Valuation committee meetings: more voices around the table

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From good to great

The sophistication of valuation committees has advanced leaps and bounds over the last five years, but **EisnerAmper** director **Craig Ter Boss** says that best practices are still evolving as managers look to further enhance stakeholders' trust in their valuation processes

Once informal meetings between portfolio managers and perhaps an impromptu recruit from the back office, today's valuation committee meetings have become much more sophisticated—a testament to how far funds have come in deriving the fair value of assets.

Some of this can be attributed to fund managers constantly reviewing and fine-tuning their practices to confidently estimate the worth of their portfolios, an outcome developed after decades of portfolio monitoring experience. But to Craig Ter Boss – who has witnessed the evolution of valuation best practices over a career spanning 20 years in the industry – it's mostly a result of LPs demanding more robust and transparent valuation practices, as well as regulatory pressure, which is forcing funds to formalize their valuation policies and procedures, document it all for recordkeeping purposes and share it with inspectors and auditors.

"The make-up of the valuation committee itself is testament to how far the industry has come," says Ter Boss, a New York-based director with EisnerAmper, the accounting, consulting and tax services firm. "The fair value estimate used to be somewhat informally determined by the portfolio managers – but now many firms have structured committees in place with detailed valuation policies and procedures to follow."

Still, the formation of polished valuation committees – comprised of a mix of characters to provide a sense of checks and balances over the process – is still a relatively new phenomenon in the private funds universe, Ter Boss notes. Accordingly, there is still room for improvement, with one area involving funds' most treasured relationship: that of LPs.

The watchmen

"It wasn't always the case that investors presented a host of questions on valuation," says Ter Boss. "In the past, it was all about performance – but over the course of five or so years, LPs started asking more pointed questions about the firm's operations, including the back office and the way valuations are performed."

This has been mostly limited to LPs' pre-investment due diligence, Ter Boss continues. A limited partner advisory committee is often responsible for reviewing quarterly estimates, but generally speaking, LPs tend to ease the brake on valuation oversight once the investment is made – either because of limited manpower or developed trust in the manager.

"That's beginning to change. We're seeing more LPs periodically review any changes to the managers' valuation policy, asking managers to perform back-testing and disclose more information on the valuation inputs. Most interesting to me, however, has been non-investment personnel having a more active involvement on the valuation committee itself."

While it would be odd to see an LP take a seat amongst portfolio managers during the valuation committee meeting, more realistic is the creation of a limited partner advisory or risk committee to establish "a sense of oversight" over the valuation committee, says Ter Boss.

The objective, he continues, is for the LP to regularly monitor whether the fund follows the valuation procedures promised during the pre-investment due diligence. Reviewing the valuation committee minutes is one way to fulfill that objective. Accordingly, the GP – or whoever is in charge of the valuation committee – should keep detailed minutes and document them thereafter, advises Ter Boss.

Items to document should include: any deviations from the valuation playbook; additions or removals of companies that are part of the comp stats; changes to the weighting of valuation methods used; and revisions to the valuation handbook itself, among other items.

But funds, take note: a good valuation committee is more than just strong recordkeeping practices – "you have to have the right people involved in the process too," advises Ter Boss.

Mixed cast

As alluded to earlier, valuation was historically a practice left to portfolio managers during irregular, informal meetups. Prior to the introduction of FAS 157 (now known as Topic 820), firms could hold an investment at cost during the initial years of ownership, reducing the need for formal valuation policies and procedures. CFOs were not necessarily excluded from the process, says Ter Boss, but their role was limited in the valuation process.

Indeed, today a valuation committee consisting solely of deal partners or investment personnel is a red flag to investors and regulators alike, Ter Boss continues.

"It's a conflict of interest issue. Having different voices from different divisions within the firm on the committee achieves an appropriate level of checks and balances. Deal partners may overvalue their pet projects. Or on the other side of coin, act too conservative when estimating value in order to manage investors' expectations. The CFO or some non-deal partner can be that independent voice pushing for true discovery of fair value."

Ter Boss: a witness to valuation evolution

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Including a representative from the compliance team on the committee is a best practice too, says Ter Boss. Following increased oversight powers, regulators and inspectors have made valuation a priority during exams. Officials from the US Securities and Exchange Commission specifically are seeking "adequate documentation on how marks were being calculated, and why certain assumptions were being made during the valuation process," says Ter Boss. A representative from the compliance team on the valuation committee can serve as a safeguard that those requirements are being met.

Indeed, CCOs have stressed to *pfm* in the past that one of their key responsibilities is also to keep investor relations and marketing staff as far away from the valuation process as possible (for obvious reasons related to conflicts of interest).

Ter Boss concludes by noting there is no fixed set of criteria a GP can follow to achieve a best in class valuation committee. "Each firm, regardless of size, will have to undergo an assessment of their internal resources and staff to determine what works best for them." Even something like "how regularly the committee meets will vary" with some firms "meeting on a quarterly basis" whereas others may hold "monthly meetings that resemble a valuation committee-lite," says Ter Boss.

What firms will not want to do is present stakeholders with a valuation committee or valuation process that resembles what normal practice was five years ago. According to Ter Boss, valuation best practices have accelerated quickly in that short five-year time span, and do not appear to have hit a wall just yet. ■