

New Valuation Regulations!

How do they apply to Alternative Investment Managers?

Background

With the advent of the 1940 Investment Company Act, Fair Value has been required for Alternative Investment Fund Managers reporting under US GAAP. The industry has evolved over time, most specifically over the past few decades with the introduction of the US PEIGG Valuation Guidelines in 2003, the International Private Equity and Venture Capital Valuation Guidelines in 2005, and the issuance of FASB Statement 157 (now ASC Topic 820) Fair Value Measurements in 2006. In recent years, as a response to investor concerns, audit pressure and expanded regulation, most investment managers have improved the rigor and robustness of their fair value measurement and reporting process.

The 2008/2009 financial crisis exacerbated the focus on fair value estimates. While many Alternative Investment Managers had strong fair value estimation processes, they were caught up in the frenzy surrounding the judgment required to value illiquid investments. Over the past decade the Public Company Accounting Oversight Board (PCAOB) has consistently found exceptions in their examinations with respect to auditing fair value estimates. In addition, the U.S. Securities and Exchange Commission (SEC) has questioned the lack of a unified identity of the valuation profession. The current regulatory environment in the U.S. does not require valuation professionals who perform Fair Value measures to have a credential or adhere to uniform standards related to documentation, code of conduct, ethical requirements or quality control. The questioning of these regulatory bodies has resulted in new and expected rules with respect to estimating fair value, and new performance standards.

Proposed PCAOB Standards

In 2014 and 2015 the PCAOB issued consultation papers for public comment on the topics of:

The Auditor's Use of the Work of Specialists

Auditing Accounting Estimates and Fair Value Measurement

After considering public comments on the consultation papers, the PCAOB has combined the topics and soon expects to release proposed new audit standards which focus on auditing fair value measurements.

New Framework for Valuation Professionals

In a prepared speech at the 2011 AICPA National Conference on Current SEC and PCAOB Developments, December 5, 2011, Paul A. Beswick, as Deputy Chief Accountant of the U.S. Securities and Exchange Commission, stated the following:

Risks created by the differences in valuation credentials that exist today range from the seemingly innocuous concerns of market confusion and an identity void for the profession to the more overt concerns of objectivity of the valuator and analytical inconsistency.

The fragmented nature of the [valuation] profession creates an environment where expectation gaps can exist between valuers, management, and auditors, as well as standard setters and regulators. ...

I think one potential solution to consider is whether there should be, similar to other professions, a single set of qualifications with respect to education level and work experience, a continuing education curriculum, standards of practice and ethics, and a code of conduct. One could also contemplate whether a comprehensive inspection program and a fair disciplinary mechanism should be established to encourage proper behavior and enforce the rules of the profession in the public interest.

In response to the SEC's concerns, over the past three years a new valuation credential has been established through the efforts of the American Society of Appraisers (ASA), the American Institute of Certified Public Accountants (AICPA) and the Royal Institution of Chartered Surveyors (RICS), major accounting firms, and others.

The Certified in Entity and Intangible Valuations credential shortened to CEIV (CEIV or the Credential) is the result of these efforts. Further information is available at <https://ceiv-credential.org/>.

The Mandatory Performance Framework

In addition to the CEIV credential, a Mandatory Performance Framework (MPF) for valuations and Application guidance for the MPF (Application) were created to provide a consistent framework for determining how much valuation work to do and how to document the work done in estimating fair value (<https://ceiv-credential.org/mandatory-performance-framework-and-application/>). The MPF and Application are required to be applied by CEIV credential holders and expected to be followed by non-CEIV valuation professionals, as a best practice.

Overall the MPF and Application require that the valuation professional provide within the work file sufficient documentation to support a conclusion of value such that an experienced professional not involved in the valuation engagement could review and understand the significant inputs, analyses, and outputs and how they support the final conclusion of value.

Application to Alternative Investment Funds and Fund Managers

Over time, it is anticipated that compliance with the MPF and Application will be expected by Investors, Auditors and Regulators. The documents state: "The framework and the Application of the MPF were designed to be used by all valuation professionals who provide valuation services for financial reporting purposes."

"An overview of the scope of adoption and adherence by valuation professionals follows:

- *Valuation professionals with the CEIV credential.* It is mandatory for valuation professionals who have earned the CEIV credential to adhere to the framework and the Application of the MPF (collectively referred to as 'MPF documents') when engaged by (a) an entity required to submit registration statements or filings to the SEC or (b) a privately held entity that prepares and issues financial statements in accordance with US GAAP, to perform a valuation of a business, business interest, intangible asset, certain liabilities, and inventory used to support management's assertions made in financial statements issued for financial reporting purposes.
- *Valuation professionals without the CEIV credential.* As noted previously, the framework and the Application of the MPF were designed for use by all valuation professionals. Although only those valuation professionals who have the CEIV credential are required to adhere to the MPF documents, the Performance Requirements Work Stream believes that adhering to the MPF documents should be considered best practice by valuation professionals who do not have the CEIV credential and who perform valuation of a business, business interest, intangible asset, certain liabilities, and inventory used to support management assertions made in financial statements issued for financial reporting purposes." (MPF page vi)

As the MPF and Application become standard practice, it is possible that it will be expected for a CEIV credentialed valuation professional to be involved in all valuation estimates prepared for financial reporting. The CEIV may be an employee of the Fund Manager and/or may be an independent valuation specialist with the credential.

Conclusion

The PCAOB's anticipated proposed auditing standards will also impact a Fund's approach to estimating and documenting fair value. Fund Managers may wish to comment on the proposal when issued to ensure that the voice of the Alternative Asset Industry is heard.

The CEIV credential, the MPF and the Application of the MPF, are in their infancy in adoption and understanding. The new credential and framework were designed for **all** fair value financial reporting by **all** US GAAP reporters, not specifically for the Alternative Asset Industry. The framework is therefore expected to be applied to the Alternative Asset Industry. As implementation of the MPF, Application and CEIV credential unfolds there will likely be inconsistencies in expectations, interpretation and application.

Overtime, compliance with the MPF should enhance consistency and transparency in the performance of Fair Value measurements for the benefit of public interest. Alternative Investment Fund Managers have a vested interest in meeting the expectations of investors, regulators and the public in general. Understanding and adopting the new valuation framework should assist in expanding public trust.

David Larsen, CPA/CGMA is a Managing Director with Duff & Phelps and serves as Vice Chair of the IPEV Board, a member of the AICPA PE/VC Valuation guide taskforce, and former member of FASB's Valuation Resource Group.