

Portfolio Valuation Creates Opportunities and Problems

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Recent developments in rules for valuing multiple securities, both public and private, for portfolios have spurred debate among regulators, portfolio managers, compliance personnel, and accountants about the proper procedures to use in portfolio valuation.

This is the first of a two-part series. In this part we discuss background rules and procedures now developing for portfolio valuation, and give a history of how valuation has grown from a narrow focus on domestic applications to an international point of view. We also discuss the effect of those developments on appraisers and portfolio valuations.

The second part in the series goes into applying the developing portfolio valuation rules, and suggests how valuation methods may have to change to be timely, economically practical, and defensible.

The changes in value of underlying securities from one period to the next decide not only the net asset value of holdings, but also measure portfolio managers' performance. Further, the valuation and periodic review of a portfolio should provide information about risk to the investor.

Illustrative of why accurate security valuation is important, open-end mutual funds must buy and sell shares daily. Unlike other industries, where directors may be "conservative" and simply mark down a security, mutual fund directors don't have that alternative.¹

In the United States, the most important contributors to portfolio valuation theory have been the SEC, the Financial Accounting Standards Board, the Investment Company Institute, and the Private Equity Investment Guidelines Group.² The Chartered Financial Analysts Institute (formerly the Association for Investment Management & Research) has been the most visible contributor of valuation issues from valuation practitioners.³

The task of fulfilling new "best practices" and regulations will eventually fall on certified valuers and appraisers to do the work, valuing securities in portfolios. Client companies and valuation experts will be the ones who may be sanctioned for failing to comply with new directives.

Valuation practitioners have the knowledge, skill, and experience to appraise company securities for multiple purposes. This appraisal work has been a primary source of case law, creating legal precedent of accepted methods and procedures. Courts examine appraisers using the Federal Rules of Evidence for admissibility of expert testimony, test their methods, subject them to peer review, and examine if the methods are accepted within the valuation community.

Appraisers know the most problematic securities are those which are either not publicly traded or where trading prices do not reflect true value. Certified business appraisers specialize in valuing private business. The certifying bodies have adopted standards, developed over time, to assure complete work product.⁴

¹"Valuation Issues for Mutual Fund Directors," Investment Company Institute, Investment Directors Conference, 2001.

²PEIGG was formed in February 2002 and is comprised of a volunteer group of industry-wide representatives (www.peigg.org).

³The CFA Institute contribution is most noteworthy for its Global Investment Performance Standards.

Business appraisal experts can benefit from emerging recommended practice. A partial listing includes addressing acceptable modeling and methods, portfolio holding liquidity, and economical and timely reporting. Although the emerging procedures consider acceptable modeling and methods, a closer inspection, in the second article, will suggest these procedures may fail in real-world application.

Implication of Methods Adoption

Proper reporting by registered funds is not trivial. Failure to provide defensible portfolio valuations can have significant effects. In August 2007 the SEC issued a cease and desist order⁵ against Allied Capital Corporation in determining the fair value of certain portfolio securities for which market quotations were not readily available.⁶ Internal personnel completed the appraisals rather than engaging an independent third party.⁷

Registered fund organizations are not the only ones sanctioned. In September 1998, the SEC issued a cease and desist order after establishing an aiding and abetting violation against certain individuals who did not use correct methods to determine the fair value of certain holdings.⁸

The United States defines portfolio

management as those who manage funds for fees or commissions. These managers decide on investments and earn fees based on the size and/or overall performance of the portfolio. Participants include managers of trusts, mutual funds, pension funds, and other portfolios.⁹

About 90 percent of the portfolios are in the hands of organizations or persons registered with the SEC under the Investment Company Act of 1940.¹⁰ These professionals have at least minimum standards of periodic reporting. However, in the past 10 years hedge funds have displayed blistering growth, and these funds have had little oversight or reporting requirements. There are unregistered investment pools besides registered funds and hedge funds, such as venture capital funds, private equity funds, and commodity pools, all of which are often called hedge funds. Some treat business development companies as part of registered investment companies, although the primary accounting challenge they also face is with valuation.

For funds registered under the 1940 Act, IBIS World estimated there were about \$10.4 trillion in assets under management at the end of 2006, and expected that to grow by 5.5 percent during 2007. Of these totals, institutions invested about \$3.06 million and individuals invested about \$7.35 trillion. Growth has averaged about 9.1 percent a year, increasing from \$7.1

trillion at the end of 2002 to about \$11 trillion by the end of 2007.

