Alternative Investments in Employee Benefit Plans

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AICPA

Introduction

The AICPA Employee Benefit Plan Audit Quality Center has developed this primer to provide Center members with a general understanding of alternative investments held by employee benefit plans. Included in this primer are discussions of unique characteristics of alternative investments, ways of identifying various alternative investments, valuation methods, reports commonly used in supporting the valuations, and references to the relevant accounting and auditing professional literature related to alternative investments.

Alternative Investments

Alternative investments do not have readily determinable fair values.

Alternative investments are assets that are not listed on any national exchanges or over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System [NASDAQ]. These investments generally do not fall under any federal or state regulator and have greater flexibility in investment strategies than registered investment companies.

Alternative investments are more commonly found in defined benefit plans, which use these investments to achieve a diversified portfolio to improve total returns over the long term. The return on investments for a defined benefit plan has a direct impact on the annual minimum required contribution that the employer must make to the plan, resulting in a desire to maximize the portfolio's return. In defined contribution plans, the most common type of alternative investments found are common collective trusts, pooled separate accounts and stable value investments; however, these plans may include other types of alternative investments in their portfolios, particularly in plans that offer self-directed accounts.

Types of Alternative Investments

Each type of alternative investment has unique characteristics.

Benefit plans invest in many different types of alternative investments with varying degrees of investment risk to the plan. The more complex, high risk alternative investments will often times be illiquid and may have restrictions on the transfer of ownership interest. As such, they are typically used by the more sophisticated investors with long-term investment horizons.

The following are examples of types of alternative investments or investment strategies used by benefit plans:

- Common/collective trusts
- Pooled separate accounts
- Stable value investments
- Private equity funds
- Hedge funds
- Real estate funds
- Funds of funds
- Securities lending

Common/collective trusts (CCT) and pooled separate accounts (PSA) are two of the most common types of alternative investments. These investments are pooled funds that look like mutual funds, but they are not registered with the Securities and Exchange Commission. Often times, they will be invested in mutual funds or other marketable securities, but the unit price generally will be different from the value of the underlying securities because the fund may also hold cash for liquidity purposes, and the fees imposed by the fund are deducted from the fund value rather than charged separately to investors. Some CCTs and PSAs have no restrictions as to their investment strategy and can invest in riskier investments, such as derivatives, hedge funds, private equity funds, or similar investments.

Stable value investments are classified as alternative investments as they do not have a readily available market price. Stable value investments are primarily guaranteed investment contracts (GICs) issued by banks or insurance companies, synthetic GICs, or a CCT, or PSA that invests in a GIC or synthetic GIC. The issuer of a traditional GIC takes a deposit from the plan and purchases investments that are held in the issuer's general account. The issuer is contractually obligated to repay the principal and the guaranteed interest rate to the plan. The value of a traditional GIC is the value of the contract between the plan and the issuer. In a synthetic GIC arrangement, the plan itself owns the underlying investments (generally high quality government securities, private and public mortgage-backed and other asset backed securities, and investment grade corporate obligations) and purchases a "wrapper" (usually from an insurance company) which guarantees full payment of principal and interest. The fair value of the synthetic GIC is the total fair value of the underlying investments plus the value of the "wrapper" contract.

Private equity funds include venture capital investment companies or partnerships, limited partnerships and other start-up ventures. Investments in such funds typically are evidenced by a written agreement, which allows for call commitments and withdrawal restrictions. These agreements may be illiquid due to the very nature of the assets in which they invest (typically securities with no public market). The companies which these funds invest in may be in the research and development stage which are not currently producing revenue. Techniques utilized in valuing these investments often are subjective. Additionally, the investment values may be based on a valuation specialist's report including projected cash flows and industry analysis.

