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Will SEC Quants Jump from Funds to Public Companies on Valuation Issues?

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With great fanfare over the last several years, the SEC has been highlighting the role of new enforcement tools in generating cases. In particular, the SEC has credited its Asset Management Unit and a quantitative tool called the Aberrational Performance Inquiry (API) with helping to identify and pursue private equity, mutual, and hedge funds for alleged violations involving asset valuation.

The SEC has signaled that it is using the same types of task force-based, quantitative-driven tools in the public company arena. For example, much as it established the specialized Asset Management Unit in the fund adviser area, the SEC created the Financial Reporting and Audit (FRAud) Task Force to focus on public company financial reporting issues. The public company algorithmic analog to the Asset Management Unit's API is the much-heralded Accounting Quality Model (AQM or "RoboCop") tool, which combs through public company filing data to identify red flags of various sorts. In a September 2013 speech, then-SEC Enforcement Director Andrew Ceresney pointed to a particular case as evidence of things to come in this area: an enforcement action against a publicly traded company alleging fraudulent valuation of portfolio holdings. Mr. Ceresney suggested the FRAud Task Force and AQM had "plenty more in the pipeline."[1] After more than 18 months, many observers are eager to learn whether the SEC is poised to bring valuation actions against public companies.[2]

While its impetus—the AQM, the FRAud Task Force, or something else—has not been disclosed, the public company valuation case that Mr. Ceresney referred to in 2013, *In the Matter of KCAP Financial, Inc.,* was "the SEC's first enforcement action against a public company that failed to properly fair value its assets according to the applicable financial accounting standard—FAS 157."[3] In it, the SEC settled charges against three executives for allegedly overstating the value of certain debt securities and collateralized loan obligations held

KCAP is only the latest case in a series of recent SEC enforcement actions against investment advisers/managers:

- London-based hedge fund adviser GLG Partners paid nearly $9 million to settle charges that it overvalued a fund's equity stake in an emerging market coal company.
- In an ongoing case, Millennium Global Emerging Credit Fund's portfolio manager allegedly overvalued the fund's returns and net asset value, conspiring with a broker to use fictional prices for two of the fund's illiquid securities holdings.
- ThinkStrategy Capital Management LLC's manager allegedly inflated the fund's assets, thus far leading to a $5 million civil judgment in January 2013.

by one of the company's investment portfolios. The SEC alleged that the company—both public issuer and investment adviser—improperly concluded that any trades of debt securities held in the fourth quarter of 2008 reflected "distressed transactions." Rather than use those prices to value the debt securities, the company employed an "enterprise value"[4] methodology to value them and valued other investments at cost. The SEC found that the debt valuations caused KCAP's net asset value to be overstated by approximately 27% as of year-end 2008. As a result, the SEC alleged a host of reporting, books and records, and internal controls over financial reporting violations, and the company executives agreed to pay $125,000 in combined civil penalties.

One thing that distinguishes the SEC's case against KCAP from those it brought against other investment managers/advisers is that the filing entity is also a public company. Whether with help from the new tactics and tools or in reliance on old-fashioned forensics, the SEC may be preparing to bring other public company valuation cases. To help protect themselves from being targeted, issuers can learn from the SEC's much more active presence in the investment advisor asset valuation area.

In the fund advisor space, two valuation issues stand out as receiving particular attention from the SEC. First, the SEC strongly disfavors stated valuation policies that differ from actual valuation practices. This divergence between policy and practice can occur either because the valuation policies are simply verbatim recitations of accounting standards without any specific applicability to the assets held or because asset classes held by the company have changed over time, making the once accurate policy out of date.

Second, the SEC has repeatedly found fault with valuations that fail to adequately adjust in the face of changed market conditions. Such valuations may reflect the use of stale market data, abuse of discretion in making valuation judgment calls, or an absence of procedures for correcting or adjusting values.

Public companies can best avoid the valuation problems faced by many in the investment adviser space by employing best practices in accounting and valuation.

