Getting Started: Applying New Accounting Rules for Measuring and Reporting Fair Value of Plan Investments

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Considerations for Employee Benefit Plan Implementation of FASB Statement No. 157, *Fair Value Measurements*

Employee benefit plans are now required to implement new accounting rules for valuing and reporting the fair value of their investments in the plan's financial statements. The EBPAQC has prepared this document to help plan sponsors and administrators implement the new requirements of Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157). FAS 157 establishes a framework for measuring fair value under generally accepted accounting principles (GAAP), clarifies the definition of fair value within that framework, and expands financial statement disclosures about the use of fair value measurements. While employee benefit plans currently report plan investments at fair value in their financial statements, the FAS 157 framework for measuring fair value may change current valuation practices for certain investments and requires additional disclosures about the use of fair value measurements.

All plans that prepare year end GAAP financial statements are affected.

FAS 157 must be implemented for all plans that prepare GAAP financial statements, regardless of whether the plan administrator engages its independent auditor to perform a full scope or a limited scope audit of those financial statements. FAS 157 applies for fiscal years beginning after November 15, 2007.

Implementation issues will vary based on the types of investments held and the availability of information.

Plans that invest only in mutual funds and equity securities with readily determinable fair values should find it easier to implement FAS 157 than plans that hold investments for which there is little, if any, market activity at the measurement date, such as limited partnerships, private equity funds, funds of funds, real estate, and investment contracts with insurance companies. Valuing these types of investments may present plan sponsors and administrators with significant challenges, including understanding whether the valuation assumptions and methods used are appropriate under the FAS 157 fair value definition, whether the values are as of the plan's year end (for example, investments in limited partnerships may be reported by the trustee or custodian as of the partnership year end and not as of the plan's year end), and obtaining additional information about the valuation inputs to make the appropriate note disclosures required by FAS 157. Because many plans outsource investment management activities to third party service providers, information regarding the pricing and valuation of the plan's investments may not be fully transparent to those responsible for plan financial reporting. For certain investments, it may even be necessary to hire additional valuation services for investments for which year end fair value information is not available.

Additional time will be required to prepare and audit the investment information.

Plan management responsible for financial reporting should expect to spend additional time to fully understand the valuation process for plan investments and whether investments are properly reported in the financial statements as of the plan's year end under the new FAS 157 definition of fair value, and to prepare additional investment note disclosures. Similarly, the plan's independent auditor will need to assess whether the plan has established proper internal controls, used appropriate valuation assumptions and methods, and made the necessary disclosures.

While plan administrators may outsource the mechanics of the plan investment valuation process, they will need to retain responsibility for the oversight of the final valuations reported in the plan's financial statements, including determining the adequacy of the related note disclosures. As such, it is important to read and understand FAS 157 in its entirety. The full text of FAS 157 is available at the Financial Accounting Standards Board website at **http://www.fasb.org/pdf/fas157.pdf**.

Below are steps that you as a plan sponsor or administrator can take now to prepare for implementation of FAS 157.

1. Understand how FAS 157 affects your plan's financial statements.

You should become familiar with the requirements of FAS 157, including the definition of "fair value," and how it may change current practice for valuing the plan's investments. Fair value is defined as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. The definition focuses on the price that would be received to sell the investment—an exit price—not the price that would be paid to acquire the investment (an entry price). FAS 157 also clarifies which market should be considered in determining the exchange price and the appropriate assumptions that market participants would use in pricing the investment, establishes a fair value hierarchy, and clarifies that market participant assumptions should include assumptions about risk and the effect of a restriction on the sale, transfer or use of an asset.

FAS 157 also discusses the concept of the "unit of account" which reflects what is being measured by reference to the level at which the plan's investment is aggregated (or disaggregated) for purposes of applying other accounting pronouncements. For example, the unit of account for a defined contribution plan's investment in a self-directed brokerage account is the individual investments selected by the participants. The unit of account for a defined benefit plan's derivative investment generally is the entire contract.

2. Learn what additional financial statement disclosures are required and what information you will need to prepare these disclosures.