Funds management is a fragmented industry. IBIS World estimates the four largest managers of registered funds account for about 20 percent of the market. They estimated there were 1,170 enterprises and about 12,300 establishments in the industry for registered funds, employing about 212,000.¹¹

Hedge funds have been unregulated and have achieved high growth in recent years. Although there is no universally accepted definition of hedge fund, it usually refers to an entity that holds a pool of securities and/or other assets which are not sold in a registered public offering, and where the fund is not registered as an investment company. In 2003 the SEC estimated that 6,000 to 7,000 hedge funds (and funds of hedge funds, or FOHFs) were operating in the United States, managing \$600 billion to \$650 billion in assets. Then the SEC expected hedge fund assets to exceed \$1 trillion by 2008.¹² By 2007, the hedge fund industry had increased to about 9,000 companies.¹³

The SEC report and actions focused on (a) an increase in hedge fund enforcement, (b) limited ability to obtain basic information, (c) emergence of FOHFs, which do register but hold securities that are not registered, (d) hedge fund disclosure and marketing practices, (e) valuation practices, and (f) conflicts of interest.

⁴The Appraisal Standards Board of The Appraisal Foundation has been authorized by the U.S. Congress as the source of appraisal standards and appraisal qualifications with respect to certain appraisal for government purposes. The ASB issues these standards in the Uniform Standards of Professional Appraisal Practice, the most current edition of which is effective from January 1, 2008 through December 31, 2009. Presently the only certifying organization that requires adherence to USPAP is the ASA. All of the certifying organizations, however, have standards; the most recent issuance was by the AICPA through the Statement of Standards for Valuation Services, Number 1, effective January 1, 2008, which is consistent with USPAP but in greater detail for business valuation. The other certifying body standards contain provisions which are similar to those issued by the AICPA.

⁵If the SEC finds, after notice and opportunity for hearing, that any person is violating, has violated, or is about to violate any provision of Section 21C, the Commission may publish its findings and enter an order requiring such person, and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule,

or regulation.

⁶SEC Administrative Proceeding File No. 3-12661; Securities Exchange Act of 1934 Release No. 55931; Accounting and Auditing Enforcement Release 2618.

⁷See also "An Analysis of Allied Capital, Questions of Valuation Technique," Greenlight Capital, June 17, 2002.

⁸SEC Administrative Proceeding File No. 3-9317, In the Matter of: Parnassus Investments, Jerome L. Dodson, Marilyn Chou, and David L. Gibbon. See also *Western Asset Management Co. & Legg Mason Fund Advisor, Inc.* IAA No. 1980, Sep. 28, 2001) and *Hammes* (ICA Rel. No. 26290; Dec. 11, 2003).

⁹This activity is generally reported under North American Industry Classification 52392.

¹⁰"Implications of the Growth of Hedge Funds," Staff Report to the SEC, 2003.

¹¹"Portfolio Management in the US: 52392," IBISWorld Inc, July 30, 2007.

¹²"Implications of the Growth of Hedge Funds," Staff Report to the United States Securities and Exchange Commission, September 2003.

¹³"Hedge Fund Management," First Research, Quarterly Update November 12, 2007.

In 2005 the Financial Services Authority¹⁴ issued a discussion paper in which it listed valuation weaknesses in hedge fund methods. It assigned the weaknesses to skill shortages and potential conflicts of interest which created significant potential for ill-informed investment decisions and harm to market confidence.¹⁵

With the rising investor, regulator, accountant, and other stakeholder concern, several groups have made efforts to set up guidelines and standards for funds.

Accounting Pronouncements

The pivot point for valuing investments has been the Financial Accounting Standards Board (FASB). On one side are the CPAs who must sign off on the audit and the appraisers who must sign off on the values, while the SEC has been on the other side, issuing and enforcing new requirements.

Driving the SEC is the Investment Company Act of 1940. The 1940 Act has driven policy since then, encouraging the SEC to take certain positions which have had significant influence on how FASB has decided its definition of fair value. The SEC has influenced many of FASB's decisions by referring to the 1940 Act. Auditors and appraisers have had much less influence.

Mutual funds began in 1924 and were widely and quickly accepted by investors. Five-and-a-half years later the stock market crashed. To renew market confidence, Congress wrote the Securities Act of 1933 and the Securities Exchange Act of 1934, regulating the securities industry.