Hedge funds are similar to mutual funds but are allowed to use aggressive strategies typically not found in mutual funds, including selling short (i.e., leverage), and extensive use of derivatives. These funds are also currently exempt from many of the rules and regulations governing mutual funds. In some cases, these funds do not prepare audited financial statements and obtaining the list of underlying investments can be difficult due to confidentiality agreements. This lack of transparency often makes it difficult to value these funds and to calculate the proportionate ownership share of the fund.

Real estate funds, as their name suggests, invest in real estate ventures, and the valuation of such investments will tend to follow the real estate market. The investment structure is either a limited partnership or a corporation that typically involves a direct purchase of a basic real estate property, and could provide for additional capital calls. The fund's financial statements can report the value of these investments at fair value, historical cost, or on the tax basis of accounting. Valuation can be obtained through third party appraisals, cash flow projections or insurance valuation and often involve subjective assumptions.

Funds of funds are investment companies that invest in other investment companies. These funds can include limited liability partnerships or corporations, mutual funds, hedge funds, private equity funds, and other similar investments. This structure is popular in the investment partnership market and more recently in the registered fund market. Many multi-tiered structures are U.S. domiciled, but recent trends include the creation of offshore, domestic and blended structures. A blended structure might include a fund with significant assets in other investment companies and also assets in individual securities. For publicly-traded investee funds, market quotes are usually available. However those investee funds that are not publicly traded can involve many layers of funds before identifying the individual assets, thus making them difficult to price and audit.

Securities lending is the practice of lending portfolio securities, usually to a broker to cover a short sale or fail transactions, the latter arising when securities are not delivered in proper form. In exchange for lending the securities, the plan should receive cash (or other consideration) collateral from the broker in an amount equal to or exceeding the market values of the securities on that day; this collateral is immediately invested for the plan's benefit. The market values of the securities on loan should be closely monitored, as changes in excess of an agreed-upon range may cause the release of the collateral or an increase in collateral.

Other types of alternative investments such as derivatives (forward contracts, futures and credit default swaps), are also found in the more complex plans. (Refer to AICPA Audit and Accounting Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* for further discussion of these types of investments.)

Identifying Alternative Investments

Identifying alternative investments in plan portfolios can be challenging.

Identifying alternative investments in a plan investment portfolio can often times be challenging. Depending on the timing of the Form 5500 preparation, reviewing the attached schedules may provide valuable information as these investments should be identified by applicable line item or applicable schedule. The trustee's report contains clues as well. The name of the security listed in the trustee report may not specify that it is an alternative investment, but it may give you an indication to look further. If the security name includes such terms as common, collective, trust, CCT, PSA, venture capital, limited partnership, LLC, LLP, Fund I, II, III, associates or real estate, it may be an alternative investment.

Some investments may be identified by the name of a mutual fund. However, in instances where the unit value does not equal the published value of the mutual fund, this may be an indication that the mutual fund is actually held in an alternative structure, i.e., a CCT, or a PSA instrument. These investments generally will invest in a mutual fund, but, as discussed above, the unit value may include other items, such as the expenses of the trust or cash.

Additionally, reviewing the investment agreements, the audited financial statements or the tax returns of the investment can help in identifying whether the plan holds alternative investments. These documents can also help in identifying specific issues relating to the asset, such as verification of ownership percentage, investment transactions and other related information. Finally, discussing the investments with the investment manager should provide an understanding of the portfolio and how the investments are valued.

Valuation Methods

There are many different valuation methods for these investments.

Refer to the AICPA's *Alternative Investments – Audit Considerations: A Practice Aid for Auditors* (AICPA Practice Aid) for in-depth information on the valuation of and best practices for auditing alternative investments.

Alternative investments, by definition, are hard to value, as they do not have readily available market prices. If the plan is required to submit audited financial statements with the Form 5500, plan investments must be reported in the financial statements following GAAP. Starting with plan years beginning after November 15, 2007, GAAP requires investments to be valued at fair value as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (FAS 157). FAS 157 supports valuation techniques consistent with the market approach, income approach and/or cost approach to measure fair value.

