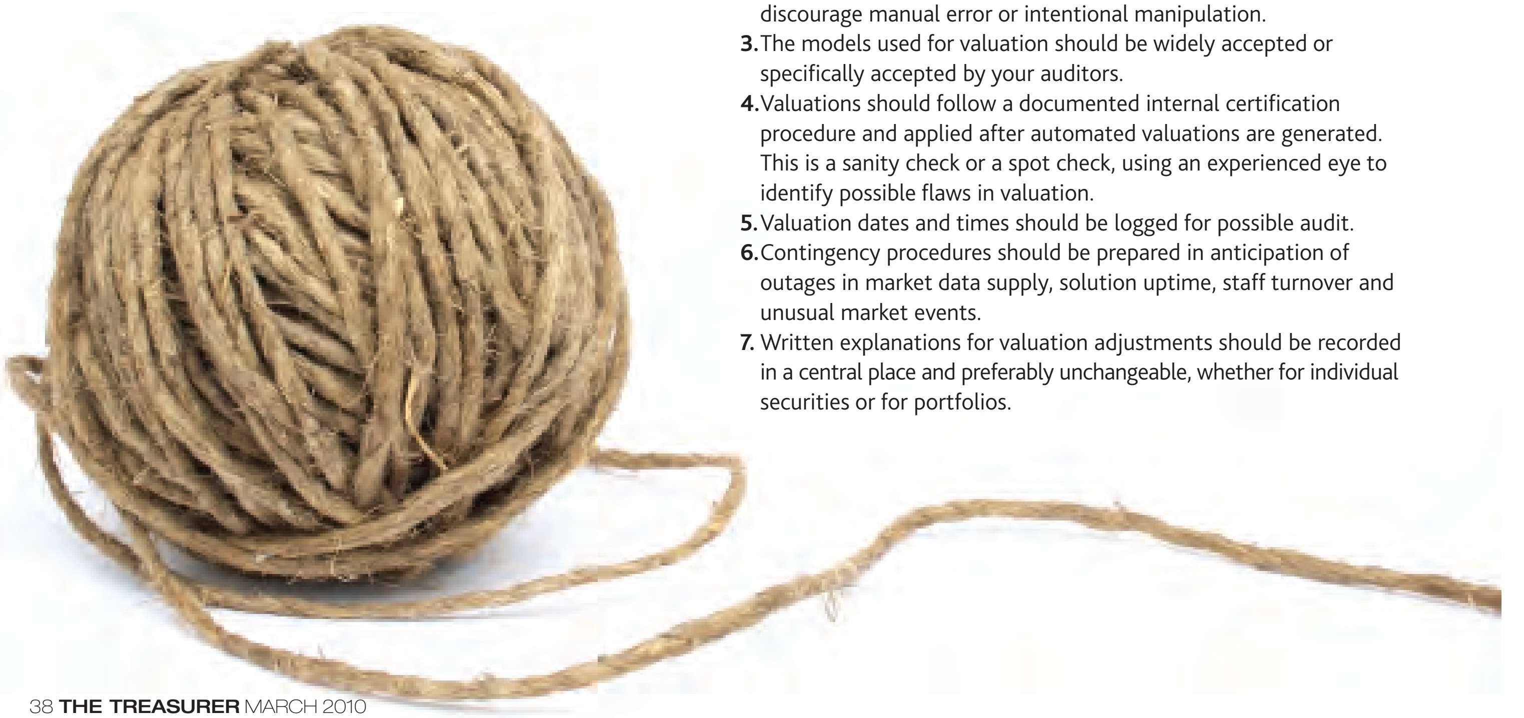
The seven pillars of valuation

ROBUST VALUATIONS TRANSLATE INTO HIGH-QUALITY CORPORATE FINANCIAL STATEMENTS THAT ENSURE THE REPUTATIONAL INTEGRITY OF THE BUSINESS. **BOB PARK** OUTLINES THE SEVEN KEY PROPERTIES OF AN EFFECTIVE VALUATION PROCESS.

With today's increasing demand for transparency and accountability, an examination of your valuation process through the lens of key attributes is worthwhile. Reputational risk varies inversely with the quality of your financial statements, both for your company and yourself as a treasury professional. Having an explicit, well-documented process in place to audit-proof reported valuations is the treasurer's key to a strong reputation for transparency. If audit is the gateway, then transparency is your passport. Having passage denied, even if later fixed, is a matter of reputation and goodwill to all users of your financial statements.

