7 Steps Towards Financial Transparency:

Helping Corporate Treasuries Implement Auditor-Ready Derivative Valuation Processes

FINCAD®

7 Steps Towards Financial Transparency

Introduction

With today's increasing demand for transparency and accountability, an examination of your valuation process through the lense of key attributes is worthwhile. Reputational risk varies inversely with the quality of your financial statements, both for your company and for yourself as a treasury professional. Having an explicit, well-documented process in place to audit-proof reported valuations is your key to a strong reputation for transparency. If audit is a gateway, transparency is your passport. Having passage denied, even if later fixed, is a matter of reputation and goodwill to all users of your financial statements.

If you hold financial instruments that must be valued to report gains and losses, hedge effectiveness or off-balancesheet disclosures, a robust valuation process can contribute to your transparency. Although the valuation process ultimately depends on your portfolio holdings (more exotic issues may require more documented reasoning for valuations), there are steps you can take to increase reliability and decrease valuation risks. In this whitepaper, seven simple and practical steps are outlined and discussed.

Seven Key Properties of an Effective Valuation Process

1. Your source of market data should be widely recognized and above reproach.
2. The methods for obtaining your market data and calculating valuations should be consistent and as automated as possible to discourage manual error or intentional manipulation.
3. The models used for valuation should be widely accepted or specifically accepted by your auditors.
4. Valuations should follow a documented internal certification procedure, to be applied after automated valuations are generated. This is a sanity check or a spot check, using an experienced eye to identify possible flaws in valuation.
5. Valuation dates and times should be logged for possible audit.
6. Contingency procedures should be prepared in anticipation of outages in market data supply, solution uptime, personnel turnover and unusual market events.
7. Written explanations for valuation adjustments should be recorded in a central place and preferably unchangeable, whether for individual securities or for portfolios.

There are steps you can take to increase reliability and decrease valuation risks

Your Source of Market Data

Market data is the lifeblood of your valuations based on observable inputs. The transparency of these valuations depends on the credibility of the input data. Using a trusted, well-known name for market data establishes a firm basis for valuation changes. Market theories impound expectations into valuations for speculative and investment purposes; however, if your valuations are for reporting mark-to-market, hedge effectiveness testing or internal position evaluation, your report must reflect immediately observable changes, whether or not a market is in theoretical equilibrium.

Market data is therefore at the heart of your reportable valuations and must be trustworthy and reliable. The goal is to make your valuations "as good as observable", as if your instruments were quoted directly in a reasonable exit transaction with a willing buyer.

The Method of Obtaining Your Market Data

Reliable automation increases consistency. If a system has been built to source market data the same way every day and faithfully does so, exceptions should be rare.

Possible exceptions include problems with the market data itself such as reversed exchange rates, technical exceptions such as server outages, or unanticipated extreme values that cause validation rules to be triggered or cause models to fail. The reliability of market data depends on the original source of that data, which may be your solution vendor or a third party. Either way, it is important to establish that the source is credible (widely accepted in industry or specifically accepted by your auditor), and the method of obtaining it is consistent. Disruptions in data supply can delay the availability of your valuations and further, can create exceptions that prompt questions from your auditor. For example, you may end up creating manual valuations for a particular period if your data supply is interrupted.

Although technical exceptions can never be fully avoided, your data provider's service level agreement should be examined closely and your valuation risk from an outage should be evaluated before it happens. It is even better to have contingency processes in place. In the case of extreme values, the burden falls on the accepted models or calculation approaches to those models, and not the operational method of data acquisition. A mitigation strategy for extreme values would be to understand what validation rules your data provider has in place, if any. Ask your vendor to identify his process for monitoring extreme values – whether they arise from error or actual market events.

Models Used in Valuations

The models for valuing the most common financial instruments and derivatives are somewhat commoditized.

More exotic models and the software approach used to provide those models is therefore a key differentiator for valuation software providers and for outsourced valuation experts who use vendor software.

In some instances, valuation providers use their own proprietary analytics. In this situation, the proprietor's reputation and credibility are relied upon to uphold the validity of the models used, especially if they differ significantly from a mainstream norm. However, the more exotic the instruments being valued are, the more specialized becomes applied expert opinion. In the end however, the user of the model must have confidence in it. Confidence can be gained by using analytics providers that have documented the model and assumptions and are willing to answer any and all questions related to the valuations. The specific methods used to generate valuations must survive your own scrutiny before they can stand up to an auditor's thorough hand. In many cases, model validation may need to be done with an additional third party to get auditor signoff especially in the cases of esoteric models.

Right Tools for Right Valuations

While not universal, the practice of certification is used regularly in software development. The idea is to deem packages of software code ready for promotion to their next stages, or to fail them on the basis of known standards. Final products thereby have built-in assurances of consistency and due attention to removing flaws.

Right tools lead to right valuations. A strong solution consists of reliable reference market data, proven analytics and explainable methods. A solution can pass audit on vendor reputation or clearly explainable, acceptable processes and inputs. Therefore, solutions that have already been proven to auditors are a proven path to the required transparency.

Internal Certification of Valuations

The applicable analogy for performing financial instrument valuations is to establish tests for validity and either test valuations exhaustively or through sampling for each reporting period. This practice can increase your process transparency and heighten the stringency of your valuation practices.