Market approach – The market approach, which is the valuation method used for most investments in employee benefit plans, uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (including a business). In many instances the market approach for these investments will be an estimate in good faith and should, to the extent necessary, take into consideration all indications of fair value that are available. The following is a list of some of the commonly considered factors:

- Financial standing of the issuer
- Business and financial plan of the issuer and comparison of actual results with the plan
- Cost at date of purchase
- Size of portion held and the liquidity of the market
- Contractual restrictions on disposition
- Pending public offering with respect to the financial instrument
- Pending reorganization activity affecting the financial instrument (such as merger proposals, tender offers, debt restructurings and conversions)
- Reported prices and the extent of public trading in similar financial instruments of the issuer or comparable companies
- Ability of the issuer to obtain needed financing
- Changes in the economic conditions affecting the issuer
- A recent purchase or sale of a security of the company
- Pricing by other dealers in similar securities
- Financial statements of investees

Income approach – Some investments generate a cash flow, such as rental property, patents, etc. For these types of investments, an income approach may be the best option. This approach uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single present amount (discounted). The measurement is based on the value indicated by current market expectations about those future amounts.

Cost approach – Some investments, such as venture capital funds and limited partnerships, are valued at the total dollar invested in the project. In many of these cases, these investments involve start-up companies that are not marketable. In these situations there may not be a basis for fair value; the historical cost is often times the most attainable. For purposes of employee benefit plan audited financial statements and financial information for the Form 5500 filing, the cost method of accounting for plan investments is not an acceptable basis. However, in some cases, such as venture capital funds in the initial year of investment, this method may approximate market value.

Common Management Reports

Various management reports are used in monitoring and analyzing alternative investments.

Various reports are used to assist in analyzing and monitoring alternative investments. These reports vary from management cash flow analyses to audited financial reports and often times are useful in supporting the valuation of the plan's alternative investments. Some of the management reports that may be utilized include:

Audited financial statements – Many of the limited partnerships, joint ventures, CCTs and other investments will have audited financial statements. The audited financial statements present the financial condition of the investments as well as important disclosure information, such as how the investment is valued and any significant subsequent events. These financial statements may be useful as a basis for the investment valuation. However, depending on the investment structure, the investment's financial statements may not be valued at fair market value, but on some other basis, which would be disclosed in the notes to the financial statements. Disclosure in the notes that investments are valued using FAS 157 may not necessarily be indicative of the value of the limited partnership, joint venture, or CCT investment in the plan's financial statements, due to the illiquidity of the ownership interest, possible sale restrictions or other considerations by the plan. Additionally, the plan and the fund may have different fiscal year ends. In such cases, the custodian or plan sponsor may be able to roll forward the investment's valuation to reflect the fair value as of the plan's year end by obtaining interim financial information and management's tracking analysis.

Periodic management reports – For joint ventures, hedge funds and limited partnerships, the investment advisor traditionally prepares quarterly management reports which give a status of underlying investments included in the funds. These reports will help provide a better understanding of these investments and the viability of the ventures, particularly when the audited financial statements are as of a different year end.

Third party valuation reports – Start-up companies will sometimes hire a valuation expert to perform a valuation study to calculate the net worth of the company. These studies will consider the business plan, current assets, management and comparable businesses to calculate what the business might be worth. The studies are traditionally used to raise venture capital money.

Year-end or subsequent cash receipts and disbursements journals – For pooled separate accounts, common or collective trusts and other unitized investments, reviewing the transactions that occurred at year end or shortly thereafter may help support the investment valuation at year end.

IRS Form 1065, Schedule K-1 – When a plan invests in a partnership, it should receive a schedule K-1 each year reporting its share of the partnership's income, deductions, credits and other relevant information. This schedule is prepared on the plan's percentage ownership share of the partnership, and could be used to verify the existence of ownership interest in the entity. This schedule would also indicate if there is any unrelated business income that would need to be disclosed in the Plan's financial statements. Capital account balances are typically recorded on the K-1, but may not be presented on a U.S. GAAP basis.

