

● ● ● | “Fair Value”




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● ● ● | Fair vs. Contract Value

- Fair value =
  - Current value (term used in official instructions)
  - Market value
- Contract value =
  - Book value
- ERISA §3(26) defines “current value” as fair market value where available and otherwise the fair value as determined in good faith by a trustee or named fiduciary, assuming an orderly liquidation at time of determination.

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● ● ● | DOL Considerations

- DOL targets line 4g of Schedules H / I
- If no ready market exists, then auditor must evaluate plan's method for setting fair value
  - Is it appropriate?
  - Is it consistently applied?
  - Can the measurement be tested?
  - Should a specialist be engaged?

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## Understanding Alternative Investments

- The odds are that your plan has alternative investments
- Ever heard of these?
  - Pooled separate accounts
  - Common or collective trusts
  - Hedge funds
  - Venture capital funds
  - Limited partnerships
  - Private placements
  - Fund of funds

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## Identification

- Welcome to the Alphabet Soup of Alternatives!
  - Look for clues in the security description
    - PSA COLTV LP LLC FD
  - Look at Form 5500 Asset Categories
    - Joint Venture/Partnerships
    - Value of Interest in Common/Collective Trusts (CCTs)
    - Value of Interest in Pooled Separate Accounts (PSAs)
    - Value of Interest in 103-12 Entities
      - LPs/LLCs/DBTs that choose to file a Form 5500 on behalf of participants
    - "Other" category (hedge funds, offshore funds, etc.)
  - Look at the Plan's Investment Policy and/or individual Investment Manager Guidelines

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## Understanding Alternative Investments

- Characteristics of alternative investments:
  - Not listed on national exchanges or over-the-counter markets (NYSE or NADDAQ)
  - Quoted market prices are not available from financial publications, exchanges, or NASDAQ
  - Think: commingled investment/ private deals/ illiquid assets
- Challenges include: Identification, Valuation, and Auditing

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## 2006 Accounting Guidance

- Affects Stable Value Funds, GICs
  - FASB Staff Position (FSP) AAG INV-1 and SOP 94-4-1, “Reporting of Fully Benefit Responsive Investment Contracts Held by Certain Investment Companies Subject to the AICPA Investment Company Guide and Defined-Contribution Health and Welfare and Pension Plans”

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## SOP 94-4-1

- Applies ONLY to defined contribution plans
- Effective for plan years ending after December 15, 2006
- Applies to fully benefit responsive GICs, synthetic GICs and stable value funds in DC plans

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## Fully Benefit Responsive Investment Contracts – DC Plans

- Traditional Guaranteed Investment Contracts (GICs)
  - Contract with insurance company
  - Guarantees a specified rate of return
- Synthetic GICs
  - Plan owns underlying assets
  - Insurance company or bank issues a wrapper contract to simulate performance of GIC
- Stable Value Funds: common/collective trust funds

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### Form 5500 Considerations

- No changes in Form 5500 Instructions
- Form 5500 historically required:
  - fully benefit responsive insurance contracts at contract value
  - stable value funds at fair value
  - synthetic contracts at fair value
- Reconciling footnote to financial statements may be required

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### Statements of Net Assets Available for Benefits Presentation

	<u>2008</u>	<u>2007</u>
Participant-directed investments, at fair value (Note x)	\$2,700	\$ 900
Net assets reflecting all investments at fair value:	<u>2,700</u>	<u>900</u>
Adjustment from fair value to contract value for fully benefit-responsive contracts	<u>(700)</u>	<u>600</u>
Net assets available for benefits	<u>\$2,000</u>	<u>\$1,500</u>

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### Schedule A Fair vs. Contract Value

- Lines 3 and 4 of Schedule A are always "current" or fair value.
- General account holdings
  - If none – then everything reported at fair value on Schedules A, H, and I
  - If contract not fully benefit responsive, then fair value on Schedules A (line 3), H, and I
  - If contract is fully benefit responsive, then contract value on Schedules A, H, and I

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## What's This Thing Called SFAS 157 ?

- Issued by FASB on September 2006
- Effective for 2008 plan years
- Establishes a framework for measuring fair value
  - Defines fair value: exit price concept
- Requires 3 new financial statement disclosures:
  - Fair Value Hierarchy Table (Level 1,2,and 3)
  - Roll Forward Table of Level 3 Assets
  - Expanded footnote description of entity's specific valuation methodologies

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## Fair Value Hierarchy

- Level 1 inputs – quoted prices
- Level 2 inputs – observable inputs other than quoted prices included with level 1
- Level 3 inputs – unobservable inputs, for example, situations where there is little, if any, market activity for the asset.

