Valuing Retirement Plan Investments Under FAS 157

The Roles of Plan Sponsors, Record Keepers, Investment Providers & Auditors

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THE SPARK Institute, Inc.
SHAPING AMERICA'S RETIREMENT

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The SPARK Institute represents the interests of a broad based cross section of retirement plan service providers and investment managers, including members that are banks, mutual fund companies, insurance companies, third party administrators and benefits consultants. Our members include most of the largest firms that provide record keeping services to employer-sponsored retirement plans, ranging from one participant programs to plans that cover tens of thousands of employees. The combined membership services over 62 million participants in 401(k), 403(b) and other defined contribution plans.

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INTRODUCTION

If you are going through a retirement plan audit, the difficulties of valuing plan investments under Statement of Financial Accounting Standards 157 ("FAS 157" or the "Standard") have probably become all too apparent to you. There are practical difficulties for just about everyone involved, including plan sponsors, record keepers, investment providers and auditors, even though volumes have been written about the technicalities of FAS 157. The vast majority of the problems stem from each of the parties having differing views of their roles and responsibilities and uncertainty regarding how the Standards apply to retirement plan investments. This white paper:

1. identifies the most significant practical problems;
2. reviews the Standard and guidance that relates to retirement plan investments; and
3. summarizes the general roles and responsibilities and what can reasonably be expected from retirement plan record keepers with respect to FAS 157 in the audit process.[1]

[1] This general educational summary is not intended as legal or accounting advice to anyone. This material has not been reviewed or approved by any regulatory or governmental agency. You should contact your own legal counsel or accountant regarding advice on your particular situation and circumstances.

FAS 157 OVERVIEW

FAS 157 is intended to uniformly define "fair value" and defines new fair value reporting requirements for financial assets and liabilities. The Standard defines fair value by using the term "exit price," which refers to the dollar amount a firm could expect to receive when selling an asset, or to be paid to transfer a liability, in an orderly transaction between market participants at the measurement date. FAS 157 also introduces disclosure requirements that require evaluation of the inputs used to arrive at a valuation and to determine if these inputs are observable to market participants. FAS 157 establishes a three-level hierarchy that defines inputs from "most observable" (referred to as Level 1 inputs) to "least observable" (Level 3 inputs).

Inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. Inputs may be observable or unobservable. Observable inputs are those that reflect the assumptions market participants would use in pricing the asset or liability, primarily those developed from market data obtained from sources independent of the reporting entity. Unobservable inputs are those that reflect the reporting entity's own assumptions about what market participants would use in pricing the asset or liability and are developed based on the "best information available" under the circumstances.

FAS 157 is not entirely clear regarding how to classify and value certain investments.

Level 1 inputs **-** are observable inputs that reflect quoted prices for identical assets or liabilities in active markets. The quoted price for an identical asset or liability in an active market is assumed to be the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2 inputs - are directly or indirectly observable inputs other than those included in Level 1 that the entity has the ability to access at the measurement date. The input must be observable for substantially the full term of the asset or liability. Level 2 inputs include quoted prices for similar assets in active markets, quoted prices for identical assets in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, yield curves, and volatilities that are observable at commonly quoted intervals), and inputs that are derived principally from, or corroborated by, observable market data by correlation or other means.

Level 3 inputs **-** are unobservable market inputs that reflect the reporting entity's own assumptions about what another market participant would use when valuing an asset. They should only be used if observable market inputs are not available.

FAS 157 also introduces another important concept, "the unit of account." The unit of account determines what is being measured by reference to the level at which the asset or liability is aggregated for purposes of applying other accounting pronouncements. This concept creates issues for investments in unitized commingled vehicles, where one reporting entity must determine what the classification and value should be based on the unitized vehicle or the underlying investments held by the vehicle.

PRACTICAL PROBLEMS

As noted previously, a number of practical problems have become apparent as all of the affected parties work through their first audits under FAS 157.