Appraisals – Fair values for real estate often are based on independent appraisals. An independent third party appraiser is often used to evaluate and value the asset based on market conditions and comparable transactions. Generally these appraisals are performed annually.

Cash flow analysis – For investments which generate cash flows such as rental property or patents, a cash flow analysis may be the best tool in calculating a fair value. This analysis details the assumptions used in the calculation of the asset value using the income approach. In most circumstances, this worksheet would estimate future income and expenses (cash flows) for the investment over an expected life and the discount rate used to calculate these dollars to a present value.

Contact the issuer – If your client is unable to obtain any of the above reports, or the information received is inconsistent or incomplete, your client should contact the issuer to discuss their concerns. The client should be able to comprehend the plan investments and how the valuations are calculated and the issuer of the investment should be able to remit the proper information.

References to Auditing and Accounting Professional Literature

FASB Statement No. 157, Fair Value Measurements establishes a framework for measuring fair value, and expands disclosures about fair value measurements. Plans will be expected to follow FASB Statement No. 157 in valuing their plan investments.

AICPA Audit and Accounting Guide, ***Employee Benefit Plans***, Chapter 7 gives guidance on auditing plan investments. Additionally this chapter provides guidance on the auditors responsibility when engaged to perform a limited scope audit and what additional steps the auditor should take when one becomes aware of discrepancies in the information certified by the plan's custodian.

AICPA Audit and Accounting Guide, ***Investment Companies*** gives audit and accounting guidance on various investment companies and can help the plan auditor in understanding some of the underlying alternative investments.

AICPA Audit Guide, ***Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***, provides practical guidance to clarify and illustrate the application of the requirements of SAS No. 92.

AICPA's ***Alternative Investments – Audit Considerations, A Practice Aid for Auditors*** is a resource useful to plan auditors relating to the audit testing of these investments. This Practice Aid includes an example confirmation for alternative investments, illustrative examples of due diligence, ongoing monitoring, and financial reporting controls as well as practical advice in auditing these investments.

PCAOB Staff Audit Practice Alert No. 2, ***Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists***, issued December 10, 2007, this alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of GAAP that are particularly relevant to the current economic environment.

EBPAQC's ***Plan Advisory: Valuing and Reporting Plan Investments***, is a guide to assist plan sponsors in understanding their responsibilities for valuing and reporting their plan investments. It is a comprehensive document that contains information about their responsibility for reporting plan investments, how plan investments are reported, investment valuation and related disclosures, their responsibility for valuing investments and establishing internal controls, special considerations for alternative investments, investment information they should request from the plan trustee or custodian, how their independent auditor can assist them, and where to obtain additional information.

EBPAQC's ***Investment Resource Center***, gives general information about investments, and links to authoritative literature, primers and past center calls related to those investments.

AICPA Audit Risk Alert, ***Employee Benefit Plans Industry Developments***, the annual audit risk alert highlights the hot topics in the employee benefit plan industry. This alert will include current issues with alternative investments.

APPENDIX

Glossary

allocated contract. A contract with an insurance company under which related payments to the insurance company are currently used to purchase immediate or deferred annuities for individual participation.

asked price. A potential seller's lowest declared price for a security.

benefit-responsive investment contract. A contract between an insurance company, a bank, a financial institution, or any financially responsible entity and a plan that provides for a stated return on principal invested over a specified period and that permits withdrawals at contract value for benefit payments, loans, or transfers to other investment options offered to the participant by the plan. Participant withdrawals from the plan are required to be at contract value.

bid price. The highest declared price a potential buyer is willing to pay for a security at a particular time.

