

EY US Structured Finance: valuation services

Through an auditor's lens: structured products valuation

Insights from an auditor's perspective on demystifying the valuation of Level 2 and 3 structured financial products.



Building a better working world

Navigating the complex terrain of valuing structured products is essential to robust financial reporting and informed investment choices. This article, crafted from an auditor's perspective, explores the nuanced world of valuing these sophisticated financial instruments, providing critical insights that can help streamline the process, conserve valuable time and resources, and circumvent missteps. By adopting industry standards, stakeholders can enhance the precision of their valuations, bolstering confidence in their financial assessments and strategic decisions. Advance your financial acumen by exploring the auditor's approach to valuation, detailed in the insights that follow.

Understanding structured products

In finance, structured products stand as a testament to innovation, offering a spectrum of investment opportunities that cater to diverse risk appetites and financial goals. These products, which include asset-backed securities, mortgage-backed securities, commercial mortgage-backed securities and collateralized loan obligations, represent pools of cash-flowing assets that have been deliberately packaged to provide investors with varying degrees of maturity, liquidity, credit quality and yield potential. Each asset pool is a reflection of the consumer's financial commitments, offering a glimpse into the health of different sectors of the economy.

From an auditor's perspective, valuing these products is rooted in a deep understanding of their underlying assets and the market dynamics that influence their performance. The valuation process is not merely a matter of numbers; it is a complex synthesis of economic indicators, borrower behavior and regulatory frameworks.

Valuation methodologies

In the intricate world of financial markets, asset valuation is a critical exercise, categorized into a three-tiered system that reflects the transparency and accessibility of pricing data. At the top, Level 1 assets have the most clarity, their prices visible to all players in the market. These assets, including actively traded stocks, bonds and funds, benefit from a straightforward application of the market approach to valuation.

Descending into the more complex strata of Level 2 and 3 assets, the valuation landscape becomes increasingly challenging. Level 2 assets, while lacking direct market prices, have related observable inputs that guide their valuation. Level 3 assets, on the other hand, are valued based on unobservable inputs, which calls for sophisticated estimation techniques. The valuation of these assets demands a refined approach to capture their true worth in the absence of clear market prices.

Accounting Standards Codification 820 (ASC 820) provides the compass for navigating this terrain, presenting the income, market and cost approaches as the foundational methodologies for valuation. Among these, the income approach – and its cornerstone





the credibility and verifiability of these inputs.

For complex Level 3 assets with inputs that are not directly observable in the market, auditor knowledge becomes indispensable. They must cut through the thicket of financial projections, confirming that every assumption is not only market-based but also stands on a solid foundation of empirical evidence. This is no small feat – it requires auditors to possess a profound understanding of market dynamics and to take a disciplined approach to data examination.

Valuation issues

The complexity around the valuation of structured products is often compounded by a reliance on assumptions that may not be anchored in robust market data. This disconnect can create a chasm between initial valuations and auditor expectations, leading to a time-consuming and resource-intensive process of reconciliation. It's a scenario that plays out all too frequently in the financial industry, highlighting the need for vigilance and precision in the valuation process.

Another common stumbling block emerges when the client's valuation team approaches the valuation from the perspective of the asset's intrinsic value to the client, rather than through the lens of a market participant. This viewpoint, while understandable, runs counter to the principles set forth by ASC 820, requiring valuations to reflect the asset's fair market value.

The challenge lies in shifting the focus from a subjective client-centric valuation to an objective assessment that a hypothetical market participant would recognize. The disconnect between these two perspectives can result in valuations that, while perhaps valid from an internal standpoint, do not meet market-based standards. This can lead to a quagmire of discrepancies, as auditors grapple with figures that fail to mirror the market consensus. Such misalignment can precipitate extensive

efforts to reconcile differences, consuming valuable time and resources, as well as increasing the risk of financial statement errors.

Industry standards in valuation

In the financial reporting ecosystem, the valuation of Level 2 and 3 assets is a high-wire act requiring a meticulous balance of precision and insight. The importance of implementing industry standards to guide the valuation process cannot be overstated, as they serve as a bulwark against the risks of valuation inconsistencies and the subsequent domino effect on audit reviews.

A well-documented, auditable valuation model is the cornerstone of an efficient process. It serves as a safeguard against excessive audit inquiries, providing a clear trail of assumptions, methodologies and data sources that auditors can follow. This degree of documentation is particularly vital for Level 3 assets, for which the lack of observable market data means valuations are often based on internal models or estimates. Here, transparency is not just a buzzword – it's a rigorous requirement that can make or break the credibility of a valuation.

