What’s It Worth? Practical Thoughts on Valuation

By Joel Stocksdaile

Valuation is a vitally important process for every investment adviser. Incorrect valuations can result in incorrect performance figures, and thus, misleading marketing materials. Clients pay fees that are based on a percentage of assets under management, so inaccurate valuations may result in incorrect fee calculations. Once a valuation error has been found, an adviser would need to correct false performance information, and recalculate fees, possibly requiring refunds, and resulting in negative publicity for the firm. Asset prices are important to most advisers’ portfolio management and trading processes. Regulatory filings require advisers to indicate their assets under management – a number based on the value assigned to those assets. As you can see, having a strong valuation process in place is essential for every investment adviser.

In this article, we will briefly provide the background and explore the guidance that relates to valuation. We will also discuss common valuation processes that many advisers use. Finally we will also cover some practical valuation tests that may be used to help strengthen the valuation process.

Valuation Guidance

The Securities and Exchange Commission (“SEC”) requires all investment advisers to adopt and implement policies and procedures that are reasonably designed to price investments in a manner that is fair, accurate, and consistent with any disclosures. The adopting release to Rule 206(4)-7 (the “Compliance Rule”) under the Investment Advisers Act of 1940 (“Advisers Act”) states that valuation is one of the areas the SEC expects an adviser’s compliance program to address. Specifically, with respect to valuation it says that at a minimum the compliance program will address, “processes to value client holdings and assess fees based on those valuations”.

Processes used to value client holdings should be designed based on an assessment of the types of securities held in client portfolios. Different securities should be priced using different processes. Securities that are frequently traded on public exchanges, such as large cap domestic equities, are relatively easy to price. However, the valuation of investments for which there is no readily available pricing information is a highly judgmental process, which can be difficult to perform and document. thinly traded fixed income securities, privately issued securities, and other types of securities may need to be fair valued.

The Financial Accounting Standard Board’s Accounting Standards Codification (“ASC”) 820, Fair Value Measurements and Disclosures, provides guidance regarding appropriate valuation methodologies. ASC 820’s recommended hierarchy of valuation metrics is summarized below in descending order of preference:

- **Level 1**: Quoted prices in active markets for identical assets or liabilities;
- **Level 2**: Observable inputs other than quoted prices, such as:
  - **Level 2a**: Quoted prices for similar assets or liabilities in active markets;
  - **Level 2b**: Quoted prices for identical or similar assets or liabilities in markets that are not active;
  - **Level 2c**: Inputs other than quoted prices that are observable for the asset or liability (such as interest rates, yield curves, implied volatilities, and credit spreads);
- **Level 2d**: Inputs derived from or corroborated by observable market data by correlation or other means;
- **Level 3**: Unobservable inputs for the asset or liability.

While the valuation hierarchy is important, it is by no means the only guidance in ASC 820; a full discussion of which is beyond the scope of this article. ASC 820 also discusses important concepts related to the fair valuation of assets. For more complete information, see ASC 820 which is available from the FASB.

Regardless of which valuation metric is used, the fair value of an asset should be the price at which it could be acquired or sold in a current transaction between willing parties in which the parties each acted knowledgeably, prudently, and without compulsion. Fair value should not be based on what can be obtained from an immediate “fire sale” disposition, nor on what a buyer might pay at some later time or under more favorable circumstances. Thus acquisition cost is often not a reliable or reasonable value to use for valuation purposes.

Assets should be valued using the highest level of input available. Under ordinary circumstances, exchange traded equities are considered Level 1 assets because they can be priced at a quoted price from an active market. Privately offered securities are often Level 3 assets because there may be little publicly available information to indicate the value of the security. If a reliable market quote is available for a Level 1 asset that is the price that should be used for valuation, rather than relying on a fair valuation process.

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Common Valuation Policies and Procedures

Just as every firm is different, so every adviser will have valuation policies and procedures that are different. A firm’s valuation practices should be based on an assessment of the valuation-related risks that the firm faces. Once these risks have been identified, processes should be put in place to mitigate them. Even though every firm must customize its compliance program, there are certain valuation practices that are common, and are found at many firms.

Pricing Methodology

It is important to establish the pricing methodology that must be followed for each asset class. This may include closing prices, broker quotes, model pricing, or matrix pricing depending on the type of asset and its characteristics. Advisers should carefully consider the best source for pricing for each asset, and select the source that will be most likely to result in the value that could be obtained in a current sale between willing parties.

Many policies also indicate the primary sources to be used for pricing, and establish an internal hierarchy that establishes which sources will take precedence over other sources. This is useful in those instances in which a price from the usual source is unavailable, or if there are extenuating circumstances that require a closer consideration of the valuation to be used.

The valuation policy should also cover fair valuation. Fair valuation pricing is needed any time an asset does not have an independently established price from a third party source, or when circumstances indicate that the pricing may not be reliable. In addition, securities that trade infrequently, and various types of complex securities, may require fair valuation.

