

## The Fair Value Quality Initiative

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### The Fair Value Quality Initiative Explained

Regulators and participants in the private capital markets have long wrestled with the inconsistent levels of analysis and documentation applied to fair value measurements, and the Fair Value Quality Initiative is the industry's newest solution to the issue.

While the immediate and longer-term impact of these developments on the private capital markets is not yet clear, we believe that they will change industry norms and best practices, and we advise General Partners to familiarize themselves with the initiative and be ready to adopt its standards in the near future.

The Fair Value Quality Initiative was formed in 2013 to address this issue and provide enhanced guidance and structure to the valuation industry. Led by valuation professional organizations (VPOs) such as the American Institute of Certified Public Accountants (AICPA), the American Society of Appraisers (ASA) and the Royal Institution of Chartered Surveyors (RICS), the group united to address the challenges, and they have come up with two solutions:

**The Mandatory Performance Framework (MPF):** a set of best practices and process guidelines for fair valuing corporate entities and intangible assets for financial reporting purposes; and

**The Certificate in Entity and Intangible Valuation (CEIV):** a certification to be earned by valuation professionals who wholly understand and embrace these standards in their work product.

The main goal of these efforts is to improve the overall quality and integrity of valuations, leading to greater investor confidence and further increasing investors' asset allocation into the private capital market space.

### What is the Mandatory Performance Framework (MPF)?

The MPF outlines best practices concerning the level of rigor that must be documented throughout a valuation performed for investor reporting purposes. The goal is to provide clear, consistent support for the inputs, analyses and assumptions that substantiate the conclusion of fair value. This includes challenging, testing and documenting any subjective decisions made throughout the valuation process.

Some examples include substantiating the use of financial forecasts provided by management, the adjustments made (or not made) to inputs, the comparable public companies selected (or not selected) and more. This level of analysis must then be applied consistently across all similar assets in your portfolio.

While not explicitly required of non-CEIV holders, the MPF guidelines are considered to be best practice and the new industry benchmark against which practitioners will be measured.

#### Items that must be documented under the MPF include:

- The source data and documents that were collected to inform the valuation. The cited source of this information and its use within the valuation (or the decision not to use it) must be explained and the artifacts must be included in the work papers. Data sources covered by this requirement include interview notes, guidance from the management of the portfolio company, financial statements, external data sources, industry research and competitor information.
- A discussion of any evidence throughout the valuation process that is contrary to the conclusion of value.
- A summary describing the qualifications of the valuation professional responsible for the conclusion of value.
- Documented support for all assumptions or decisions made. The quantity of documentation provided to support a given assumption or decision should be directly proportional to its significance and its impact on the final conclusion of value.
- Proof that the organization upheld the same standards of analysis and documentation for both internal valuations and those conducted by valuation service providers.
- The rationale under which guidance from management was either accepted or adjusted must be documented. (This is most commonly attributable to prospective financial information.)
- A calibration of an investment's transaction price to its fair value at the time of acquisition.

## What is the Certificate in Entity and Intangible Valuation (CEIV)?

To indicate expertise in valuations, a new credential has been created that identifies an individual as being Certified in Entity and Intangible Valuations (CEIV). The prerequisites required to obtain the credential are extensive and it is presently unclear which industry participants will be expected to obtain the credential.

As things currently stand, the credential is specifically targeted towards those performing valuations that will affect public company financial statements and it appears that it will be embraced first by those providing valuation advisory services. However, many people in the private capital markets expect that adoption across all industry participants will rise over time as firms respond to auditor pressure to accept and incorporate the MPF guidelines into their valuation processes.

To obtain the credential, an individual must either demonstrate extensive experience in valuations or earn a certification from either the AICPA, ASA or RICS. Once complete, he or she must then satisfy a number of additional criteria, including:

- 3,000 hours of direct valuation experience within the past five years
- Educational requirements that include both one-time and ongoing components
- A passing grade on the certification exam, which covers audit requirements, the market environment and the MPF standards

By obtaining the CEIV credential, practitioners are committing to conduct each valuation that they perform according to specified guidelines, following the processes outlined by the Mandatory Performance Framework and the VPO credential that you hold. If there is any disagreement between the two, the standards of the VPO are to take precedence.

## How does the Fair Value Quality Initiative affect General Partners?

Many General Partners want to know how the Fair Value Quality Initiative will impact their operations now and in the coming years. While much of this is still in flux, we believe that a few principles are clear:

- 1 Service providers must deliver a higher level of rigor when producing independent valuations.** As things currently stand, the largest burden falls upon the providers of professional valuation services. These individuals have the most to gain from the CEIV, as the accreditation provides a level of confidence in the services that they provide. In turn, this will require accredited valuation service providers to conduct additional analyses and produce a deliverable that reflects this higher level of rigor, in line with the MPF and guidance from the AICPA. This is expected to become the norm throughout the industry.
- 2 Current valuation procedures and documentation requirements will need to be re-evaluated.** With an increased regulatory focus on valuation processes, there will be pressure to adopt these best practices. In addition to the guidance that the MPF provides on documentation, the AICPA is expected to release scenario-based “how-to” valuation guidance in 2018 that will further clarify the appropriate and inappropriate approaches to specific types of instruments and valuation scenarios. This will drive further standardization and improvements in how assumptions should be documented, helping both valuation professionals and practitioners to produce more defensible and repeatable valuations for financial reporting purposes. However, holistic adoption of this guidance will require individual firms to re-evaluate any unique adjustments or approaches followed, as bespoke and inconsistent approaches will raise concern from reviewers.
- 3 The adoption of MPF guidelines as best practice will lead to changes throughout the private capital markets network.** As General Partners and their service providers spend more time digging into the assumptions that exist within each valuation, it is clear that they will need to capture more data and supporting documentation to allow for greater analysis and a clearer rationale for the decisions made throughout the valuation process. The likely result of implementing these more robust guidelines will be an increase in the scope of data requests that institutionally funded private companies receive. As the amount of data obtained by general partners increases and the adoption of these more rigorous valuation standards spread, the ability to collect and manage this data will become even more important and relevant. Additionally, as General Partners obtain more data, Limited Partners will likely come to expect a more robust data set of the underlying investments, including valuation metrics both the time of acquisition and current.

In this dynamic landscape, you need a partner that can help guide you through these changes and provide the tools that you need to scale your existing process to meet these enhanced standards. IHS Markit Private Capital Markets can help your firm manage this transformation, with industry expertise and a suite of products that support your enhanced data collection, valuation and reporting needs.

Further reading: <https://ceiv-credential.org>

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