



Additional transparency thanks to the Financial Accounting Standards Board (FASB)

By the issuance of the Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS 157) in September 2006 (well before the beginning of the credit crisis) it appears that auditors had the ability to forecast the future. The main objective of SFAS 157 was to provide a definition to the principle of “fair value” commonly used in various accounting principles but for which no proper guidance was ever defined. The new standard provided an extra level of transparency to shareholders on the type of securities held by the fund.

Fair value is defined by the Standard as the “price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” It takes on an “exit price” approach.

For illiquid securities where a market may not exist, the fund must develop a fair value approach based upon a hypothetical market which incorporates certain assumptions potential market participants would use in purchasing the security.

The measurement assumes an orderly and hypothetical transaction in the principal market for the asset or liability. If no principal market exists, and there are multiple markets, then the most advantageous market is used.

The most significant element of the Standard is the development of a three-level fair value hierarchy. Level 1 consists of the most “observable” market inputs to arrive at a fair value (e.g., liquid securities). Level 2 would broadly include securities valued using observable inputs other than quoted prices used to value Level 1 securities, whereas Level 3 consists of the most “unobservable” inputs (e.g., highly illiquid securities). The designation of a level is based on the lowest level input that is significant to the fair value measurement. Unfortunately, the term “significant” is not defined by the Standard.

The matrix hereinbelow, prepared, by Rothstein Kass, provides their interpretation relative to the types of inputs and the typical instruments for each of the standard’s three levels:

Matrix of Levels and Typical Level Designations

Level	Types of Inputs	Typical Instruments (Note 1)
Level 1 - Valuations based on quoted prices in active markets for identical assets or liabilities	Unadjusted quoted prices from an exchange or broker-dealer market that is deemed to be active.	Exchange-traded securities, most U.S. government securities, certain other sovereign government securities, listed derivatives, futures contracts and over-the-counter (OTC) securities traded in an active market.
Level 2 - Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly	Adjusted prices from an exchange or broker-dealer market that is deemed to be inactive, brokered markets for restricted securities, registered debt and observable market inputs, such as equity prices, yield curves, implied volatility, interest rates, prepayment speeds, loss severities, credit risks, and default rates (including those inputs extrapolated from other observable inputs). (Note 2)	Exchange-traded securities (Note 3) and listed derivatives that are not actively traded, most OTC derivatives, restricted stock, corporate and municipal bonds, certain corporate loans, certain high-yield debt, certain residential and commercial mortgage loans, certain mortgage-backed securities (MBS), asset-backed securities (ABS), and collateralized debt obligation (CDO) securities, futures and forward contracts, and physical commodities.
Level 3 - Valuations based on inputs that are not observable and significant to the overall fair value measurement	Models utilizing significant inputs that are unobservable (e.g., historical volatilities); such as Black-Scholes, discounted cash flows, multiples of earnings or EBITDA including risk assumptions consistent with what market participants would use to arrive at fair value.	Certain corporate loans, certain mortgage loans, certain high-yield debt, distressed debt (i.e., securities of issuers encountering financial difficulties, including bankruptcy or insolvency), certain MBS, ABS and CDO securities, investments in real estate funds and other private investment companies, private equity investments, and complex OTC derivatives (including certain foreign currency options, long-dated commodity options and swaps, certain mortgage-related credit default swaps, derivative interests in mortgage-related CDOs, and basket credit default swaps).
<p>Note 1 - Level designation is based upon the lowest level input that is significant to the fair value of the measurement of the security and actual designation may vary from the “typical” designations illustrated above, based on actual facts and circumstances.</p> <p>Note 2 - For Level 2 designations, any models used must be widely accepted, non-proprietary and the data used must be observable. Any significant judgments or adjustments to the model or data will result in a Level 3 designation. In addition, quotes from brokered markets must represent a firm commitment to transact or are developed from other observable market data.</p> <p>Note 3 - Exchange-traded securities that are not traded in an active market or the prices from the exchange that are adjusted due to aftermarket events would be assigned a Level 2 designation.</p>		

For most funds, the first financial statement subjected to SFAS 157 will be the December 31st, 2008 statement. Even if the yearend audit is only a snapshot of the fund portfolio at the end of the year, the new standard will still provide investors an indirect indication of the liquidity of the assets held by the fund and the level of reliability/independence of the fund’s valuation at a certain point in time. In any event, it is unlikely that the investment manager will have an opportunity to sell illiquid positions in the fund’s portfolio just to avoid being included in the yearend audit. Another positive point is that the investment manager will have to adopt more detailed pricing policies to ensure the proper classification of the assets traded in the right categories.

The new standard is obviously not the perfect answer to the demand for more transparency from hedge funds’ investors but it will certainly contribute to it. The main problem with the fund’s financial statements is that auditors benefit from certain “privity” principles; thereby allowing them to avoid confirming their role in the audit. As such, the validity of the audit report should always be questioned when evaluating a fund. SFAS 157 is a good step forward but there is still some way to go before the audit report can become an unquestionable part of a proper due diligence.

Latest Due Diligence

- Iridian Opportunity Fund

Register to this monthly newsletter by visiting us at

www.hedgefundappraisal.com

About Us:

Hedge Fund Appraisal is providing due diligence services to hedge fund investors.

- Compensated only by end investors, achieving complete objectivity
- Appraisals offered on pay-per-use basis, no need for a subscription
- The lowest prices in the industry
- Strong expertise; due diligence is our only service
- Background Check, Operational Due Diligence, Investment Risk Analysis
- Consultancy

For further details, contact us info@hedgefundappraisal.com