Investment companies were still new in 1940. To give investors confidence in this unique offering, Congress passed the 1940 Act, which regulated conflicts of interest in investment

companies and securities exchanges and protected the public by requiring disclosure of material details about the investment company.

The 1940 Act applies to all investment companies but exempts several types of investment companies from coverage. Sections 3(c)(1) and 3(c)(7) contain the most common exceptions and include hedge funds. The Act (as amended) requires open-end investment companies to sell and redeem their shares at a price based on "current net asset value," defined as the amount that reflects calculations made substantially as follows:

- Managers must value portfolio securities for which market quotations are readily available at current market value.
- Managers must value at fair value other securities and assets for which market quotations are not readily available, and the board of directors must determine fair value in good faith.
- Managers must reflect changes in portfolio holdings by the first business day following the trade date.

The 1940 Act did not define "readily available market quotation," "fair value," or "good faith" for valuation.¹⁶ As the gatekeeper responsible for enforcing the 1940 Act, the SEC became responsible for oversight and made interpretations.

SEC Guidance

Issues may arise even if market quotations are readily available on a specific security. For example, restricted securities differ materially from unrestricted securities, so the market quoted price is not applicable. The following chronology summarizes important SEC guidance, starting with the

question of restricted securities and then addressing fair value considerations and overall overseeing by fund boards of directors.¹⁷

1969. Accounting Series Release No. 113 (October 21, 1969) provides guidance on fair valuation determinations for restricted securities. It defines fair value as "the amount which the owner might reasonably expect to receive for [the securities] on their current sale." Although there can be no "automatic formula" by which an investment company can value restricted securities, ASR 113 requires that a fund's board of directors consider all relevant factors. These factors include the operations of the issuer, changes in general market conditions, and the extent to which the inherent value of the securities may have changed.

1970. In ASR No. 118 (December 23, 1970), the SEC sought to provide more general guidance about how funds should value portfolio securities. Where market quotations are not readily available, including where existing quotations are unreliable or invalid, a fund must price its securities at fair value. ASR 118 describes several nonexclusive methods of valuation a board may use to value securities: a multiple of earnings, a discount from the market price of a similar freely traded security, a yield to maturity for debt issues, or a combination of these principles. Further, a fund's board of directors should consider several general reasons when choosing a valuation method, including (a) the fundamental and analytical data about the investment, (b) the nature and duration of any limits on disposition of the securities, and (c) an evaluation of the forces that influence the market in which the securities are purchased and sold.

1999. The staff issued an interpretative letter to the Investment Company Institute (December 8, 1999). The letter was an effort to clarify and provide

¹⁴FSA is an independent, United Kingdom, non-governmental body, given statutory powers by the Financial Services and Markets Act 2000, limited by guarantee and financed by the financial services industry.

¹⁵"Briefing Note BN008/2005," FSA, 23 June 2005, www.fsa.gov.uk/

pages/about/media/notes/bn008.shtml

¹⁶John Ake, Martha Hays, "Regulatory and Accounting Standards on the Valuation of Portfolio Securities," *Wall Street Lawyer*, January 2007.

¹⁷Ibid.

more guidance on pricing issues in an emergency or other unusual situations.

2001. A second interpretative letter (April 30, 2001) supplemented advice in the 1999 letter about valuing foreign securities. The key phrase in this letter was that where a fund board knows or has reason to believe that its fair value determination does not reflect the amount the fund might reasonably expect to receive for the security upon its current sale, or where a board acts with reckless neglect about its fair value determination, a fund board would not be judged to have acted in good faith.

2003. The SEC adopted Investment Company Act Rule 38a-1 (ICA Rel. No. 26299, December 17, 2003), which requires invested companies to adopt, and boards of directors approve, written compliance policies and procedures, including procedures covering the pricing of portfolio securities.

The preceding SEC directives explain how SEC's interpretations following implementation of the 1940 Act have expanded what investment companies and appraisers must now consider when making fair value determinations. These directives have become part of Generally Accepted Accounting Principles through the FASB.

Accounting Pronouncements & FASB

The SEC has statutory authority to set up financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, the SEC's policy has been to rely on the private-sector FASB in this role.

Created in 1973, FASB is independent of all other business and professional organizations. Before FASB, the Committee on Accounting Procedure of the AICPA (1936–1959), and then

the Accounting Principles Board, also a part of the AICPA (1959–73), set up the financial accounting and reporting standards.