If you hold financial instruments that must be valued to report gains and losses, hedge effectiveness or make off-balance-sheet disclosures, a robust valuation process can contribute to transparency. Although the valuation process ultimately depends on your portfolio holdings (more exotic issues may require more documented reasoning for valuations), there are seven simple and practical steps you can take to increase reliability and decrease valuation risks:

1. Your source of market data should be widely recognised and above reproach.
2. The methods for obtaining your market data and calculating valuations should be consistent and as automated as possible to discourage manual error or intentional manipulation.
3. The models used for valuation should be widely accepted or specifically accepted by your auditors.
4. Valuations should follow a documented internal certification procedure and applied after automated valuations are generated. This is a sanity check or a spot check, using an experienced eye to identify possible flaws in valuation.
5. Valuation dates and times should be logged for possible audit.
6. Contingency procedures should be prepared in anticipation of outages in market data supply, solution uptime, staff turnover and unusual market events.
7. Written explanations for valuation adjustments should be recorded in a central place and preferably unchangeable, whether for individual securities or for portfolios.



1. YOUR SOURCE OF MARKET DATA. Market data is the lifeblood of your valuations based on observable inputs. The transparency of these valuations depends on the credibility of the input data. Using a trusted, well-known name for market data establishes a firm basis for valuation changes. Market theories impound expectations into valuations for speculative and investment purposes, but if your valuations are for reporting mark-to-market, testing hedge effectiveness or evaluating internal position, your report must reflect immediately observable changes, whether or not a market is in theoretical equilibrium.

Market data is therefore right at the heart of your reportable valuations and it must be trustworthy and reliable. The objective is to make your valuations as good as observable, as if your instruments were being quoted directly in a reasonable exit transaction with a willing buyer.

2. THE METHOD OF OBTAINING YOUR MARKET DATA. Reliable automation increases consistency. If a system has been built to source market data the same way every day and faithfully does so, exceptions should be rare.

Possible exceptions include problems with the market data itself such as reversed exchange rates, technical issues such as server outages, or unanticipated extreme values that cause validation rules to be triggered or cause models to fail.

The reliability of market data depends on the original source of that data, which may be your system vendor or a third party. Either way, it is important to establish that the source is credible (that is, widely accepted in the industry or specifically accepted by your auditor), and the method of obtaining it is consistent. Disruptions in data supply can delay the availability of your valuations and can create exceptions that prompt questions from your auditor. For example, you may end up creating manual valuations for a particular period if your data supply is interrupted.

Although technical exceptions can never be fully avoided, your data provider's service level agreement should be examined closely and your valuation risk from an outage should be carefully evaluated before it ever happens. It is even better to have contingency processes in place. In the case of extreme values, the burden falls on the accepted models or calculation approaches to those models, and not the operational method of data acquisition. A mitigation strategy for extreme values would be to understand what validation rules

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HOW LIKELY IS IT THAT YOUR NORMAL VALUATION PROCESS WILL FAIL AT SOME POINT? NO AUTOMATED PROCEDURE IS PERFECT AND THE QUESTION IS NOT IF BUT WHEN AN OUTAGE OR FAILURE WILL OCCUR. WHAT WILL IT COST YOU IF YOU LOSE YOUR ABILITY TO PRODUCE ACCEPTABLE VALUATIONS ON TIME?

your data provider has in place, if any. Ask your vendor to identify the process for monitoring extreme values – whether they arise from error or actual market events.

3. MODELS USED IN VALUATIONS. The models for valuing the most common financial instruments and derivatives are commoditised to some extent. More exotic models and the software approach used to provide those models is therefore a key differentiator for valuation software providers and outsourced valuation experts who use vendor software.

In some instances, valuation providers use their own proprietary analytics. In this situation, the proprietor's reputation and credibility are relied on to uphold the validity of the models used, especially if they differ significantly from the norm. However, the more exotic the instruments being valued, the more specialised becomes applied expert opinion. In the end, the user of the model must have confidence in it. Confidence can be gained by using analytics providers that have documented the model and assumptions, and are willing to answer any and all questions related to the valuations. The specific methods used to generate valuations must survive your own scrutiny before they can stand up to an auditor's thorough hand. In many cases, model validation may need to be done with an additional third party to get auditor sign-off.

Certification is used regularly in software development. The idea is to deem packages of software code ready for promotion to their next stages, or to fail them on the basis of known standards. Final products thereby have built-in assurances of consistency and due attention to removing flaws.