FAS 157 requires expanded financial statement disclosures about the use of fair value to measure plan investments subsequent to initial recognition. These disclosures include information that enables readers of the financial statements to assess the inputs used to measure fair value by identifying the fair value hierarchy based on the lowest level of any input that is significant to the fair value measurement and, for recurring fair value measurements using significant unobservable inputs, the effect of the measurements on changes in net assets for the period. Also, for recurring fair value measurements using significant unobservable inputs, a reconciliation of the beginning and ending balances, separately presenting changes during the period, must be disclosed.

3. Establish responsibility at the plan level for implementing FAS 157 and participating in the audit process.

Plan management is responsible for properly reporting plan investments in the plan's financial statements. This responsibility cannot be outsourced or assigned to another party. While you may use outside service providers to assist in the investment valuation and reporting process, this does not relieve you of your responsibility under the Employee Retirement Income Security Act (ERISA) for plan administration functions including filing complete and accurate financial statements. You will need to have a sufficient understanding of the nature of the plan's investments and the valuation methodologies, key assumptions and inputs used to determine fair value. *This responsibility does not change even in situations where the plan's trustee or custodian certifies the completeness and accuracy of the plan's investments for a limited scope audit.*

It is important to have a designated individual from the plan sponsor who is knowledgeable about the nature of the plan's investments, the valuation process and GAAP financial reporting to take an active role in the financial statement preparation and audit processes. This will be particularly essential when the plan audit is coordinated through the human resource or benefits department. Regardless of the scope of the audit engagement (i.e., full scope or limited scope), the requirements of FAS 157 and the significance of plan investments will require individuals in the financial accounting and/or treasury departments to take a more active role in understanding the valuation process, preparing the financial statements and related disclosures and providing the auditors the information they need to perform the audit.

4. Communicate with your plan trustee, custodian or other investment service provider about information they can provide to help you determine the fair value of your plan's investments.

Because you as plan management ultimately are responsible for ensuring that investments are properly valued and reported in the plan financial statements, it is critical that you communicate with your plan trustee, custodian or other investment service provider and understand the information they are providing in periodic investment reports and certifications.

The information offered by your service provider may depend on the services for which you have contracted. The typical services given by a service provider may include providing values that are based on the best available information at the time they generate the trustee or custodial statement. If the plan is invested solely in assets with readily determinable fair values, such as exchange traded mutual funds or equity securities, the service provider typically obtains the value for such investments from nationally recognized pricing services using quoted prices (unadjusted) in active markets for identical investments. Those values should be relatively easy to verify.

However, if the plan holds investments in assets without readily determinable fair values, the values provided in the trustee or custodial statement may be a pass-through of the values given to the service provider by the issuer or fund manager. In these situations, the values provided by the service provider may or may not be an appropriate measure of fair value. As such, you need to understand how the service provider's values were determined so you can evaluate whether the value is a reasonable estimate of fair value under the framework provided under FAS 157 and prepare the required disclosures. For investments for which there is little, if any, market activity, you may need additional information from other sources to prepare the disclosures required by FAS 157.

Most trustees and custodians are aware of the requirements of FAS 157 and are anticipating the need to provide greater transparency about the source, type, and age of the prices that are reflected on their statements. Contact your service provider, and discuss the specific investments held in your plan so they are prepared to give you the information you will need in a timely manner. Following are some questions you should consider discussing with your service provider(s):

- Which investments, if any, are valued using quoted prices in active markets for identical investments?
- Which investments, if any, are valued using inputs other than quoted prices in active markets? (For these investments, ask your service provider to give you the information made available to them so that you can determine whether the valuation provided by the service provider meets your needs.)
- Are there investments that are valued based on the best available information, which may be stale information from a previous month or quarter, or may be based on a cost basis rather than a GAAP basis? (In these situations, ask the service provider if they have subsequently received updated information from the issuer or fund manager to help determine the fair value as of the plan's year end.)
- Will additional information be provided to help determine the appropriate fair value hierarchy in which to report the investments? (Keep in mind that even if that information is provided by the trustee and/or custodian, it is your responsibility to evaluate whether the fair value hierarchy is appropriate based on the lowest level of any input that is significant to the fair value measurement.)
- For any investments valued using unobservable inputs, will information be provided summarizing the changes in fair value for such investments? (This disclosure requires the plan to distinguish its unrealized gains and losses from its realized gains and losses for any investments measured using unobservable inputs at either the beginning or the end of a reporting period.)
- Are any investments subject to restrictions such as liquidation and transfer provisions that could result in an adjustment to the net asset value (NAV)? (Evaluation of the provisions in the investment-related contracts may be necessary when assessing whether adjustments to NAV/unit values are required.)

