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Fair Value – Best Practices and Implementation

OCTOBER 17, 2019

CPE Certification

Recommended CPE Credit: 1 CPE hour (50 minutes as defined by NASBA)

Field of Study: Specialized Knowledge and Applications

- Participants must answer all three poll questions offered throughout the webinar to qualify.
- Certificates of completion will be emailed to qualifying participants following the webinar.

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Our Presenters

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Agenda

- Primary valuation approaches
- Inputs and the Fair Value Hierarchy
- Valuation from an auditor's perspective
- ASC Topic 820 disclosure requirements

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Definition of Fair Value

- **Fair Value in accordance with FASB Accounting Standards Classification Topic 820:**
  - Defined as "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"
  - Fair value is an *exit price* vs. entry price
  - Fair value is a *market-based measurement* (assuming change of control), not an entity-specific measurement
  - Assumes a transaction in the principal market, or, alternatively, the *most advantageous market*
  - Fair value measurement is made up of one or more inputs based on *market participant assumptions*
  - Inputs form the basis of the fair value hierarchy
    - Level 1, Level 2, Level 3

Market to Market

- **ASC 820 requires:**
  - Positions must be marked to market (e.g., carrying values on balance sheets adjusted) using the fair value standard – Can not be held at lower of cost or impaired value
    - Hedge funds
    - Private equity funds
    - Mutual funds
  - Significant and detailed disclosures are required for securities that are classified as each of Level 1, 2, and 3 (per the fair value hierarchy)

Fund Management / Board Responsibility

- Non-delegable duty of the Fund's board
- However, the board may appoint others to assist the board in determining fair value and to perform the actual calculations
- Management / Board should:
  - Approve specific policies and procedures
  - Circumstances requiring fair value
  - Determine methodology (ies)
  - Resolve / avoid conflicts of interest
- Appoint others (IA or Valuation Committee) to implement policies and procedures
- Maintain oversight
  - Ensure all appropriate factors considered
  - Assess method for determining fair value of each security

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Key Valuation Policies and Procedures (P&P) Considerations

- P&Ps should be drafted to promote fairness and consistency in the valuation process
- P&Ps should clearly indicate the methods, principles and models that be will used to value investments
  - This is especially the case for hard-to-price investments
- P&Ps are meant to be living documents. They should be reviewed at least annually and can & should be updated
- Consider forming a pricing/valuation committee to address valuation difficulties
  - This will assist in minimalizing / avoiding internal conflicts of interest
- Valuation P&Ps are likely to be the starting point for SEC examiners

Best Practices

- Adoption of written/documented valuation policies and procedures
- Improving internal systems for retaining and monitoring fund holdings data
- Establishing an internal pricing committee
- Maintaining an advisory board or committee
- Continuous investment monitoring
- Appointing an independent valuation provider

CPE Poll Question #1

Why is Valuation So Important?

- Fair value drives net assets, can overstate performance and over-charge investors management and performance fees
- If an adviser inflates the value of the investments, then:
    - overpaid in performance fees
    - overpaid in management fees
    - investors think holdings are worth more than they are
    - new investors in a fund will overpay for their interests
    - redeeming investors in a fund will receive too much for their interests
- The opposite will occur if the adviser understates valuation

Fair Value Hierarchy

- Identifies the assumptions that a representative market participant would use to price an asset or liability, including an adjustment for risk whenever a market participant would include such an adjustment to price the asset or liability
- Establishes a fair value hierarchy that prioritizes the inputs used to measure fair value into three broad levels, considering the relative reliability of the inputs
  - **Level 1 Inputs** – quoted (unadjusted) prices in active markets for identical assets or liabilities, where the reporting entity has the ability to access these markets for a potential transaction at the measurement date
  - **Level 2 Inputs** – inputs that are observable, either directly or indirectly as of the measurement date, other than quoted prices included within Level 1
  - **Level 3 Inputs** – unobservable inputs (unobservable inputs may be used to measure fair value to the extent that observable inputs are not available)
- In practice, when valuing holdings other than publicly traded stock or debt (or other assets traded on active public markets) the valuation inputs will typically include Level 3 inputs, such as required rates of return, pricing multiples, fair yields, or management provided projections or estimates, resulting in a Level 3 conclusion of value

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Fair Value Hierarchy

- **Level 1 "Mark to Market"**
  - Unadjusted quoted prices from an exchange or broker-dealer market that is deemed to be active
  - Need to have a consistent approach as to how the quoted price is used
  - Quoted prices should not be adjusted because of the size of the position relative to trading volume (i.e., blockage discount)
  - Bid (long positions) quotes are preferred, given the exit price concept
  - If any significant adjustments are made to quoted prices, these become Level 2 assets

Fair Value Hierarchy

- **Level 2 "Mark to Matrix"**
  - Observable inputs: quoted prices for similar assets in active markets
  - Broker quotes: if the trade can be executed at that price (may require more than one or two quotes)
  - Quoted prices for identical or similar assets in inactive markets (a blockage discount may be appropriate)
  - Other observable market inputs: interest rates, yield curves, volatility factors, credit risks
  - Inputs derived from or corroborated by observable market data through correlation or regression analysis
  - For Level 2 designations, any models used must be widely accepted and non-proprietary, and the data used must be observable
  - If any significant adjustments are made to Level 2 Inputs, they generally become Level 3 assets

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Fair Value Hierarchy

- **Level 3 "Mark to Model"**
  - Unobservable inputs (e.g. required rates of return, pricing multiples, fair yields)
  - Models (e.g., Black-Scholes, discounted cash flow, multiple of earnings or EBITDA) utilizing significant inputs that are unobservable
  - May include publicly listed securities with very little market activity
  - Reflects the entity's own data about the valuation assumptions that market participants would use
  - Cannot ignore reasonably available information without undue cost and effort to market participants

