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DUE DILIGENCE IN THE NEW REGULATORY REGIME



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PREPARING FOR AN AUDIT OF YOUR VALUATIONS IN THE NEW REGULATORY REGIME

The 2008 financial crisis continues to drive major change in the regulatory landscape. More stringent requirements for disclosure, oversight and control are shaping how business is conducted and what is demanded of buy-side and sell-side firms.

Nowhere are the changes more impactful than in valuations. Transparency into the underlying methodologies and assumptive drivers that determine evaluated prices is key to addressing the new requirements. But preparing for an audit of your valuations entails more than just transparency. It requires an understanding of the regulatory climate as well as ensuring that senior management, compliance, risk, accounting, legal, pricing and other groups are aware of their responsibilities and possess the knowledge, training and resources to execute those responsibilities. And it means taking preemptive steps to prepare for what will no doubt be an extremely comprehensive audit process.

UNDERSTAND THE REGULATORY DRIVERS

The Sarbanes-Oxley Act of 2002 (SOX) was enacted to improve controls over financial-risk reporting and restore investor confidence following the fraud and accounting issues revealed in the collapse of Enron, Tyco, Worldcom and others. It set in motion a stream of enhanced oversight and accountability requirements, including making senior management ultimately responsible for the accuracy of financial statements. SOX also established regulatory oversight entities to monitor adherence to these new obligations.

One such entity, the Public Company Accounting Oversight Board (PCAOB), polices auditors of public companies to ensure "accurate and independent audit reports." Overseen by the SEC, the primary "Sergeant at Arms" for most regulated entities, the PCAOB is tasked with overseeing auditing standards, conducting inspections and ongoing enforcement of audits of publicly registered firms.

With the adoption of FAS 157 in 2007, the Financial Accounting Standards Board (FASB) sought to bring uniformity to the definition of fair value used in various accounting and reporting standards. Now known as Topic 820, this Fair Value Measurement became effective just as the financial markets were entering a severe crisis fueled primarily by unprecedented defaults in mortgage- and asset-backed securities.

Recognizing that capital charges, margins, spread and basis risk, volatility, counterparty risk and other inputs rely on asset valuations, the SEC and PCAOB continue to raise the bar for disclosure and documentation around the valuations process as established by Topic 820. In particular, they are increasing scrutiny of auditors and the evidence collected and documented to support their audit opinions. This means that both the SEC (via its own examination staff) and public accounting firms' auditors will be demanding more transparency and disclosure to achieve compliance. With greater emphasis placed on due diligence, auditors are requiring companies to document and support how valuations are determined before they will sign off on financial reports.

As a result, companies are spending a great deal of time to deliver documented audit trails, independent valuation inputs, additional supporting data and detailed disclosures for pricing decisions. Firms should also be prepared to explain processes and valuation dynamics to both auditors and regulators, who may not have experience with or a deep understanding of those elements.

The cost and time implications of enhanced due diligence and reporting are significant; but the risk of noncompliance is greater, as it can negatively impact a company's financial stability and reputational integrity.

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QUEST FOR TRANSPARENCY

Transparency has become the holy grail of valuations. Organizations seek information as “evidence” and/or protective “armor” for audits. Obtaining and providing transparency into the underlying assumptions and inputs that drive evaluated pricing – and being able to substantiate prices to regulators, auditors, stakeholders and end users – is a key element of the ongoing valuation due diligence process.

Valuations of securities are often obtained from independent third-party providers. However, responsibility for valuations cannot be delegated. It falls squarely on the shoulders of senior management, who are ultimately accountable for the accuracy and reliability of financial statements.

The SEC and PCAOB effectively require companies to perform on-site due diligence by “walking the floor” of their valuation providers to understand the process, inputs and methodologies used to determine prices. Providers are expected to cooperate by explaining and demonstrating their models, processes and methodologies.

To provide structure and consistency to the valuations process, Topic 820 requires firms (reporting entities) to allocate assets to one of three predefined levels based upon the nature of inputs to the valuation. This process is straightforward for most exchange-traded instruments, which are generally classified as “Level 1” (direct observations for the target instruments are readily available). However, the waters get murkier and auditors dig deeper when valuing “Level 2” and “Level 3” securities. Level 2 describes assets whose valuations are not based on identical assets and/or the market is inactive. Level 3 instruments are typically illiquid securities whose valuations are not based upon observable market inputs – direct or indirect observations. Instead, Level 3 instruments have valuations based on internal assumptions that lead to relevant price drivers.