1. Whose Job Is It?

a. **Plan Sponsors** - Although some large plan sponsors may have technical staff who understand FAS 157 and have the expertise to meet their obligations, the vast majority of plan sponsors were unaware of the existence of the Standard until they were confronted with a request from their plan auditors earlier this year. Plan sponsors are asked to gather and provide information about the investments and to classify them according to FAS 157. When the required information is not available from the record keeper, plan sponsors are faced with having to track down the information from the investment provider. Many plan sponsors do not feel that they have the expertise to address the issues under FAS 157, do not believe that they are responsible for resolving the issues, and prefer that their record keeper and plan auditor resolve any issues with each other.

> ***The plan sponsor as the issuer of the plan's financial statements is responsible for attesting that the plan assets have been reported at fair value and for classifying the plan investments under FAS 157.***

b. **Auditors** - Auditors are auditing retirement plans under the new and unclear Standard for the first time. They are faced with collecting information from plan sponsors who, as noted above, may not have the expertise or are unwilling to accept a role in this process. The plan sponsor may also direct the auditor to the plan record keeper or the investment provider for answers to their questions, including classifying investments.

c. **Record Keepers** - As a result of the problems faced by plan sponsors and auditors, record keepers are finding themselves in the middle of very difficult situations. Generally, record keepers are providing the information they have to plan sponsors so that the plan sponsor can classify the assets and provide information needed by the auditors. In some instances, the record keeper may not have the information that is needed (e.g., plan specific assets maintained by the record keeper as an accommodation for the plan). In other instances, FAS 157 is unclear regarding how to value the asset and the record keeper is unable to determine what information is required under the rule. Many record keepers have reported that they are being asked by plan sponsors and auditors to sign documents classifying plan investments. However, based on the Standard and advice of their independent accountants and legal counsel, record keepers understand that classifying investments is beyond the scope of their responsibilities. Consequently, they may find themselves at an impasse with an unhappy plan sponsor customer and a frustrated auditor.

d. **Investment Providers** - Investment providers are receiving requests for information regarding how they value their investment products. Some of the requests come from entities that the investment provider does not have a direct relationship with. For example, a request directly from a plan that offers an investment product that is made available to the plan through an intermediary such as a retirement plan record keeper. In such instances, the investment providers may be unwilling to respond to the plan sponsor's request because it expects that the intermediary will handle such issues based upon its product and services structure.

2. What information is required and available to meet the Standard?

As noted above, FAS 157 is not entirely clear regarding how to classify and value certain investments. For example, the Standard does not describe how to value and classify plan loans. The manner in which plan investments are held for accounting and record keeping purposes in retirement plans further complicates this issue. For example, some investments, such as mutual funds and employer stock, can be held and accounted for on a share basis. However, those same assets can be held and accounted for on a unitized basis for a number of reasons, such as a fund of funds or maintaining a cash reserve for liquidity needs of daily valuation trading. Additionally, the information that is readily available from a record keeper or investment provider may vary from company to company. In some instances the information may not be readily available on a cost effective basis. For example, record keepers have reported being asked to provide detailed participant loan reports, providing loan initiation dates, maturity dates, beginning loan balance as of January 1st, ending principal, interest paid, deemed distributions, principal paid, new loans to participants during the year, and number of remaining payments. While record keeping systems hold the requested information, most generally do not have a readily available standard report available with the requested data. Providing the requested data in the requested formats may require developing and running multiple reports and manual intervention, which can be costly for the plan sponsor or the plan.

REASONABLE EXPECTATIONS AMONG AFFECTED PARTIES

Lawyers, accountants and other experts have written extensively about the legal and technical aspects of FAS 157, but practical problems continue to plague everyone involved in the process. In the following section we outline the roles and responsibilities of the various parties based on existing guidance. Additionally, we summarize various categories of assets and identify what information record keepers can and should reasonably be expected to be able to provide to plan sponsors and their auditors.

