

Assessing the Fair Values of Your Plan Investments

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Considerations for Plan Management in Understanding How Fair Values Are Determined under FASB Statement No. 157, *Fair Value Measurements*

This document was prepared to assist you in implementing FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157).

FAS 157 is important to all plans required to prepare GAAP financial statements, regardless of whether you engage your auditor to perform a full scope or a limited scope audit. You will need to have the appropriate valuation processes in place and sufficient data to determine the fair value of the plan's investments using the framework provided in FAS 157 and to present the disclosures about the use of fair value measurements required by FAS 157. The EBPAQC's *Getting Started: Applying New Accounting Rules for Measuring and Reporting Fair Value of Plan Investments: Considerations for Employee Benefit Plan Implementation of FASB Statement No. 157, Fair Value Measurements*, can help you understand what steps you can take to start the process of implementing FAS 157.

Because a fair value measurement is for a particular asset or liability, one important responsibility you will have in implementing FAS 157 is determining the unit of account (i.e., what is being measured by reference to the level at which the investment is aggregated or disaggregated) for your investments. For example, the unit of account for a defined benefit plan's derivative investment generally is the entire contract. The unit of account for a defined contribution plan's investment in a self-directed brokerage account is the individual investment selected by the participants.

Following are suggested considerations that might be relevant as you assess the valuation of your plan's investments.

General:

- Have you determined how the trustee or custodian is obtaining the fair values for each class of investment (e.g., U.S. treasury securities, domestic equities, foreign government bonds, high yield bonds, credit default swaps, etc.)? If pricing services and/or broker quotes are used, determine (a) the pricing source, (b) how the prices that were used were derived (e.g., closing price on an exchange, mean of bid and ask, valuation model, etc.), and (c) what documentation is available to support those prices. If a valuation model was used, do you understand the methodology and inputs to the model?

Unit of Account:

- Have you performed an analysis of plan investments based on a measurement of the plan's "unit of account"? For example, have the underlying holdings in the separately managed accounts, synthetic investment contracts and self-directed accounts been considered?

Common/Collective Trust Funds and Similar Arrangements:

- What is the periodic basis for the net asset value (NAV) calculation (e.g., daily, monthly, etc.). Were there recent transactions at NAV?
- Are there liquidity restrictions? Is the fund granting redemptions?
- Does the declaration of trust include any restrictions?
- Is the fund open to new investors?
- For stable value collective trusts:
 - Is the fund transacting at \$1?
 - Is the NAV per unit \$1 per the year-end audited financial statements?

Investment Contracts Issued by Insurance Companies:

- Does the contract include transfer restrictions, early termination penalties, or restrictions of liquidation over a certain percentage of the contract?
- What is the credit worthiness of the insurance company?
- Can new monies be invested in the contract?
- Does the value provided by the insurance company represent contract value or fair value?
- Does the contract have a maturity date? Can fair value be estimated based on future cash flows?
- How often is the crediting rate adjusted to reflect current market rates?

Limited Partnerships/Hedge Funds/Venture Capital Investments:

- Are audited financial statements presented at fair value as of the same date as the plan's financial statements available for the limited partnership, hedge fund, and/or venture capital investment? If not, what other evidence of fair value can the issuer provide (e.g., appraisals, fair value of the underlying investments, etc.)?
- What are the valuation policies of the fund? Does the reported information from the fund (e.g., financial statements, NAVs, etc.) represent GAAP fair value or some other basis (e.g., cost) that may need to be adjusted to GAAP fair value? Are the accounting policies consistent with the policies of the plan?
- What is the periodic basis for the NAV calculation (e.g., daily, monthly, quarterly, etc.)?
- Are there recent transactions (i.e., subscriptions/redemptions) at NAV? The existence of redemptions but no subscriptions may be an indication that an adjustment for fair value needs to be taken.
- Are there any provisions to suggest an adjustment to NAV at year end may be necessary (e.g., holdbacks, side pockets, initial lock-ups, redemptions fees, gates, liquidity restrictions, etc.)?
- Are there lock-up provisions put in place by the limited partnership or fund preventing redemptions?
- Are there any indications that the fund will close in the near future?
- For a private equity fund, does the unit of account include both the funded and unfunded capital commitments?
- Is the exit market through a direct sale to a third-party buyer?
- Is the NAV provided by the general partner intended to represent the limited partner's exit price for selling its interest?

Derivatives (Futures, Forwards, TBAs, Options, Shorts, etc.):

- Are the derivatives traded on an exchange or traded over the counter? Do you understand the exposure for the over the counter derivatives?
- Is the price used by the trustee based solely on information provided by the counterparty or is an independent price obtained?
- Has counterparty credit risk, and the plan's own nonperformance risk, been considered in the fair values of the derivative contracts?
- Have you prepared an analysis of the risk of liabilities relating to bankrupt derivative counterparties (e.g. TBAs, etc.)?
- Who is determining collectability if the counterparty is bankrupt? How is this reflected in the determination of fair value?

Securities Lending:

- Have you read and gained an understanding of the provisions of the securities lending agreements, specifically, the rights and responsibilities of the plan with respect to collateral received and the borrower with respect to the securities borrowed?
- Are there restrictions put in place relating to the plan's ability to change its securities lending position?
- Are there any issues with the securities lending collateral being marked to market (e.g., has the fair value of the collateral received declined to less than cost)?
- For collateral funds with \$1 net asset values, is the investment in the collateral fund transacting at \$1? Is the net asset value per unit \$1 per the year end audited financial statements?
- What happens if the plan cannot collect the securities back from loan? Is there any exposure for bankrupt counterparties?

Synthetic Investment Contracts:

- What is the credit worthiness of the wrap provider?
- Have you read and gained an understanding of the wrap contracts including the provisions regarding investments in default and the ability to receive contract value for redemptions?
- Do you understand how the underlying investments are valued? Are there illiquid investments or investments in default in the underlying portfolio?

Illiquid Investments (e.g., Private Placement Debt Issues or Private Equity Investments):

- What are the pricing sources for the illiquid securities?
- Which investments are priced by brokers versus obtaining a quoted market price?
- Are the brokers willing to stand by and transact at the price they quoted?
- Do you understand the valuation models and assumptions used by brokers to value these investments?

Money Market Funds or Short-Term Collective or Common Trust Funds:

- Are there any restrictions on redemptions for money market funds?
- Is the fund transacting at \$1?
- Is the NAV per unit \$1 per the year end audited financial statements?

Issuers of Investments Affected by Credit Market Crisis:

- What are the pricing sources for such securities?
- Which investments are priced by brokers versus obtaining a quoted market price?
- Do you understand the valuation models and assumptions used by brokers for these investments? Also, see general pricing questions above.

Real Estate

- What is the basis for the fair value information used by the trustee or custodian?
- If appraisals are used, how often are appraisals performed and are such appraisals performed by an independent third party and reviewed by management? Does management understand the methodology and assumptions for such appraisals?
- If the real estate value is determined using another method (e.g., cash flow projections) does management understand the methodology and assumptions surrounding that method?