions and/or methodologies on the same investment from one period to the next. However, it is key to point out that recurring valuation work for asset managers and their investments is a dynamic process that must react not only to changes in the subject investment fundamental performance, but also to changes in the market, or other new information that may become evident. Sometimes this requires that the valuator make a change to an assumption or methodologies in order to accurately reassess the subject valuation. Documentation of such changes and the rationale as well as access to any new information for review is critical. The ready access to not only the base information used in the valuations but also any new information received in subsequent reviews is part of a sound valuation documentation process as well.

This leads to another best practice recommendation. Firms should create a strict documentation process and a centralized repository of all the information received to better support valuation conclusions. Clients are now using more cloud-based services such as Intralinks and Dropbox not only to retain information securely but also to serve as a centralized database for sharing information with outside vendors and constituents, such as valuation providers, investors and auditors. This is replacing the age-old distribution method of numerous emails or the mailing of data disks or thumb drives. Clear access to supporting documentation shows constituents that the process is organized and data is readily available for review or audit purposes. In addition, it mitigates a level of risk when using outside valuation agents as it gives evidence that the third party has full access to all information provided to and retained by the asset manager for the valuation, and thus no data mining is evident.

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**ASC 820**

Accounting Standards Codification (ASC) 820 provides guidelines for determining the fair value. ASC 820 contains the following key concepts:

- Exit price - fair value is the “price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
- Price is measured using all assumptions market participants would use.
- Market participants are buyers and sellers in the principal market who are independent of the reporting entity, knowledgeable, have the ability to transact and are willing to transact.
- Measurement assumes an orderly, hypothetical transaction in the principal market or the most advantageous market.
- A fair value hierarchy prioritizes market inputs into three broad levels and focuses on whether inputs are observable or unobservable.
  - Level 1 inputs refer to quoted prices in active markets for identical assets or liabilities.
  - Level 2 refers to observable inputs other than those in Level 1.
  - Level 3 inputs refer to unobservable inputs.
Additionally, valuation models should be thorough, but flexible, and provide for periodic monitoring. The goal is to ensure consistent application and then document all related information. This is a significant change from years past when few firms had documented processes in place. Typically, most holdings are valued at least once a year. Larger funds may have significant or large positions valued more often – typically quarterly.

Periodic monitoring or review is the next critical step. This can take the form of internal look-back testing, seeking external compliance advice, external mock audits and the use of independent, third party valuation agents.

When establishing processes, procedures and documentation, be mindful of each audience’s concern around valuation. Investors (limited partners) are primarily concerned with accuracy and transparency. Auditors are looking for support and insight into the rationale for your valuation decisions. The SEC is looking for processes and documentation, consistency and comparability of valuation methods, disclosure of pricing methodologies, and reporting of unrealized performance.

Communication is paramount at all steps and with all parties involved to make sure everyone understands the processes and works together, including auditors, third party valuation firms, fund administrators and others.

**EXTERNAL VS. INTERNAL VALUATION**

As pressures surrounding valuation practices increase, hedge funds and private equity sponsors need to balance their resources to the most efficient end. Hedge fund and private equity firms can perform valuation work internally, but may not have the expertise and data required and will have to focus resources toward valuation-related work at the cost of resource allocation to investment management-related work.

Many fund managers are moving toward engaging a third party. As one fund manager described it, “using a third party is a little like using the navigation unit in your car - once it becomes part of your process, it is hard to live without. You could use maps or print directions from the internet and hope you are going the right way, but it is not the easiest or most efficient method.” Independent third parties can provide an independent perspective because they are not vested in the ultimate valuation conclusion. Dedicated valuation firms see many securities and companies across numerous industries as opposed to an internal investment team who may only perform a few valuations per year. In addition, valuation firms often have access to databases as well as their own vast proprietary data set. Valuation firms generally have large teams with diverse experiences and, when there is a gray area, can tap professionals with specific knowledge to help with critical judgment. In addition, on behalf of the hedge fund or private equity fund, the external valuation firm will stand up to questioning around derived valuations by auditors, boards of directors, or even the SEC, rather than requiring the fund’s employees do so.

While price is a consideration, some find quality, timeliness and internal staff’s ability to focus on their work compelling reasons to hire an outside firm. The improved confidence in the disclosures can also help with investor relations, especially when considering fee-based NAV calculations or performance measurements. Independent valuation firms may also value the same or similar investments for multiple other funds, which can prove invaluable.