call option. A contract that entitles the holder to buy (call), at his or her option, a specified number of units of a particular security at a specified price (strike price) either on (European-style) or at any time until (American-style) the stated expiration date of the contract. The option, which may be transferable, is bought in the expectation of a price rise above the strike price. If the price rises, the buyer exercises or sells the option. If the price does not rise, the buyer lets the option expire and loses only the cost of the option. There is a listed and also an over-the-counter market in options. During the existence of an option, the exercise price and underlying number of shares are adjusted on the exercise date for cash dividends, rights, and stock dividends or splits.

collateralized mortgage obligation (CMO). A mortgage-backed bond that separates mortgage pools into different maturity classes called tranches. Each tranche is then sold separately.

common (collective) trust. A trust for the collective investment and reinvestment of assets contributed from employee benefit plans maintained by more than one employer or a controlled group of corporations that is maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency.

contract value. The value of an unallocated contract that is determined by the insurance company in accordance with the terms of the contract.

deposit administration contract (DA). A type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Payments to the insurance company that are intended to provide future benefits to present employees are credited to an account. For investment purposes, the monies in the account are commingled with other assets of the insurance company. The account is credited with interest at the rate specified in the contract; it is charged with the purchase price of annuities when participants retire and with any incidental benefits (death, disability, and withdrawal) disbursed directly from the account.

fair value. The amount that the plan could reasonably expect to receive for a plan investment in a current sale between a willing buyer and a willing seller.

forward foreign exchange contract. An agreement to exchange currencies of different countries at a specified future date at a specified rate (the forward rate). Unlike a securities futures contract, the terms of a forward contract are not standardized.

futures contract. A transferable agreement to deliver or receive during a specific future month a standardized amount of a commodity of standardized minimum grade or a financial instrument of standardized specification under terms and conditions established by the designated contract market.

general account. An undivided fund maintained by an insurance company that commingles plan assets with other assets of the insurance company for investment purposes. That is, funds held by an insurance company that are not maintained in a separate account are in its general account.

guaranteed investment contract (GIC). A contract between an insurance company and a plan that provides for a guaranteed return on principal invested over a specified time period.

hedge fund. An investment company seeking to minimize market risks or maximize returns by holding securities believed likely to increase in value and simultaneously being short in securities believed likely to decrease in value. The only objective is capital appreciation. Hedge funds also may use leverage techniques.

illiquid. Not readily convertible into cash, such as a stock, bond, or commodity that is not actively traded, and would be difficult to sell in a current sale.

immediate participation guarantee contract (IPG). A type of contract under which contributions are not currently applied to the purchase of single-payment deferred annuities for individual participants. Payments to the insurance company that are intended to provide future benefits to present employees, plus its share of the insurance company's actual investment income, are credited to an account. The insurance company is obligated to make lifetime benefit payments to retired employees.

individual separate account. A separate account in which only one plan participates. Also referred to as a separate-separate account.

index option. Calls or puts on indexes of stock.

investment partnership. A partnership, usually a limited partnership, organized under state law to invest and trade in securities.

leverage. Borrowing to enhance return. Buying securities on margin is an example of leverage.

liquidity. A measure of the ease with which a security trades in large blocks without a substantial drop in price.

mark-to-market. A procedure to adjust the carrying value of a security, option or futures contract to fair value.

market price. Usually the last reported price at which a security has been sold or, if the security was not traded or if trading prices are not reported, a price arrived at based on recent bid and asked prices.

master trust. A combined trust account made up of assets of some or all of the employee benefit plans of a company that sponsors more than one plan or a group of corporations under common control. Each plan has an undivided interest in the assets of the trust, and ownership is represented by a record of proportionate dollar interest or by units of participation.

mortgage backed security (MBS). A pass-through security created by pooling mortgages and selling interests or participation in the MBS. The mortgage originator usually continues to service the underlying mortgages while passing through principal and interest payments received from the mortgagors.