The standards and interpretations rendered by FASB are considered authoritative not only for the SEC, but for AICPA as well, where GAAP rules apply to all audits, reviews, and compilations, regardless of whether the companies are public or private, unless otherwise stipulated. For example, through the Uniform Accountancy Act the FASB has encouraged these rules to be broadly adopted.¹⁸

FASB's mission is "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, including issuers, auditors, and users of financial information." It is a seven-member, independent board consisting of accounting professionals in a private, not-for-profit organization.

FASB standards (GAAP) govern the preparation of corporate financial reports. The Financial Accounting Foundation (FAF) funds, oversees, administers, and decides governance issues at FASB, including determining what makes up a sufficient majority for adopting new rules.¹⁹ FAF is also responsible for the Governmental Accounting Standards Board (GASB) and advisory councils for both FASB and GASB. Founded in 1972, FAF consists of 16 trustees.²⁰ A group of organizations decides who is on the FAF Board of Trustees. These organizations include:

- American Accounting Association
- American Institute of Certified Public Accountants
- CFA Institute
- Financial Executives International
- Government Finance Officers Association

- Institute of Management Accountants
- National Association of State Auditors, Comptrollers and Treasurers
- Securities Industry Association

As part of its role in providing guidelines for U.S. accounting, FASB is part of a convergence project with the International Accounting Standards Board (IASB). The project is to make it easier for companies to report financial statements on an international level, so U.S. and international companies don't need separate financial statements. As part of the convergence project, FASB has worked toward transitioning from the principle of historical cost to fair value.

The 1940 Act had referred to fair value, and the SEC's history of enforcement has in part involved evaluating methods to get fair value. IASB has also incorporated language and set forth definitions using fair value and has been working toward substituting fair value for historical cost accounting. Although there are many places that referred to fair value within past accounting statements and interpretations,²¹ until 2006 FASB had not assembled and resolved these various pronouncements about fair value.

Effective November 15, 2007, FASB's Statement of Financial Accounting Standard (SFAS) 157 became effective, which now defines fair value and deals with fair value measurement protocols, financial statement disclosure, and measurement techniques. During 2008, FASB expects to complete 157, defining financial assets.

Auditors must use SFAS when examining financial statements, including those funds which hold multiple secu-

¹⁸ "Standards for Regulation, Including Substantial Equivalency," *Uniform Accountancy Act*, Fifth Edition, July, 2007, AICPA, New York.

¹⁹ "Financial Accounting Foundation Changes Financial Accounting Standards Board's Voting to Increase Efficiency," Norwalk, CT, Financial Accounting Foundation press release, April 24, 2002.

²⁰ "2006 Annual Report," Financial Accounting Foundation.

²¹ Jim Hitchner, in "Fair Value Measurement: Understanding and Applying SFAS 157, 141 & 142", 7th Annual MNCPA Business Valuation Conference, October 17, 2007, said that SFAS 157 amends 28 Opinions, Statements, Interpretations, and other official pronouncements of FASB and applies to another 39 pieces of accounting literature.

rities.²² Because the SEC considers this work authoritative, it references the new statement and integrates the SFAS into their requirements. Therefore, SFAS 157 is a critical determinant in how appraisers should value funds and report to users, at least for registered funds or other audited reporting entities.

Examining the history, composition, and principle mandate of FASB highlights its focus on politics and its concentration on satisfying requirements for the SEC, the 1940 Act, and publicly traded securities. There is less evidence of contributions from the private valuation community. Court decisions also differ in some respects from that considered important to public companies.

One troublesome feature proposed by SFAS 157 is to forbid applying a blockage discount when valuing a large position in an unrestricted security. This prohibition would fail to recognize that the valuation community and courts accept the idea.²³ There is strong empirical evidence of the effect of blockage discounts. Many now think appraisers should divide the traditional idea of a discount for lack of marketability into a discount for lack of marketability and a discount for lack of liquidity, which is essentially a blockage discount.²⁴

Investors who trade thinly traded public stocks, or who own a proportionately large position in a stock that otherwise has reasonable trading activity, recognize the difficulty of selling blocks of stock in a timely manner. Most experience a discount or must conduct a costly secondary registration.²⁵ The failure to provide a discount for liquidity of large block holdings thus potentially rewards portfolio managers who acquire thinly traded

equities. The portfolio manager's buys may increase the quoted price of the stock, while also failing to describe to fund investors the potential risk of selling stock.