Primary Valuation Methodologies

- **Market Approach**:
  - Comparable Company Market Multiples (e.g., EV/Revenue, Price/Book)
  - Comparable Transaction (same as above, but based on control acquisitions)
  - Previous Transaction in Subject Co.'s Stock / Last Investment Round
  - Firm Offer
- **Income Approach:**
  - Discounted Cash Flow
  - Capitalization of earnings
- **Cost Approach:**
  - Investment Cost
  - Cost to build
  - Replacement Cost

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Methodology Considerations

- **Methodologies should consider a variety of factors, such as:**
    - sources of prices
    - priority of sources
    - how the sources are used
- **Methodologies should generally include, as applicable:**
    - readily available quotes (for exchange traded securities)
    - broker-dealer quotes
    - third-party pricing services
    - proprietary pricing models
    - original cost of investment, etc.

Valuation Methodologies & Examples

- **Common Equity**
  - Income Approach
  - Market Approach
  - Cost Approach
- **Preferred Equity/Convertible Preferred**
  - Current Value vs. Option Pricing Method
- **Fixed Income/Illiquid Debt/Convertible Debt**
  - Spread Based Model
  - Option Based Model (e.g., Black Scholes)
  - Recovery Value Method
- **Structured Products**
  - Collateral Input Assumptions (e.g., default rates, recovery rates
- **Other Considerations**
  - Discount for Lack of Control
  - Discount for Lack of Marketability

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Valuation Firm Considerations

- Independent
- Expertise in asset class & industry
- Experience interacting with auditors, regulators, investors, administrators
- Ability to support valuation analyses and conclusions
- Team capacity to meet volume and timing needs
- Resources to access market information

CPE Poll Question #2

Auditing of Fair Value

- Auditors will request various information in order to audit the valuation of investments. Your auditors may request the following items depending on the entity's activity and the auditors' professional judgement.
  - Valuation policy for each type of investment
  - Public identifiers for Level 1 and certain Level 2 investments
  - Valuation write-ups for investments that are either Level 2 or Level 3 and the underlying support
  - Written confirmation that practical expedient was utilized for investments where net asset value (NAV) was utilized along with any adjustments to NAV that were considered necessary.

Auditing of Fair Value – Level 1

- Audit support is readily available and supported by quotes through use of pricing services.

Auditing of Fair Value – Level 2

- Valuation can be supported with observable inputs.
- The auditor will utilize audit techniques related to the observable and non-observable inputs used to determine fair value.

Auditing of Fair Value – Level 2 (cont'd)

- Many digital assets have values that are publicly available. Since most digital assets are traded continuously and simultaneously in multiple active markets they are often valued using a weighted average price based on the volume of trading at those different markets.

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Auditing of Fair Value – Level 3

- Valuation is determined primarily with non-observable inputs.
- The auditor will use the client’s investment valuation write-ups and underlying support to gain an understanding of the investment fair value.
- The auditor will utilize audit techniques related to the inputs used to determine fair value.
- The *AICPA Private Equity and Venture Capital Accounting and Valuation Guide* provides guidance related to fair value of investments.

Audit Techniques

- The auditor will consider the guidance provided in the *AICPA Private Equity and Venture Capital Accounting and Valuation Guide*.
- Determine if the valuation approach utilized by the entity is consistent with the entity's valuation policy and appropriate for the investment's life cycle.
- Obtain financial information and confirmation of non-observable valuation inputs directly from the investment or other sources.
- Perform audit procedures related to valuation calculations.

CPE Poll Question #3

Fair Value Measurement Disclosures

- The U.S. GAAP disclosure requirements related to the fair value measurement of investments are described in Financial Accounting Standards Board (FASB) Codification topic 820 *Fair Value Measurement* (Topic 820).
- FASB Accounting Standards Update Fair Value Measurement (Topic 820): *Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement* (ASU 2018-13) was published in August 2018 and will be effective for all entities for fiscal years and interim periods within those fiscal years, beginning after December 15, 2019, early adoption is permitted.

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Disclosure Summary – Prior to the Adoption of ASU 2018-13

- Accounting policy footnote regarding the fair value measurement policy of the reporting entity.
- Tabular presentation of the fair value hierarchy of investments at the reporting date classified in the fair value hierarchy and practical expedient, if applicable.
- Tabular representation of the rollforward of Level 3 fair value measurement as of the reporting date, including the unrealized appreciation (depreciation) included in earnings during the reporting period.

Disclosure Summary – Prior to the Adoption of ASU 2018-13 (continued)

- If applicable, the amount and reasons for transfers between the levels including the policy of timing of the transfers between the levels.
- Unrealized appreciation or depreciation related to Level 3 investments still held on the reporting date.
- A tabular presentation of the quantitative information regarding the significant unobservable inputs (valuation method and relevant multiples) for Level 3 investments.

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Topic 820 –Changes to the Disclosure Requirement for Fair Value Measurement (ASU 2018-13) Nonpublic Entities

- In lieu of a tabular representation of the Level 3 fair value rollforward as of the reporting date, a nonpublic entity is required to disclose transfers in and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities.
- For investments in certain entities that calculate net asset value, an entity is required to disclose the timing of liquidation of a reporting entity’s assets and the date when restrictions from redemption might lapse only if the reporting entity has communicated the timing to the entity or announced the timing publicly.
- ASU 2018-13 also clarifies that the measurement uncertainty disclosure is to communicate information about uncertainty in measurement as of the reporting date.

Questions?

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