But most often, the realized value is cost savings from efficiency and more effective staff utilization. Investment professionals focus on higher margin investing. Hedge funds and private equity funds can reduce time spent on lengthy audits and reduce the potential for litigation over disputed measurements when the cumbersome valuation process is outsourced.

**CONCLUSION**

Added scrutiny on valuation is likely here to stay. Asset managers across the board are getting pressure from limited partners, boards, auditors and, increasingly, regulators. Establishing a formal process, creating a governance mechanism, and focusing on documentation are best practices to avoid costly regulatory issues or litigation. Bringing in an independent valuation firm can help to build confidence in valuations, save staff time, and, in the long run, reduce cost.

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ABOUT VRC

Valuation Research Corporation is an independent, global valuation firm. Our global network of nearly 1,000 valuation professionals has provided objective, supportable conclusions of value for more than 40 years to domestic and international clients ranging from Fortune 500 companies to privately-held organizations of all sizes across all industries. VRC also works closely with private equity firms, attorneys, not-for-profit institutions, fiduciaries and individuals.

Our core services include:

- Valuations of tangible and intangible assets, business enterprises and fixed assets
- Financial opinions with respect to valuation in support of allocation of purchase price, goodwill impairment, stock based compensation, legal entities and deferred compensation
- Solvency, capital adequacy and fairness opinions in connection with mergers, acquisitions, divestitures, leveraged buyouts, recapitalizations, financings, and financial and tax reporting matters

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THE ADVANTAGES OF EXTERNAL PORTFOLIO VALUATIONS

The increasing importance placed by authoritative accounting bodies on fair value has reinforced the need to arrive at fair value that is consistent with generally accepted accounting principles. Valuation challenges are particularly acute for illiquid securities. Historically, many illiquid investments have been valued at cost or written up based upon an event such as the latest round of financing. Write-downs were usually driven only by impairment or a down round of financing.

Today, such a limited approach is incompatible with the concept of fair value. With the issuance of Accounting Standards Codification (ASC) 820 (formerly SFAS No. 157), in 2007, new guidance for the measurement of fair value was established. ASC 820 also includes clarifications to the definition of fair value. Increased volatility in financial markets combined with reduced liquidity has focused attention on the role of current market conditions on fair value. Yet by their very nature, illiquid securities may have important differences and features that need to be properly understood in the determination of fair value.

Our valuations of illiquid investments are performed in accordance with ASC 820. Engaging a third party to perform valuations of illiquid investments is recommended for the following reasons:

- Results in a more robust valuation policy and conforms to best practices
- Provides the Board of Directors with another input into its determination of fair value
- Independence
- Greater consistency and transparency
- Fulfillment of lender requirements for securities-based lending
- Experience in the application of required valuation framework and with illiquid securities

WHY CHOOSE VRC

VRC provides portfolio valuation services as part of a firm’s valuation policy enabling funds and companies to provide greater transparency, consistency and independence, as well as adopt best practices while meeting financial reporting requirements concerning the fair value of illiquid investments. Our experience and practical implementation can make a difference.

Independence & Objectivity

Our goal is to provide clients with the practical guidance needed to achieve their business objectives. Professionals in our firm combine valuation and corporate finance experience and skills with accounting expertise to provide clients with impartial assistance.

Transaction Excellence

VRC’s professionals provide clients with impartial assistance in the consideration of mergers and acquisitions, divestitures and significant corporate changes. Our valuation experts provide fairness and solvency opinions to assist company directors, special committees, ESOP trustees, lenders and other corporate advisors to ensure that their transactions are fair and financially adequate.

Senior Level Professionals

Our highly-skilled senior professionals participate in all phases of assignments from initial client discussions through final recommendations. Our professionals average more than 23 years of experience. Most have backgrounds in accounting, economics, finance and statistics, and hold advanced degrees and certifications, including CFA, CPA, MAI and ASA.

Industry Expertise

We are widely respected for the depth of our industry knowledge. While we have served clients in most major industries, we have particular experience in serving clients in the following industries: automotive, chemical, consumer products, energy, financial services, health care, industrial products, life sciences, private equity, professional services and technology.