Relevant Accounting Standards

At first glance, it would seem that the accounting rules are clear: market transactions are the best measure of value. Section 820 of FASB's Accounting Standards Codification (ASC) requires that certain financial assets and liabilities must be recorded at fair value. The process is straightforward for securities actively traded on an exchange or other public market. The market price reflects the fair value. Under GAAP the use of such market prices reflects Level 1 inputs—the most credible. For securities that are not actively traded, inputs for measuring fair value may still be directly observable. This would be the situation if similar, but not identical, securities were actively traded. The prices of such securities would be classified as Level 2 inputs. When neither of the above scenarios applies, and prices for both identical and similar securities are not directly observable, fair value must be estimated, using an acceptable methodology. These fair values should reflect the perspectives of market participants, not the entity's management.

The SEC asserted that KCAP's illiquid securities were not carried at fair value. The complaint alleges that there were observable prices for selected securities that KCAP did not utilize. The underlying question in regard to these securities was whether the market in which they were traded reflected an "Active Market"[5] in which "Orderly Transaction(s)"[6] occurred. The answer is often not black or white, but gray. In such situations, it is incumbent on management to determine whether the market price meets the conditions for use as a Level 1 input. Management must either use observable prices to value its investment securities or explain why doing so would be inappropriate and why its alternate method is superior. The use of Level 3 inputs when trade prices for identical or similar securities are available could be a red flag to the SEC. Therefore, it is essential that management describe and disclose the valuation technique(s) used to estimate the exit price of the asset. According to ASC 820, the acceptable approaches are the market, cost, and income methods.[7] Any application that does not explicitly use one of these methods, such as use of "enterprise value" by KCAP, should be accompanied by sufficient disclosures explaining how the valuation approach complies with GAAP, or if applicable, justifying its departure therefrom.

A perhaps obvious but nonetheless key issue is whether the methods that management represented as the company's were in fact used to value the assets. The SEC will review the adequacy and accuracy of the methods utilized and the consistency of such application with the descriptions included in the filings. Any inconsistencies will be a red flag and should be avoided.

When Directly Observable Inputs Are Unavailable, Unreliable, or Not the Best Evidence of Value

The KCAP dispute highlights a central function of valuation professionals: deciding on the appropriate standard and estimate of value, especially when directly observable inputs are unavailable, unreliable, or not the best evidence of value. Taking a step back from the KCAP case, it is theoretically possible that Level 1 inputs may not always be the best estimate of value for a particular holder of a publicly traded security.

For example, and perhaps counterintuitively, consider the valuation of common stock. The value that a specific entity places on its holdings of an actively traded security may be higher or lower than current trading prices under certain circumstances. Such divergence could be caused by restrictions on the sale of the securities, controlling interests, or transactions by a strategic acquirer who places a higher value on the same company. In the valuation literature, these differentials are referred to as liquidity discounts, control premiums, and strategic premiums, respectively.

To be sure, it is one thing to observe that market prices are not always the best measure of value for a specific entity under all circumstances, and quite another to determine when accounting standards can accommodate a departure from these prices and what particular departure would be acceptable. When reliable, directly observable inputs such as actively traded securities prices are available, relying on valuations that are higher or lower than those market prices for inclusion in a public company's financial statements requires careful scrutiny and very strong support. However, strictly from a valuation professional's standpoint, it is not unreasonable to posit a situation in which the value an entity places on its holdings of publicly traded securities differs from the most recent transaction prices, even if this is rare.

If the value a specific entity places on an actively traded security can theoretically deviate from current trading prices, then this possibility is magnified for illiquid securities. For example, while no actively traded market may exist for debentures that are convertible into common stock of a public company, the market price of the underlying common stock is one piece of evidence of the debentures' value, and could be considered a Level 2 input. However, a valuation expert would be advised not to simply value the convertible debentures by using the unadjusted market prices of the common stock that the debentures may be converted into. Among other issues, such a methodology would ignore the dilutive impact of any conversions on the equity holders, as well as the relief from interest payments for the company that a conversion would provide. In fact, a reasonable methodology in such a circumstance would incorporate modeling the convertible debenture as some combination of a debt security and a call option on the company's stock. The actual calculations involved would incorporate certain valuation methodologies that veer into Level 3 inputs (e.g., volatility and interest rate data) and treatments (e.g., option pricing theory). If anything, this situation demonstrates the lack of a fine line between the three different levels dictated by the accounting standards.

