Auditor Tips For a Smooth Year-End Audit of Valuations

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This is the last article in a three-part series where we share our experiences and conversations with Big 4 auditors. In previous articles, we asked them to describe their areas of anticipated focus in the 2017-2018 audit and identify the factors that trigger additional scrutiny for Topic 820 valuations.

Here, we share their tips for easing the process of YE audit cycles, managing the expectations around it, and ensuring a smoother year-end:

For large and unusual investments, reach out early

The legacy thought process for investments outside the norm is to discuss them towards the tail end of the audit, with hopes to 'get one by' the audit team. That's not a good strategy.

Instead, the Big 4 auditors we spoke to recommended identifying the big and the bold and discussing them with your audit team early on. Keep close tabs on investments that comprise over 10% of your fund/portfolio, or that have unusual aspects, which includes those that have pending investments/LOI, significant growth/decline in value or outlook, potential IPOs or exits on the horizon, conflicting internal opinions on value, or anything else that's out of the ordinary.

If you identify them upfront, you and the audit team can spend time collaboratively defining the best path forward. Remember, you not only have to get these investments through the audit this year, but for the following years as well.

Reconcile approaches with consistent and proper rationale

The auditors we spoke to advised using at least two methods or approaches to value (except in cases where only the prior transactions (backsolve or post money) can be relied on). In cases where the company's financials are significant enough to apply additional methods, spend time reconciling the values from each method. If you have diverged values from two different approaches and you reconcile them just by weighting them, it will stand out. At the very least, include a rationale for the divergence and explain why you relied on one or the other or the combination. In cases where you are concluding on value based on a combination of approaches, it would be prudent to justify your rationale for weighting each method.

Build a strong but flexible internal valuation policy

A valuation policy does not have to be a book or pages and pages of 'ifs' and 'buts.' It simply has to be a repository of rules and guidelines you follow when valuing your investments. It would be most prudent to include thoughts from GPs, auditors, valuation experts, and perhaps even LPs while creating this repository.

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There are two important points that many firms fail to consider, but which should be included in your valuations policy:

✓ **Define the buckets.** Clearly define how you will segregate your investments. You may choose to segregate them on the basis of holdings value, revenue, prior valuation, or another factor. But whichever basis you use to start separating the investments, make sure it's well documented in your valuation policy, and includes a clear outlined path that shows how your team will value each of the defined categories or types of investments.

✓ **Think about the future.** Almost all the auditors we spoke to agreed that this piece is missed in most valuation policies - probably because it's easy to omit. When we are in the thick of year-end audits, we get tunnel vision and focus solely on the current year statements and valuations. But how will we value our investments next year? If we make certain subjective adjustments this year to make our valuations work, how will those judgement calls affect the valuation next year? What if the company receives new funding in six months with a significant uptick in valuation? How will that be reflected in next year's audit, and will that information be consistent with this year's valuation?

Document everything in detail

The auditors we spoke to couldn't say this enough: document. Document everything. Document often. After you have finished running 20 or 50 or 300 valuations, it is extremely difficult to recall your rationale for individual investments unless the documentation is there to remind you. Many of the assumptions you make while performing valuations seem trivial, and it's easy to omit them while documenting your rationale. But this is a recipe for trouble later on when you are conducting final reviews with your audit team. Hence, documenting each and every assumption, however minute, is important. (Did we say document?)

Know your audit team's food preferences

We saved the best tip for last. Audit is a process. It may not be cool or enjoyable, but it needs to be done—every year. Working with internal and external teams that are happy will make things easier. One of the easiest ways of ensuring the team is happy is to keep them well fed. Preferably with food of their choice…

That's it! In this series, we discussed what auditors will be looking out for in this year's audit, what triggers additional scrutiny on valuations, and, finally, how to get through this year's audit cycle smoothly.

Hopefully, this series has helped lift the veil from both the audit process and the auditor's thought processes.

Happy New Year, and we hope you have an uneventful audit!

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