NASDAQ. An electronic quotation system for over-the-counter securities, which, for securities traded on the NASDAQ National Market System, reports prices and shares or units of securities trades in addition to other market information.

net asset value per share. The value per share of outstanding capital stock of an investment company, computed (usually daily by mutual funds) by dividing net assets by the total number of shares outstanding. (See rule 2a-4 of the Investment Company Act of 1940.)

NYSE. Acronym for New York Stock Exchange. That is the largest securities exchange in the United States. The NYSE also furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

offering price. The price at which mutual fund shares or investment trust units can be bought, often equaling net asset value plus a sales load.

offshore fund. An investment company organized outside the United States.

over-the-counter (OTC). A market for securities of companies not listed on a stock exchange and traded mainly by electronic communications such as NASDAQ or by phone. The over-the-counter market is the principal market for U.S. government bonds and municipal securities.

passive foreign investment company (PFIC). A foreign corporation is a PFIC if either (1) 75 percent of its gross income is passive, or (2) 50 percent or more of the average value of its assets, computed quarterly, produce or could produce passive income, as defined in the Internal Revenue Code.

pooled separate account. A separate account in which several plans participate.

put option. A contract entitling the holder to sell (put), at his or her option, a specified number of shares or units of a particular security at a specified price (strike price) at any time until the contract's stated expiration date. The option, which is for a round lot and may or may not be transferable, is bought on the expectation that the price will decline below the strike price. If the price declines below the strike price, the buyer exercises or sells the option. If the price does not decline below the strike price, the buyer lets the option expire and loses only the cost of the option. There are both listed and over-the-counter markets in options. The exercise price and number of shares of an equity option are adjusted on the ex-date for cash dividends, rights, and stock dividends or splits.

real estate mortgage investment conduit (REMIC). An investment vehicle created to hold fixed-rate pools of mortgages and to issue two classes of interest in the REMIC: regular interest and residual interests. The vehicle is not subject to taxation and may be used to protect investors in mortgage-related instruments from double taxation.

registered investment company. An investment company that has filed a registration statement with the Securities and Exchange Commission as an investment company in accordance with requirements of the Investment Company Act of 1940. The investment company, as defined in section 3(a) of the act, primarily invests, reinvests, or trades in securities (section 3(a)(1)), issues face-amount certificates (section 3(a)(2)), or engages in investing and owning investment securities, other than government securities, that have a value exceeding 40 percent of the company's total assets (section 3(a)(3)), with some exceptions to the latter (stated in section 3(b)).

Securities and Exchange Commission (SEC). An agency established by Congress to administer federal securities laws.

securities lending. The practice of lending portfolio securities, usually to a broker to cover a short sale. The loan is usually collateralized by cash or government securities.

seed money. An initial amount of capital contributed to a company at its inception. (See section 14(a) of the Investment Company Act of 1940.)

self-directed plan. A defined contribution plan in which the participant authorizes specific investment transactions, such as purchases and sales of specific common stocks or bonds. A self-directed plan does not provide predetermined investment fund options.

separate account. A special account established by an insurance company solely for the purpose of investing the assets of one or more plans. Funds in a separate account are not commingled with other assets or the insurance company for investment purposes. A separate account may be an individual separate account or a pooled separate account.

unit investment trust. An investment company, organized under a trust indenture, that issues only redeemable securities, each of which represents an undivided interest in a unit of specified (usually unmanaged) securities. (See section 26 of the Investment Company Act of 1940.)

unit of participation. An undivided interest in the underlying assets of a trust.

unlisted security. A security that is not listed on a securities exchange. (See over-the-counter.)

venture capital investment company. A closed-end investment company whose primary investment objective is capital growth and whose capital is usually invested wholly or largely in restricted securities in negotiated transactions to form or develop companies with new ideas, products, or processes.

warrant. A type of option to purchase additional securities from the issuer. Commonly affixed to the certificates for other securities at the time when the combined securities units are originally issued, and usually separable, sometimes on and after a subsequent date. Also, a document evidencing options to purchase shares.