Just documenting a certification procedure and following it can make you more audit-ready, especially if you have a high volume of valuations to report. Creating a tiered sequence of sign-offs in the valuation process can alleviate concerns with valuation tampering or unintended inaccuracy. For each stage in the valuation process, an explicit sign-off can be recorded before promotion to the next stage, for ultimate sign-off on financial statements.

An example would be having the front-line valuation analyst, often a treasury analyst, review and sign off on the initial valuation to certify first-hand review, the absence of irregularities in business-as-usual valuations. A second level of certification can include a higher level manager's signature, indicating that the valuations look reliable according to her best judgment, and that an effort has been made to explain any unexpected results. The layers of internal certification can reach as high as your practice deems necessary, including all the way to the final financial statements. The process should be applied consistently and recorded so that it can be examined if necessary.

Following a tiered approval process as part of regular operations will increase your transparency without much additional effort. Even if a final valuation is questioned, your auditor will have to challenge all of your documented efforts to make his case.

Valuation Logs

As with every business procedure, leaving an audit trail is better than not. As always, this is a balancing act between traceability and expediency. A log of valuation times can answer questions about valuation disparities, for example, when using market data from different sources. If intraday volatility has increased sharply and suddenly and you and your auditor are using two different data snapshots taken at different time points using the same models may still give you different valuations. When portfolios contain valuations of different instruments at different times, logged valuation times can be invaluable for tracing portfolio impacts of individual securities.

Contingency Procedures

Even when your valuation process is humming along efficiently, you're not done yet. How likely is it that your normal valuation process will fail at some point? No automated procedure is perfect and the question is not "if" but "when" an outage or failure will occur. What will it cost you if you lose your ability to produce acceptable valuations on time?

Keeping written manual procedures for backup purposes is recommended. You should back test your contingency procedures with your main, mostly automated valuation process to mutually verify the results.

One common pitfall of contingency planning is to set up full contingency procedures, but to never test them. Environments change, people change jobs, hard drives have an implicit "best before" date and network reliability is never 100%. An untested contingency plan can unwittingly be the same as no contingency plan. Test your contingency plans one per year, to identify vulnerabilities and to practice so that you can react instantly and effectively when the need arises.

Hard drives have an implicit "best before" date and network reliability is never 100%. An untested contingency plan can unwittingly be the same as no contingency plan.

Written Explanations

With an automated valuation system in place, or an outsourced valuation provider on your side, it is tempting to skip over explanations of valuation adjustments. Although the validity of bulk adjustments to instrument valuations in a portfolio is objectionable from some perspectives, it is a "better than nothing" approach that can pass muster. For example, most financial professionals would agree that simply adjusting a valuation by a raw absolute or percentage amount sounds pretty arbitrary, even if the adjustment is designed to address, say, counterparty credit risk that was previously unheeded. However, if the adjustment represents a best effort reflection as opposed to no reflection of specific risks not impounded into the raw valuation, a record of your reasoning can at least dampen any impression of sloppiness or neglect towards the issue. All the better if explanations are kept directly with valuation records and cannot be changed.

Concluding Remarks

Although there is no formal definition for a perfect valuation process, the FINCAD derivatives transparency scorecard can provide an assessment of a corporation's valuation process maturity and provide certain process attributes that can be promoted to strengthen credibility and reliability, in answer to the call for higher transparency.

Following the thematic steps above will remove doubts and make your valuations stand out as reliable.

If your process is deficient in any of the areas examined, perhaps it's time to consider addressing them before a valuation risk manifests. The basic awareness of what makes a strong valuation process will pave the way for yours to eliminate vulnerabilities and strengthen advantages you can refer to under scrutiny.

There are no guaranteed processes for perfect valuations, but following the thematic steps above will remove doubts and make your valuations stand out as reliable. Having these steps in place gives you a documented reference to fall back on under scrutiny and a baseline process that can be explicitly modified or expanded if your auditor requires improvements. These explicit conditions are a far cry from ad hoc or unclear valuation operations that have to be explained or modified under audit conditions.

To learn about FINCAD solutions that help you increase your derivatives valuation transparency, contact us.

Disclaimer

FINCAD makes no warranty either express or implied, including, but not limited to, any implied warranties of merchantability or fitness for a particular purpose regarding these materials, and makes such materials available solely on an "as-is" basis. In no event shall FINCAD be liable to anyone for special, collateral, incidental, or consequential damages in connection with or arising out of purchase or use of these materials. This information is subject to change without notice. FINCAD assumes no responsibility for any errors in this document or their consequences, and reserves the right to make improvements and changes to this document without notice.

Copyright

Trademarks

Revisions

Every effort has been made to ensure the accuracy of this document. FINCAD regrets any errors and omissions that may occur and would appreciate being informed of any errors found. FINCAD will correct any such errors and omissions in a subsequent version, as feasible. Please contact us at:

FINCAD®

fincad.com

Vancouver
New York
London
Dublin

USA/Canada	1 800 304 0702
Vancouver	1 604 957 1200
New York	1 646 435 5920
Europe	00 800 304 07020
London	44 207 464 4190
Dublin	3 531 400 3100
Fax	1 604 957 1201
Email	info@fincad.com