FASB's proposed position reflects positions upheld in the past by the SEC. In SEC Accounting Series Release 118,²⁶ the commission stated that for securities listed or traded on a national securities exchange, market value is the last quoted sales price on the valuation effective date. In that ASR, there was no allowance for an adjustment for commissions (or other selling expenses) or other adjustments, such as liquidity.

The SFAS uses "exit price" and has thus sidestepped the question of commissions or selling costs. It uses the bid price of a security, when available, rather than its offer or last selling price. There was a debate during the writing of 157, with some concerned about using the bid price rather than the ask price or other measure, such as an average of the bid and ask. The Investment Company Institute expressed concern that this "could cause funds to undervalue their shares, to the detriment of shareholders."²⁷ The 1940 Act set up the ASR rules. The ASR requires, where market quotations are available, that securities be valued at market value, and all other securities be valued at fair value. The fund's board of directors estimates fair value "in good faith."

SFAS 157 has set up a Fair Value Hierarchy of three levels, which prioritizes valuation techniques for valuing the portfolio securities and aids in understanding what "good faith" should mean:

- Level 1 uses quoted prices in active markets of the subject securities. FASB considers active markets those where transactions occur with enough frequency and volume to

provide reliable pricing information.

- Level 2 are prices other than those quoted in Level 1 that are observable either directly or indirectly. Level 2 includes prices for similar investments in active markets, quoted prices for identical or similar assets in markets that are not active, or drawn from or corroborated by observable market data.
- Level 3 pricing considers unobservable inputs, also termed entity inputs. This includes projections used for discounted cash flow analyses.

Understanding this division of levels is important because it affects the methods used and the documentation auditors need for working papers and disclosure footnotes to financial statements. The cost of auditing and valuation will increase progressively from Level 1 to Level 3.

Although appraisers need more clarification, SFAS 157 recognizes that a market quote in a thinly traded or inactive stock may not reflect fair value and, therefore, may need more analyses before simply "marking the price to market."

XBRL Format

Another linkage between FASB and the SEC has been their recent advocacy of extensible business reporting language (XBRL), an XML-based, standards-based format to define and exchange business and financial information. Metadata defines these communications set out in taxonomies. Taxonomies define individual reporting concepts as well as the relationships between concepts.

An international consortium, XBRL International, governs and mar-

²² Although effective in late 2007, FASB has delayed implementing many of the portions which treat financial assets.

²³ See, for example, *Edwin A Gallun*, 33 T.C.M. 1316 (1974).

²⁴ Ashok Abbott, "Role of Liquidity in Asset Pricing," West Virginia University, 2004.

²⁵ Shannon Pratt, *Valuing A Business*, Third Edition, Irwin Professional Publishing, Chicago, 1996, page 324; and Robert Reilly, *Handbook of Advanced Business Valuation*, McGraw-Hill, New York, 2000, page 140.

²⁶ Investment Company Act Release No. 6295 (December 23, 1970).

²⁷ Comment letter from ICI Director-Operations / Compliance & Fund Accounting to FASB, dated May 31, 2000.

kets the XBRL format. The consortium consists of about 600 organizations, including, companies, regulators, government agencies, “infomediaries,” and software vendors. The consortium is promoting the format to move business information from paper-based and proprietary electronic formats to Internet-oriented processes.²⁸

Availability of financial and other information through XBRL in the future will have a significant impact on use of public company information for analysts as the SEC reporting adopts its use.

Emerging Best Practices

The background on regulation and accounting is important for understanding how best practices have changed for valuing portfolios. Because those setting the standards expect findings of value to be used in the context of the 1940 Act, the standards have been created for public company reporting. The appraiser must rethink the kinds of methods and procedures to use and how to report the findings.

The American Society of Appraisers (ASA) College of Fellows in 1989²⁹ stressed defining the standard of value pertinent to a specific valuation. The Fellows noted there are many different standards of value, including fair market value, fair value (which now has two definitions, as one relates to shareholder oppression and dissenting rights), intrinsic value, and investment value. Also, the standard of value may vary among legal jurisdictions, such as in matters of divorce where states may depart from the standards of other states.