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## Ok Already, So What Does This Mean?

- Plan Administrators own the valuation responsibility
  - They can outsource the mechanics, but not the ownership
- NAV may not equal exit price per SFAS 157
  - New validation procedures will be required
- Understanding pricing methodology is a must
  - Transparency to custodian's and fund company's "black box" pricing
- Custodial reports will only be the starting point
  - Final FAS 157 bucketing decisions will rest with plan administration

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## Ok Already, So What Does This Mean?

- o Auditors will be taking a deeper look
  - Expect to devote more resources and cost to audit process
- o FV validation takes time
  - Plan administrators may need outside experts
  - Start sooner, rather than later!

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## Transparent Pricing for FAS 157 Tables

<u>Past</u>	<u>Present</u>
Behind-the-scenes custody pricing world was of little interest	Financial Statement preparers have to be conversant about the nuances of custodian's pricing operations
	Custodian's have had to provide much more detail about who priced the asset and what inputs were used
	Custodian have created new FAS 157 suite of reports, which may come with an additional fee

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## Custodial Reports are Starting Points

<u>Past</u>	<u>Present</u>
Presumption that custodians will be able to provide turn-key report	oCustodians may not be able to assign levels to alternative investments
	oClients will need to <ul style="list-style-type: none"> <li>• Assign missing levels for alternatives</li> <li>• Override any pre-assigned levels or market values, where they differ with the custodian's interpretation</li> <li>• Determine which asset class break-downs will be displayed in their FAS 157 tables</li> <li>• Finalize FAS 157 bucketing decisions for 12/31/07 &amp; 12/31/08 for Roll Forward Table</li> </ul>

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## Auditor's Deeper Dive

### Past

Auditors relied on Limited Scope Exemption

### Present

o Auditors likely to suggest reconsideration of Limited Scope option, if plan holds alternative investments

o Will ask more detailed question about valuation process, for example:

"Understand the plan's process for determining fair value measurements and disclosures, including the expertise and experience of those persons who are responsible for preparing the fair value measurements (including third parties) "

" Where appropriate, assess and document how management has assessed the appropriateness of inputs obtained from pricing services, brokers, appraisers, or other external parties, particularly for the measurement of illiquid instruments. "

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## Time-Consuming Process

### Past

Financial statements prepared by extracting numbers for custodian statements

### Present

o Greater collaboration with outside parties:

- Valuation Experts
- Investment Committee
- New custodial reports
- Pricing vendor discussions
- Outside fund companies
- Auditors of outside fund companies

o Resources will be more scarce, the longer you wait

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## FAS 132r-1 Pension Disclosures

- o FAS 132(r) has required Plan Sponsors to include annual disclosures about their pension plan assets in the footnotes to their (corporate) financial statement (10-k filings, e.g.)
- o FAS 132(r)1 further amends the disclosure, effective in 2009
- o Requires the addition of the FAS 157 Level 1,2,3 Table and the Roll Forward Table for the plan assets.
- o Plan Administrators now have to prepare these tables twice - for example:
  - Once, in Jan - Feb, for the 10-K filings (public company w/ 12/31 year end);
  - Again, in July - Oct, in the stand-alone plan financials that are attached to the Form 5500 filing

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## Financial Statement Disclosures

- For fiscal years beginning after November 15, 2007 (so, 2008 plan years)
- References to FAS 132r (also referenced in Schedule R attachments!)
- Sample disclosure content in handout. Some public companies adopted FAS 157 last year.

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## Pay Attention!

- Make sure your clients speak with their auditors early in the process about the auditors expectations with regard to disclosures
- You (your firm) may be expected to provide information to clients about pricing mechanisms
  - Issues with commingled funds – PSAs and CCTs

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## Auditing

- Full scope versus limited scope audits
- Certification of Plan Assets
  - Required to certify to the "completeness and accuracy" of the information contained in certifying institution's "ordinary business records".
  - "Ordinary business records" of settlement and custody process does not normally encompass full valuation verification.
  - What does "complete and accurate" certification mean?
- Auditors need to be engaged to perform the right audit for the plan's portfolio

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## Help is Not Far Away!

- o AICPA Practice Aid on Auditing Alternative Investments (July 06)
- o AICPA Draft FAS 157 Alternative Investments (Feb 09)
- o AICPA EBAQC Plan Administrator website

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