

Valuation issues in the investment management industry

For the past eight months, valuation issues have gripped the investment management industry like never before. In this article, we examine the main issues that have arisen and how the industry is addressing them.

The Global Public Policy Committee, which is made up of the six largest international accounting networks*, issued a paper to enhance awareness of the requirements of International Financial Reporting Standards (IFRS) in relation to the determination of fair values of financial assets and liabilities and related disclosures in the context of current market conditions. The paper does not amend or interpret IFRS - it sets out the requirements of existing IFRS literature only.

Under IFRS, Fair Value is defined (within IAS 39) as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. IAS 39.48A states that “the best evidence of fair value is quoted prices in an active market”.

Under US GAAP, Fair Value is defined within SFAS 157 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”. SFAS 157.21 states that “valuation techniques used to measure fair value shall maximise the use of observable inputs and minimise the use of unobservable inputs.”

Under IFRS, if the market for a financial instrument is not active, then IAS 39 requires use of a valuation technique. The valuation technique should be calibrated against observable current market transactions or any observable market data. Equally, under US GAAP, even if a market is not considered active, then observable transactions in that market still are considered inputs which cannot be ignored when measuring fair value.

The requirements of IFRS and US GAAP are relevant regardless of the pricing source – be it active market prices, broker quotes, consensus pricing services or model prices. Regardless of the source, the emphasis should be on whether the valuations take account of market information that is ‘reasonably available’ and therefore reflects a current market level.

Even in instances where institutions are modelling securities, it is unlikely that no market-based information is available at all. Of course, the message from the market may be unwelcome. If this is the case, and markdown is appropriate, the scale of the markdown should reflect the actual current position of the market in accordance with the Fair Value definitions of IFRS and US GAAP.

At all times, transparency is paramount. Valuations may include a number of assumptions which could significantly affect the reported value. In such cases, it is imperative that the assumptions are seen to take full account of market information. Where a write-down is deemed necessary, market participants need assurance that the markdown reflects current information.

In the case of constant NAV funds (eg. ‘2a-7’ style money market funds), a write-down may trigger a ‘break-the-buck’ event, where a money market fund’s NAV drops below \$1 per share. In such cases, the fund manager may seek to make a cash infusion to maintain a constant NAV. From an accounting perspective, such infusion must be disclosed as a related party transaction and cannot be repayable to the manager. Depending on the domicile of the fund, there are legal, regulatory and taxation issues that need to be addressed before any such action is taken.

Going forward, it is widely accepted that the accounting and valuation issues confronting the industry will continue to engage the minds of administrators, fund managers, auditors and regulators for many months to come. Timely identification of potentially illiquid or ‘difficult-to-price’ securities is paramount. Ensuring that appropriate procedures are in place to address valuation issues as they arise is equally important.

* The six largest international accounting networks include representatives from BDO International, Deloitte, Ernst & Young, Grant Thornton International, KPMG and PricewaterhouseCoopers.