5. Talk to your plan auditor about how FAS 157 will affect the audit and what information they will need.

It is important that you talk to the plan's independent auditor early in the planning process to understand what information will be needed to perform the audit. Like you, your auditor will also need to understand the methodologies and assumptions used to determine the investment valuations. The timing and extent of audit procedures performed will depend on the nature of the audit engagement (full scope vs. limited scope), and the auditor's risk assessments and materiality considerations. If you have engaged your auditor to perform a full scope audit, he or she may also ask you to provide evidence to support the valuations and related disclosures. Because investments with unobservable inputs generally will result in a higher risk assessment, you should be prepared to provide your auditor with evidence supporting your valuation measurement.

If you have engaged your auditor to perform a limited scope audit, the auditor has no responsibility to perform audit procedures on investments and related investment activity certified by the plan trustee or custodian. However, depending on the nature of the investments held in your plan (i.e., investments measured with unobservable inputs) your auditor may make inquiries to understand your valuation process and the procedures you performed in determining whether the values certified by your trustee or custodian are an appropriate measurement of fair value under the framework provided by FAS 157. If the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor's report. And because the determination of the levels into which the assets fall for purposes of preparing the new disclosures likely will not be covered by the certification provided by the plan trustee or custodian, the auditor will need to perform procedures to assess whether they agree with the levels assigned by plan management.

Your plan auditor can help you better understand the requirements of FAS 157 and help you determine the information you need to obtain to estimate fair value and prepare the required disclosures. However, the DOL, AICPA and SEC (if applicable) independence rules restrict the non-audit services auditors can perform for a plan for which they perform the annual financial statement audit. As such, your plan auditor cannot perform the investment valuations or take on management's role and responsibility for the related note disclosures.

6. Pay special attention to "alternative" and/or hard to value investments.

Valuing your plan's alternative investments (investments that do not have readily available market prices) continues to present challenges. Implementation of FAS 157 may make this process even more challenging. Alternative investments with no observable inputs (as described in FAS 157) will be subject to the comprehensive disclosure requirements and require a more robust valuation process. These include, but are not limited to, common/collective trust funds; pooled separate accounts; stable value investments; private equity funds; hedge funds; real estate/real estate funds; derivatives; and funds of funds.

While the process for valuing investments that are not complex and have readily determinable fair values may not be extensive, the nature and extent of your processes for valuing investments become increasingly important when the plan holds alternative investments, especially as the hard-to-value alternative investments comprise a larger portion of the plan's investment portfolio. You should, to the fullest extent possible, obtain information about the nature of the underlying investments; the portfolio strategy of the fund; and the method and significant assumptions used by the fund manager to value the underlying investments. You also should have in place adequate processes and controls for determining that alternative investments are recorded in accordance with the plan's stated accounting policies (see item 9 below).

Often, a wide variety of information is used to assess valuation. The valuation process needs to consider investment features that could affect the fair value of the investments, such as restrictions on ownership transfers and/or liquidation; lockout provisions; and redemption fees. In addition, it is important that you fully understand the nature of the investments and the unit of account to determine whether fair value is measured appropriately. Often the challenge with alternative investments is obtaining sufficient information with which to estimate fair value because such data is not available, or the information is as of a different date than the plan's financial statement date. The EBPAQC Primer, *Alternative Investments in Employee Benefit Plans*, provides a discussion of some of the sources of information that may be used to assess valuation.

If you are unable to obtain the information you need to assess the valuation of your plan investments, or the information received is inconsistent or incomplete, you should contact the issuer of the investment to discuss your concerns and obtain the necessary information to support the valuation methodology. You should document the process for determining the fair value measurements and related disclosures.