The seminal work on standards was IRS Revenue Ruling 59-60, issued in 1959. It remains the most important reference for valuing ownership interests in closely held businesses.³⁰ RR

59-60 applies to federal gift, income, and estate tax valuations; and the U.S. Department of Labor has incorporated it into requirements for employee stock ownership plans. Other valuation standards have referenced RR 59-60, such as in matrimonial dissolution.

In 2006, the IRS issued general business valuation standards, applicable to all IRS employees and to those who provide valuation services or review valuations for the IRS. Revenue Ruling 59-60’s continuing influence is also obvious in the comprehensive business valuation standards that began to appear in the late 1980s. The most important of these was the Uniform Standards of Professional Appraisal Practice (USPAP), issued by the Appraisal Foundation in 1987, followed by standards from professional associations such as the ASA in 1992, the Institute of Business Appraisers (IBA) in 1993, and the National Association of Certified Valuation Analysts (NACVA, publisher of *The Value Examiner*).

These appraisal associations have a history of developing valuation as a profession, distinct from accounting and the analyses of public securities, and settling accepted methods and procedures for work. This includes certification by these associations to ensure members have acceptable knowledge, skill, and experience to strengthen public confidence in work product. To fulfill the knowledge and skill components, the associations each offer education and continuing education programs to gain and maintain certification. The AICPA formally recognized the existence of business valuation and embraced it in 1996 by setting up the accredited business valuator designation.

The Appraisal Foundation and

USPAP were outgrowths of fraudulent and poor real estate appraisals which ended with several savings and loan failures. The first edition of USPAP appeared in 1987 and the most recent edition for 2008-2009 was effective January 1, 2008.

The several business valuation standards have much in common, including a common dependence on Revenue Ruling 59-60, which discusses eight factors to consider in valuations. USPAP Standard Rule 9-4 incorporates the eight factors from Revenue Ruling 59-60, and this USPAP Standard Rule has remained essentially unchanged from its first issuance. The eight factors from Ruling 59-60 also appear in ASA Standard I-iii, IBA Standards section 5.3, and NACVA’s Development Standards 3.4, as well as in the IRS Standards under “Analyzing.”

Although the SEC and FASB do not directly cite the ASA, IBA, or NACVA, FASB issued a new standard, effective January 1, 2008. It mirrors in part this body of knowledge. The Statement on Standards for Valuation Services No. 1 has incorporated most of these developed principles. Since FASB’s directives are authoritative to the SEC, industry organizations are now integrating this into the analyses of public companies.

International Standards

FASB’s influence extends to the international community. In coordinating with the IASB, FASB’s guidelines become part of the broader discussion; increasingly parties are originating or holding portfolios outside the United States. While GAAP are the rules issued within the country, the IASB’s International Financial Reporting

²⁸ Besides the SEC, the U.S. Federal Deposit Insurance Corporation, in coordination with the Federal Reserve Board and the Office of the Comptroller of the Currency, launched an XBRL project in October 2005.

²⁹ Opinion of the College on Defining Standards of Value, American Society of Appraisers, Initiation Chair Responsibility, Volume 34, No. 2, June 1989.

³⁰ Martin J. Lieberman and David Anderson, “Will the Real Business Valuation Standards Please Stand Up?” New York Society of CPAs, January 2008.

Standards (IFRS) are those now most accepted outside the United States.³¹

In 2002, FASB and IASB agreed to integrate their standards in the Norwalk Agreement. The first paragraph of the Norwalk Agreement reads: "At their joint meeting in Norwalk, Connecticut, USA, on September 18, 2002, the FASB and the IASB each acknowledged their commitment to the development of high-quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting." At that meeting, the FASB and IASB pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as is practicable, and (b) coordinate their future work programs to ensure that once achieved, compatibility is maintained.

Before making SFAS 157 effective, in January 2007, FASB formed a valuation resource group (VRG) to provide the Board with input for clarifying the guidance related to the application of the principles in SFAS 157. The VRG is comprised of a cross-section of constituents in addition to major accounting firms. This includes representatives from the valuation community: American Appraisal, Duff & Phelps, Financial Reporting Advisors, FVG International, and Houlihan Lokey. Users who are participating include the CFA Institute and Moody's; and regulators and standard setters include the AICPA, Appraisal Foundation, IVSC, PCAOB, SEC, and IASB.

Simultaneous to the joint efforts by IASB (and IVSC) and FASB (with its VRG), several other international groups have emerged and are engaging. Many reflect the concern voiced in the United States about hedge funds, but common to all is valuing private security holdings and other difficult to value securities, such as derivatives.

