CAPITA
FINANCIAL GROUP

CURRENT VALUATION ISSUES

Background

Over the last few months we have seen unprecedented volatility within the financial markets and this had led to questions being raised over the use of fair value accounting. Whilst there have been calls for fair value to be suspended this has not been forthcoming and companies will therefore need to take great care over their valuations.

It is worth highlighting some of the issues on which the Auditors will be particularly focussed, so they can be addressed at an early stage.

Listed Securities

Listed securities should be valued at bid price in accordance with accounting standards. If the Investment Manager feels that bid price is not a reflection of fair value for a particular security then this should be discussed with the Auditors at an early stage. It is worth noting that the Auditors are unlikely to accept a blanket percentage reduction from the bid price on all listed securities to reflect illiquidity in the market.

Unlisted Securities

These are valued by the Directors/Investment Manager using a wide range of information in accordance with the investment policy. In the current climate extra care should be taken in arriving at these valuations. In 2006 the British Venture Capital Association published valuation guidelines for use in valuing unquoted investments and these may be of some assistance in arriving at an appropriate valuation. The guidelines are available on the BVCA website.

A specific area to focus on closely would be where shares in an unquoted investee Company have previously been shown at cost as an approximation of fair value. As the requirement is to fair value there may be a number of cases where fair value is now actually lower than cost and these assets will need to be written down.

Auditors will be giving particular attention to this area and it is doubly important to have additional back-up for any valuations.

TECH 01/08

This was issued in February 2008 to provide guidance on realised and distributable profits under the Companies Act 1985. It reflects accounting standards and generally accepted practice at August 2007 and as such does not deal with the Companies Act 2006. A further version is currently being drafted.

The principle of Tech 01/08 is that fair value gains should be treated as realised to the extent that they are readily convertible to cash whether or not the investment is still held. The key point is that the Company should be able to immediately sell the asset without having to curtail its operations or accept adverse terms. This could apply, for instance, where a Company holds investments in large companies whose shares are listed and easily sold. It will not apply for thinly traded or unquoted investments.

Discussions with Auditors will centre on which investments fulfil the above criteria and which do not. This might be judged by level of market capitalisation, stock volumes or other available information. In the current market, shares that would perhaps have been considered highly liquid a few months ago, may not now be considered to be so. The Auditors will also expect that consideration has been given to level of block discounts in calculating the realised gains and losses.

It is important to discuss the approach to be adopted with the Auditors at an early stage, to minimise the risk of being asked to provide additional analysis at short notice.

FRS 29/IFRS 7

The above accounting standards were introduced for accounting periods beginning on 1 January 2007. As a result Companies will have already given disclosures in their last Annual Report.

However for this financial year consideration will need to be given about the quantitative disclosures given in the Report. It could be argued that where previously a 5% swing in the markets was seen as acceptable this could now be 10%, 20% or even more. If so it could be argued that it makes the note meaningless. Again, early contact with the Auditors could prevent any issues arising late in the audit.

Real Estate

This is another area that will be under greater scrutiny during the audit process with the market suffering large falls which many analysts are predicting will continue in 2009. Clients will normally engage third party valuers to determine the fair value of the investment properties in their Reports. With the current levels of uncertainty surrounding the unwillingness of banks to lend to each other and the knock-on effects on the economy as a whole, valuers are hesitant to provide valuations without referring to this uncertainty in their reports. These uncertainty reports are to make the reader aware of the financial background in which the valuation has been prepared rather than as a caveat to the valuation opinion provided.

Conclusion

These are difficult times and as such provide challenges in preparing the Annual Report. Auditors are likely to be uncomfortable, especially with unquoted securities and valuations are likely to be challenged by them. It is important that in order for the audit to run smoothly valuations are as watertight as they can be and the Auditors are engaged for their opinion at an early stage. It is worth considering (where possible) to have a pre-audit conference call or giving the Auditors the valuations ahead of the main bulk of the audit to avoid delays in the audit process.

If you wish to discuss the issues raised in this paper please contact your Manager at Capita Financial Group or myself as detailed below.

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