Relying solely on third-party vendors to value these hard-to-price assets will not fully satisfy audit standards of proof. It is here where expertise makes the difference, putting the “art” into the “science” of determining valuations. While judgment is often required to counterbalance the lack of information available for illiquid securities, auditors will be digging deep on Level 3 securities. A pricing service that provides transparency for the inputs and techniques used to value illiquid and harder-to-value securities (e.g., credit-sensitive bonds and CLOs) will greatly facilitate auditing.

DEMAND MORE FROM YOUR EVALUATED PRICING PROVIDER

Transparency is critical to understanding the dynamics, inputs and challenges of evaluated pricing. But the ability to demonstrate that sound due diligence procedures have been fully executed is equally important. Vendors that cannot adequately meet the heightened due diligence and documentation required expose all participants, including shareholders, to risk.

With so much at stake, companies can and should expect more from their pricing and reference data providers in the way of clearly defined processes, documentation and an auditable justification of prices. This also includes being apprised of pricing methodology, policy or other changes in a timely fashion.

On a daily basis, pricing vendors typically provide security identifiers and a price. The SEC’s and PCAOB’s increased emphasis of auditor review of fair values means more information will be required, including but not limited to specific security details such as ongoing performance data, trade history, rating actions and market color. Buy-side firms face critical daily time pressures in determining net asset value calculations that much of this information may seem extraneous. This is where delivery tools are important, enabling clients to pull down additional security information if necessary. In the spirit of full transparency, it is critical for pricing vendors to work with their clients through due diligence meetings and supplying the necessary additional information in a timely fashion.

BEING PROACTIVE

As the new regulatory regime takes hold with increasing requirements for due diligence, transparency and disclosure across a wider audience of participants, firms can expect a continual learning process for all involved – from reference data providers to internal auditors to regulators – regarding what information is needed. Although some uncertainty may exist, what is clear is that the old “nice to haves” are now basic requirements.

Companies that take preemptive action to meet the new standards will be better positioned to mitigate the time and cost impacts. Further, they will avoid the reputational consequences that result from “flawed” strategies that are poorly constructed, poorly reviewed, poorly executed and poorly monitored.

Preparing for an audit of your valuations should begin with an internal assessment of your company’s policies, procedures and controls. Consult with compliance, risk, accounting, legal and business units to review and update pricing policies and to ensure new regulations are captured in the group’s policies. Identify key internal and external inputs to the valuation process. In particular, confirm that proper controls and best practices are followed when pricing the hard-to-value securities.

And document everything; a representative from the SEC speaking at an industry conference recently said “if it isn’t documented, it didn’t happen.” Being able to justify valuations to auditors and regulators is paramount. Have copies of internal audit reviews and reports ready for examination and ensure relevant supporting materials (e.g., meeting minutes, designated approvers, pricing committee reports) are accessible. Additional best practices to prepare for an audit of your valuations include:

- Examine exceptions and price overrides to check proper support and approvals are evidenced
- Confirm back-testing (trades vs. vendor prices) is up-to-date and properly documented
- Segregate duties between business and valuations personnel
- Perform and document a regulatory update process to ensure that processes, systems and controls provide the required levels of information and support
- Perform on-site annual due diligence of your evaluated pricing vendor to ensure a current understanding of their systems, methodologies, models, processes and controls for price determinations
- Consider an independent review for all internal valuation policies and related controls

Throughout the process, maintain a regular and robust flow of information to senior management, auditors and other constituents.

CONCLUSION

The dynamics of the market will continue to drive regulatory change, impacting the type and amount of information firms are required to provide to regulators, auditors and stakeholders. This is no time for complacency, be proactive. Reach out to your evaluated pricing vendors to learn about their processes, models and assumptions. Educate auditors so they understand the input criteria that influence fair value. Communicate with senior management and shareholders. Imbue your operation with a “culture of compliance” that provides a greater level of end-to-end control, support and transparency.

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- Symbol Cross Referencing
- Time Series Pricing
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TIMELY – We offer end of day delivery of prices in linewith a wide range of market closes and we offer intra-day pricing. We are continuing to expand this capability and have a proven record of responding quickly to client requests.

DATA COVERAGE – We provide access to timely, superior quality data sets covering every asset class globally.

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