

Best Practices for Determining Fair Value

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It's unheard of for an accounting standard to stir up so much debate. First, the debate focused on its role in the 2008 financial crisis. Now the debate continues as private equity funds prepare to register with the SEC under the Dodd Frank Act. Layer on the report issued in September 2010 by the Public Company Accounting Oversight Board that hit the audits of the financial industry hard and called on auditors to step up review of fair value estimates.

What are some best practices to follow?

Create disciplined valuation governance. Fund managers should stick to a well-documented valuation policy that provides oversight to the process, beginning with a manager's initial assessment of fair value and ending with the board's approval.

Apply consistent valuation methods. Fair value fluctuations should not be due to methodology changes so it is imperative to establish from the outset methods that can be easily updated and replicated over time.

Prepare a thorough valuation report. Readers need to understand the entire valuation story, including key assumptions and methodologies, transaction background, security terms, portfolio company performance and their impact on fair value.

Provide observable market data. The inherent value uncertainty of private investments begs for observable market data such as valuation multiples of selected sale transactions, or of comparable public companies, to support management's significant judgments.

What is the takeaway? It is critical for fund managers to provide well supported analyses of fair value. Otherwise, in this atmosphere of heightened scrutiny they may spend more time than desired with auditors, boards of directors and investors on fair value issues.

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