Valuation Committee

Many firms find it valuable to have a valuation committee. The valuation committee generally meets quarterly and reviews valuation methodologies, as well as the fair value assigned to any security requiring fair valuation. Valuation committees commonly serve as the final say on how to price a security. Advisers should create and retain the minutes from each valuation committee meeting, as well as any documentation reviewed by the committee that is used in making a valuation determination.

Documentation

Documentation should be retained to evidence the valuation process, and to provide support for the valuations used. The documentation retained will depend on the type of security, and the methodology used to value it. In general, the more difficult a security is to value, the more documentation that is needed to support that valuation. Documentation may include evidence of multiple broker quotes, models, matrices, comparable sales, and closing prices.

Pricing Errors

Valuation policies often cover the correction of pricing errors. Any pricing errors that are identified should be documented. The review of a pricing error needs to include a determination of the cause and steps to be taken to prevent a recurrence. In addition, the adviser should determine whether the error caused incorrect performance numbers to be used or inaccurate fees to be charged. If excessive fees were charged, they will need to be refunded.

Fair Valuation

Pricing services may be unwilling or unable to price certain investments, or may assign prices that do not reflect current market conditions. Assets that may be difficult to price include, among others:

- Privately offered investments;
- Thinly traded investments;
- Assets in which trading has been suspended;
- Assets traded in certain foreign markets; and
- Options and warrants.
Advisers should continually assess the availability and reliability of the prices derived from its primary pricing sources. Advisory personnel must monitor prices to determine if prices provided by a third party appear stale or inaccurate, or, more generally, if the pricing methodology appears inappropriate for a particular investment (see Testing below). Whenever a valuation appears to be inappropriate, or the primary source for valuations is inaccurate or unreliable, fair valuation methodologies must be employed. Fair valuation methodologies may incorporate, among other things:

- Multiple broker-dealer quotes;
- Other third-party quotation providers;
- Bids and asks on exchanges where the asset is traded;
- Investment cost;
- Discounted expected future cash flows;
- Pricing formulas and models;
- Prior trades; and/or
- Pricing matrices.

Employees involved in fair valuation should maintain documentation sufficient to retroactively establish the appropriateness of a price. Such documentation may include evidence of quotes received from brokers, models, matrices, and other information considered in establishing the valuation.

**Testing**

Valuation testing is an integral part of any valuation procedure. Testing needs to be conducted on a periodic basis, and should cover all types of assets and securities. Even prices for exchange traded equities should be tested periodically, on a sample basis. The type and extent of testing performed will depend on the security being valued, and the difficulty in valuing it. The valuation of a Level 3 asset should be tested more frequently and more thoroughly than the valuation of a Level 1 asset. There are many different valuation tests that an adviser may choose to use, three of which are discussed below.

One simple and useful test is to compare the sales price of an asset when sold to the most recent valuation. This test is particularly informative when used for any assets that are fair valued or hard to price. The sales price of an asset sold to a third party in an arm's length transaction indicates its value, and so is a good measure to use to test the validity of the valuation process that is being used. Any significant variances should be reviewed to determine whether the difference was caused by an event subsequent to the most recent valuation, or if the valuation was potentially inaccurate. In addition, the results of this test should be monitored for patterns (such as valuations that are consistently higher than the subsequent sales price) which may indicate that the valuation process is flawed and needs to be updated. Documentation needs to be maintained supporting the results of the test, and any follow-up that was undertaken as a result.

Every valuation procedure should include a process for monitoring for stale prices. The definition of what is stale will vary by asset class, but may be considered as little as a few days with no price change for listed equities, with longer time periods for other assets. The definition of what is stale varies by adviser. Once a definition of stale price has been implemented, monitoring should be performed either manually or via an automated system. Prices that have been identified as stale should be reviewed to determine whether or not the price being used is accurate. The security with the stale price may need to be fairly valued in accordance with the firm’s fair valuation policy. Documentation of the stale price review, and any associated follow-up needs to be maintained.

Another possible valuation test to consider using is to monitor for daily price fluctuations. Many advisers establish a maximum daily price fluctuation, based on the type of security. All securities are monitored on a daily basis. A review is performed for any price that changed by an amount greater than the established threshold in order to confirm that the price is valid. As with all compliance testing, the results of this test, and any associated follow-up, need to be documented.

**Conclusion**

Valuation is a vitally important process for every investment adviser which requires a sound and comprehensive set of policies and procedures. These policies and procedures should be customized based on the types of securities the adviser uses to implement its investment strategies. Among other things, a valuation policy should address the valuation methodologies to be employed, fair valuation processes, and testing. Once consistently employed and properly documented, the valuation policy should serve to help the firm to avoid the problems that result from incorrect valuations. Let ACA help.

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