In October 2007, the International Organization of Securities Commission, issued its Policy Statement on Hedge Fund Valuation, Principles for the Valuation of Hedge Fund Portfolios. The Association Française des Investisseurs en Capital, the British Venture Capital Association, and the European Private Equity and Venture Capital Association produced International Private Equity and Venture Capital Valuation Guidelines to reflect the need for greater comparability across the industry and for consistency with IFRS and U.S. GAAP. In March 2007 the Private Equity Industry Guidelines Group issued its Updated U.S. Private Equity Valuation Guidelines.

This is not an exhaustive list of groups, but it gives an understanding of the international weight given the effect of changes in GAAP from a portfolio management perspective. There has been a flood of contributions offering ideas and asserting preferences about valuing private securities. Creating these rules is political. The rules must address the multiple stakeholders from around the world. There will likely be more changes and interpretations in the next few years as FASB, the SEC, the IASB, and others balance the political concerns.

The domestic valuation community, which deals only with privately held companies, may never appraise hedge funds or other passive investor portfolios, but these appraisers and their clients will experience the impact of decisions in this arena.

The Conduct of Portfolio Valuations

The background of why FASB issued SFAS 157 to provide a clearer basis for fair value and the wide-ranging impact on the domestic and international communities is essential when conducting a portfolio valuation. Al-

though business appraisers must apply their acquired knowledge, skill, and experience, the SEC and international, diverse groups will be increasingly important on setting standards and focus for financial valuation work generally and for portfolio valuations specifically.

Practical Considerations

A thoughtful review of the needs of these various organizations suggests the politics may have overlooked some practical considerations which will affect the business appraiser:

1. The fair value definition has some significant departures from fair market value, which has formed a critical basis for business valuations in the United States.

2. Fair market value has been influential in developing much of the case law in the United States, even apart from its use for tax purposes.

3. The business valuation community has become much more reliant on using methods other than the market approach for much of its work. The use of a discounted cash flow analysis, for example, has become much more common with the advent of computers. Models can be developed and are much more easily explained than when using potentially problematic public guideline companies.

4. A typical valuation for a valuation engagement (AICPA definition of a complete valuation) may cost from \$8,000 to \$50,000 or more. For a fund with multiple securities, there will likely be a high cost to get defensible values.

5. A typical valuation for a valuation engagement will take a month or more for each security analyzed. For a fund with multiple securities, this suggests a potential significant delay between the effective date of a valuation and the delivery of findings. Given the use of these findings for pricing and

³¹ Many of the standards forming part of IFRS are known by the older name of International Accounting Standards, which were issued between 1973 and 2001 by the board of the International Accounting Standards Committee.

compliance reporting, such delays will fail to meet needs.

6. The valuation community has used capital market theory in a modified form for individual security risk buildup. When doing valuation work for a portfolio, should the appraiser consider the interaction of securities within a portfolio for its affect on overall portfolio risk?

7. Hedge funds and other funds not only hold private common stocks, but also private debt, real estate, specialized equipment for leasing, derivatives, hybrid securities, and other investments. Often valuing these various securities requires specialized skills, suggesting another management issue in delivering high-quality and timely reports.

8. The time and cost issues for valuation suggests use of automated systems. However, automation is antithetical to the hands-on analysis which now is the greatest strength of business valuation, and this raises important questions about how to evaluate such tools to ensure that they fulfill the new standards.

9. The hierarchy of levels set forth by SFAS 157 increases the need for documentation and support for both appraiser and auditor as the methods shift from Level 1 through Level 3. For cost and reporting purposes, there is likely to be a need to stay away from Level 3 in which there is usually substantial analyst intervention and subjective judgment. Given the implied lower credibility from the FASB language, investors may be less confident if “unobservable” data are used, such as discounted estimated future cash flows from analysts. Thus analysts may

favor a method, even if the findings are less certain, because the conclusions have more support from the rule makers.

10. The AICPA Statement of Standards for Valuation Services No. 1 lists two forms for valuation services: a full valuation engagement or a valuation calculation. If only the market approach is used for portfolio securities, the work may technically be only a calculation and not reflect thorough due diligence. A valuation calculation has much less weight.

Applying the Rules

The second article in this series will concentrate on applying the rules and protocols this article has described, in the context of valuing privately held securities in portfolios. It will focus on using automation as a possible solution. **VE**



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