Finally, for some assets, no reliable market prices may be available to provide either direct or indirect evidence of value, necessitating Level 3 inputs for valuation. Returning to the KCAP case, for example, third-party pricing services did have available price quotes from actual transactions in the debt securities at issue. KCAP rejected those trades as evidence of value because the company concluded that the trades reflected distressed transactions due to market conditions. Instead, KCAP used an enterprise valuation as the basis for valuing its debt securities – chiefly pointing out that the debt securities at issue included a senior claim on company assets, and those assets would be sufficient to support a substantially higher value even in the event of bankruptcy. Had the securities involved not been publicly traded, KCAP obviously would have had an easier time defending its methodology. But even had those Level 1 inputs not been available, KCAP would likely have had to defend any methodology that placed a premium on the relevant debt securities relative to comparable debt trading on the open market at that time, which could have considered Level 2 inputs as well. With the market turmoil that existed, it is entirely possible that comparable debt securities were also trading at distressed prices. In essence, KCAP likely faced significant challenges in selecting and justifying methods to value its debt securities. Once again, in such cases, sufficient explanations and disclosures are critical for reducing the likelihood that the SEC will challenge the valuations.

While the SEC found fault with KCAP's decision to use enterprise value instead of available pricing information, there are certainly many instances in which pricing information is either unavailable or unreliable. In those instances, it will be necessary to value an asset using techniques such as comparable company analysis, precedent transaction analysis, or discounted cash flow analysis.

Conclusion

As the SEC applies greater scrutiny to the valuations that public companies assign to their assets and as the tools that the SEC employs to detect aberrational valuations become more sophisticated, public company financial reporting, legal, and compliance personnel should familiarize themselves with the SEC's more established approach to policing the valuation practices of other reporting entities. Much of the SEC's enforcement efforts around valuation issues have occurred in the investment advisor area, but the methods employed there have direct applicability for public companies.

Bullet point takeaways

- The SEC is paying close attention to valuation issues in public company filings.
- Increased enforcement activities can be expected as valuation approaches are challenged.
- It is well-accepted in the valuation literature that value can be different depending on the frame of reference, and market prices are not always best. These related concepts must be appropriately invoked to justify deviations from traditional measures of exit prices.
- Reporting entities are well-advised to make full disclosures of and be prepared to defend unorthodox treatments.

Notes

1 http://www.sec.gov/News/Speech/Detail/Speech/1370539845772#.UtW8KluTzQi

2 On 6 August 2015, the SEC may have signaled a renewed interest when it announced an administrative proceeding against Miller Energy Resources, Inc., its former CFO, and current COO for allegedly inflating the values of oil and gas properties held by the company, whose stock is listed on the NYSE. http://www.sec.gov/news/pressrelease/2015-161.html

3 The FASB adopted its "Accounting Standards Codification" (ASC) in 2009. Section 820 of the ASC, "Fair Value Measurements", incorporates previous FASB pronouncements on the topic including FAS 157.

4 KCAP seemingly uses the term "enterprise value" with reference not to the combined market value of debt and equity securities but to the fundamental value of debt securities.

5 Per ASC 820-10-20, Glossary, an "Active Market" is, "A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis."

6 Per ASC 820-10-20, Glossary, an "Orderly Transaction" is, "A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale)"

7 ASC 820-10-55-3A
The market approach uses prices and other relevant information generated by market transactions involving identical or comparable (that is, similar) assets, liabilities, or a group of assets and liabilities, such as a business.

ASC 820-10-55-3D
The cost approach reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).

ASC 820-10-55-3F
The income approach converts future amounts (for example, cash flows or income and expenses) to a single current (that is, discounted) amount. When the income approach is used, the fair value measurement reflects current market expectations about those future amounts.

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