7. If necessary, hire a third party to perform valuation services to obtain fair values for plan investments.

Determining fair value can be quite complex for certain investments for a number of reasons, including the need to exercise judgment concerning significant assumptions; the availability (or lack thereof) of information or evidence and its reliability; and the choice and sophistication of acceptable valuation techniques and models. Of these, obtaining sufficient and reliable information relevant to fair values may present the greatest challenge. The nature and reliability of information available to you to support your fair value accounting estimates vary widely, and thereby affect the degree of uncertainty related to estimates associated with that fair value. Complications may even exist for investments that traditionally have quoted market prices. For example, if markets become inactive, market price information becomes unavailable and estimates need to be made on the basis of other information, to which you may have very limited access. For certain alternative investments, it may be necessary to use third party valuation services that have access to information that is not available to you.

To the extent you do not have the appropriate expertise regarding investments and the related valuation, you should consider consulting with an investment adviser or valuation specialist to assist with the documentation of the valuation methodologies, assumptions and related inputs. In such cases, you still have the responsibility to evaluate and independently challenge the valuation.

8. Determine whether 2007 comparative financial information for the plan will need to be disclosed.

In most cases, plans will not be required to provide comparative financial information when FAS 157 is adopted, as the provisions of FAS 157 generally are to be applied prospectively as of the beginning of the fiscal year in which FAS 157 is initially applied. Refer to the Center tool, *New Accounting Rules for Measuring and Reporting Plan Investments: A Summary of the Reporting and Disclosure Requirements of FASB Statement No. 157*, Fair Value Measurements, for a discussion of the exceptions to the prospective application. Certain financial instruments require retrospective application as defined in paragraph 37 of FAS 157; however, plan holdings in such investments may not be that common. In the event a plan has such investments, begin to accumulate the necessary data at the earliest possible date.

9. Establish and monitor proper internal controls over the plan's financial reporting process related to the valuation of plan investments.

Establish policies and processes to ensure proper authorization of, accounting for, and reporting of plan investment transactions. These policies and procedures may include ensuring:

- A formal plan oversight committee is in place as part of due diligence with decisions made properly documented.
- Plan fiduciaries and management understand the nature of the plan's investments as well as the methods used in the valuation of those investments.
- Plan fiduciaries and management understand service agreements with investment custodians and service providers.
- Controls at all service providers used by the plan are reviewed and monitored throughout the year.

Effective controls reduce the risk of asset loss, help ensure that plan financial information is complete and accurate, financial statements are fairly stated in accordance with GAAP, and the plan is in compliance with applicable laws and regulations. Your plan auditor is required to communicate to those charged with plan governance certain deficiencies and/or weaknesses in internal control over your plan's financial reporting process. Inability to understand and apply the provisions of FAS 157 and provide accurate financial information and disclosures as required by FAS 157 can be identified by auditors as such a deficiency or weakness. For additional information, refer to the EBPAQC Plan Advisories: *The Importance of Internal Controls in Financial Reporting and Safeguarding Plan Assets*; *Effective Monitoring of Outsourced Plan Recordkeeping Functions*, and *Valuing and Reporting Plan Investments*.

10. Valuation considerations related to your plan's investments.

Issues to consider in determining proper valuations for your plan's investments will vary based on the types of investments held. It is important to ask the right questions and obtain appropriate information to allow you to determine the fair values. For example, a plan's investment in a hedge fund may have typically been measured using the fund's NAV at year end. Under FAS 157, the NAV is considered but may not be the only indication of the fair value of the plan's investment in the fund. Adjustments to the hedge fund's reported NAV may be required to reflect whether the fund is closed to new investors, the willingness and ability of the fund to provide a source of liquidity through subscriptions and redemptions, the put feature granted to the plan through its redemption right, redemption fees, halts to redemptions, side pockets and initial lock-ups or gates. The Center's *Assessing the Fair Values of Your Plan's Investments*, provides suggested considerations that might be relevant as you assess the valuation of your plan's investments.