Moreover, the importance of controls testing cannot be overstated. It acts as a quality check, so that the valuation model and methodologies are not only theoretically sound but also practical and reliable. Assessing these controls is a meticulous task. For many organizations, the complexities and the need for specialized knowledge lead them to seek external support. Third-party valuation professionals can bring a wealth of experience and knowledge to the table. By leveraging third-party professionals to assist with these critical functions, companies can alleviate the pressures associated with controls testing and improve the robustness of their valuation processes.

discounted cash flow (DCF) analysis – stands out for the ability to crystallize the value of Level 2 and 3 assets. DCF is a formidable tool, projecting future cash flows to determine present value, but it rests on the bedrock of accurate market-based assumptions. The selection of the discount, prepayment, default and loss rates is a high-stakes endeavor, as the entire valuation hinges on

Conclusion

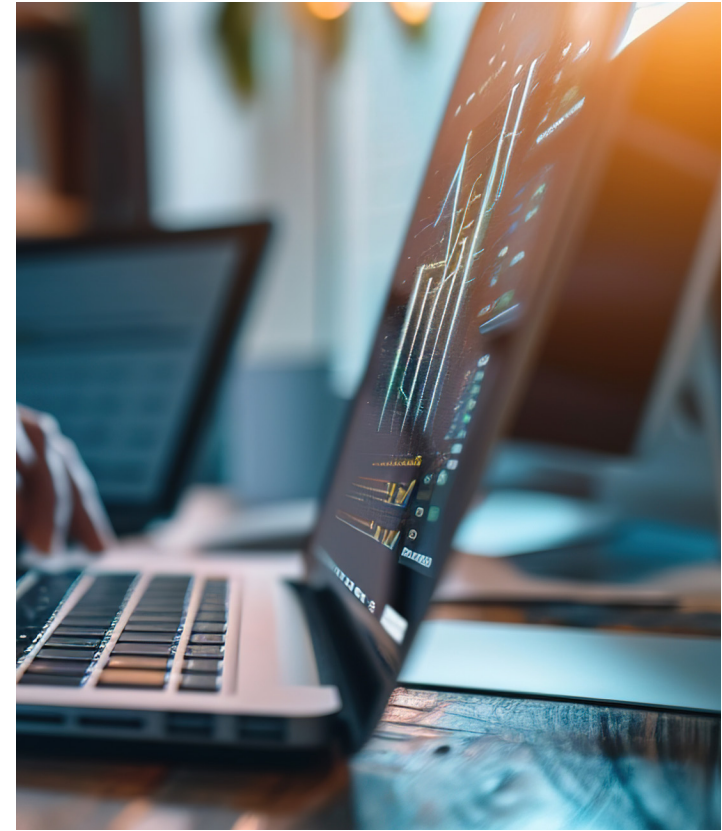
The valuation of structured products is a critical component of financial reporting and investment decision-making. As we have explored, it is a complex process that requires a deep understanding of the underlying assets, market dynamics and regulatory frameworks. The three-tiered system of asset valuation presents varying degrees of difficulty, with Level 3 assets requiring the most sophisticated estimation techniques due to their reliance on unobservable inputs.

The guidance provided by ASC 820, with its emphasis on the income, market and cost approaches, is essential for achieving accurate valuations. DCF analysis, in particular, is a powerful tool for Level 2 and 3 assets, but it is heavily dependent on the selection of credible and verifiable market-based assumptions and robust validated models. Auditors play a crucial role in scrutinizing these assumptions and establishing that they are grounded in empirical evidence and reflective of market conditions. Challenges arise when valuations are influenced by subjective client-centric perspectives rather than objective market participant views. This can lead to discrepancies that are costly and time-

consuming to reconcile.

To mitigate these risks, industry standards should be followed. A well-documented and auditable valuation model is fundamental, providing a clear path for auditors to pressure-test assumptions and methodologies. Controls testing further safeguards the reliability and applicability of valuation models, with many organizations turning to third-party professionals for their specialized knowledge and experience.

To sum up, through the lens of an auditor, the valuation of structured products is a nuanced and intricate process that is integral to the integrity of financial reporting. Companies must prioritize precision, transparency, and adherence to industry standards to uphold confidence in their financial assessments and strategic decisions. As stakeholders navigate this complex terrain, they are encouraged to engage with valuation professionals who can offer the right depth of insight and knowledge. By doing so, they will not only streamline the valuation process but also reinforce the robustness of their financial reporting – ultimately driving informed investment choices and strategic growth.





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