The right tools lead to right valuations. A strong solution consists of reliable reference market data, proven analytics and explainable methods. A solution can pass audit on vendor reputation or clearly explainable, acceptable processes and inputs. Solutions that have already been proven to auditors are a proven path to the required transparency.

4. INTERNAL CERTIFICATION OF VALUATIONS. The applicable analogy for performing financial instrument valuations is to establish tests for validity and either to test valuations exhaustively or through sampling for each reporting period. This practice can increase process transparency and heighten the stringency of your valuation practices.

Just documenting a certification procedure and following it can make you more audit-ready, especially if you have a high volume of valuations to report. Creating a tiered sequence of sign-offs in the valuation process can alleviate concerns with valuation tampering or unintended inaccuracy. For each stage in the valuation process, an explicit sign-off can be recorded before promotion to the next stage, for ultimate sign-off on financial statements.

An example would be having the front-line valuation analyst, often a treasury analyst, review and sign off on the initial valuation to certify first-hand review and the absence of any irregularities in business-as-usual valuations. A second level of certification can include a higher-level manager's signature, indicating that the valuations look reliable according to their best judgment, and that an effort has been made to explain any unexpected results.

The layers of internal certification can reach as high as your practice deems necessary, including all the way to the final financial statements. The process should be applied consistently and recorded so that it can be examined if necessary.

Following a tiered approval process as part of regular operations will increase your transparency without much additional effort. Even if a final valuation is questioned, an auditor will have to challenge all your documented efforts to make their case.

5. VALUATION LOGS. As with every business procedure, it is better if an audit trail can be left. As always, this is a balancing act between traceability and expediency. A log of valuation times can answer questions about valuation disparities, for example, when using market data from different sources. If intraday volatility has increased sharply and suddenly, and you and your auditor are using two different data snapshots taken at different time points, then using the same models may still give you different valuations. When portfolios contain valuations of different instruments at different times, logged valuation times can be invaluable for tracing portfolio impacts of individual securities.

6. CONTINGENCY PROCEDURES. Even when your valuation process is humming along efficiently, you're not done yet. How likely is it that your normal valuation process will fail at some point? No automated procedure is perfect and the question is not if but when an outage or failure will occur. What will it cost you if you lose your ability to produce acceptable valuations on time?

Keeping written manual procedures for backup purposes is recommended. You should back-test your contingency procedures with your main, mostly automated valuation process to mutually verify the results.

One common pitfall of contingency planning is to set up full contingency procedures but never to test them. Environments change, people change jobs, hard drives have an implicit best-before date and network reliability is never 100%. An untested contingency plan can unwittingly turn out to be the same as no contingency plan. Test your contingency plans one per year, to identify vulnerabilities and to practise so that you can react instantly and effectively when the need arises.

7. WRITTEN EXPLANATIONS With an automated valuation system in place, or an outsourced valuation provider on your side, it is tempting to skip over explanations of valuation adjustments. Although the validity of bulk adjustments to instrument valuations in a portfolio is objectionable from some perspectives, it is a "better than nothing" approach that can pass muster.

For example, most financial professionals would agree that simply adjusting a valuation by a raw absolute or percentage amount sounds pretty arbitrary, even if the adjustment is designed to address, say, counterparty credit risk that was previously unheeded. However, if the adjustment represents a best-effort reflection as opposed to no attempt to reflect specific risks that have not been impounded into the raw valuation, then a record of your reasoning can at least dampen any impression of sloppiness or neglect towards the issue. It's all the better, then, if explanations are kept directly with valuation records and cannot be changed.

TRANSPARENCY SCORECARD. Although there is no formal definition for a perfect valuation process, the FINCAD derivatives transparency scorecard can provide an assessment of a corporation's valuation process maturity and provide certain process attributes that can be promoted to strengthen credibility and reliability, answering the call for higher transparency.

If your process is deficient in any of the areas examined, then perhaps it's time to consider addressing them before a valuation risk manifests itself. The basic awareness of what makes a strong valuation process will pave the way for eliminating vulnerabilities in the process in your business and strengthening advantages that you can refer to under scrutiny.

There are no guaranteed processes for perfect valuations, but following the seven thematic steps outlined in this article will remove doubts and make your valuations stand out as reliable.

Having these steps in place will give you a documented reference to fall back on under scrutiny and a baseline process that can be explicitly modified or expanded if your auditor requires improvements. These explicit conditions are a far cry from ad hoc or unclear valuation operations that have to be explained or modified under audit conditions.

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