1. Roles and Responsibilities

a. **Plan Sponsors** - Under the Employee Retirement Income Security Act ("ERISA"), the plan sponsor is responsible for maintaining the financial books and records of the plan, and filing the Form 5500 Annual Return/Report of Employee Benefit Plan. Therefore, the plan sponsor as the issuer of the plan's financial statements is responsible for attesting that the plan assets have been reported at fair value and for classifying the plan investments under FAS 157. In order to satisfy those responsibilities, the plan sponsor is also responsible for determining what information is needed to classify the plan investments and obtaining the necessary information. The American Institute of Certified Public Accountants ("AICPA") Employee Benefit Plan Audit Quality Center summarized the plan sponsor's responsibility in a recent publication as follows:

> PLAN MANAGEMENT IS RESPONSIBLE FOR INVESTMENT VALUATIONS AND FINANCIAL STATEMENT DISCLOSURES - Even if you [the plan sponsor] use outside investment custodians, asset or fund managers, or other service providers to assist in determining the value of investments reported in your plan's financial statements and on Form 5500, the DOL holds plan management responsible for the proper reporting of plan investments. <u>This responsibility cannot be outsourced or assigned to a party other than plan management.</u> While you may look to the valuation service provider for the mechanics of the valuation, you need to have sufficient information to evaluate and independently challenge the valuation. Therefore, it is important that you become familiar with the assets in which your plan invests and the methods and significant assumptions used to value them, especially for investments for which readily determinable market values do not exist. (Emphasis added.)[2]

With respect to special or plan specific assets held by a record keeper for a plan as an accommodation, the plan sponsor may also be required to obtain the required information directly from the investment provider. While some record keepers may be willing and able to provide limited assistance in reaching out to the investment providers of the special assets, ultimately the plan sponsor is responsible for obtaining the information.[3] Plan sponsors should also consider their general fiduciary obligations under ERISA and hire an expert, such as a consultant or accountant, to advise them on technical matters related to FAS 157 that they do not feel equipped to address on their own. As noted above, the vast majority of record keeper and auditors are not willing or allowed to advise the plan sponsor on these matters.

b. **Auditors** - The role of an auditor in auditing a plan's financial statements is described by the Financial Accounting Standards Board ("FASB") and is outside the scope of this white paper. However, in general, an auditor will expect that the plan sponsor, as the issuer of the plan's financial statements, has performed its due diligence with respect to gathering information from record keepers and investment providers and classifying investments under FAS 157. Auditors should be reasonably experienced in auditing retirement plans and any special assets held by the plan.

[2] AICPA Plan Advisory, Valuing and Reporting Plan Investments, page 9 (2008).

[3] According to the AICPA Employee Benefit Plan Audit Quality Center, "in cases where the plan invests in assets without readily determinable fair values, and where the trustee or custodian may have been hired only to provide custodial services, the values in the trust report typically will be a pass-through of the values provided by the fund company or limited partnership for commingled funds, or by a boutique vendor or broker for nonmarketable securities. In those cases, the reported values are based on the best information available to the trustee and custodian at the time of the report, which may or may not be fair value. To obtain proper fair values for alternative investments, you [the plan sponsor] may need to contract for valuation services in addition to the custodial services provided or perform your own valuation testing." AICPA Plan Advisory, Valuing and Reporting Plan Investments, page 13 (2008).

c. **Record Keepers** - Record keepers should provide information to plan sponsors that is reasonably available regarding the valuation of the investment products that it generally makes available to its retirement plan customers. However, unless the record keeper is also the investment provider, the record keeper is generally dependent on the investment provider to provide it with the information. Record keepers should have a good working knowledge of the information that plan sponsors will reasonably need in order for them to be able to categorize the investments under FAS 157. Some record keepers may also provide plan sponsors with a suggestion regarding the classification of certain investment products that it makes available to its plan customers. However, the suggestions will generally include significant legal disclaimers that inform the plan sponsor that they are not intended as legal or accounting advice to the plan sponsor, valuations are not independently verified by the record keeper, and do not relieve the plan sponsor from its ultimate responsibility to make the determination. Record keepers should carefully review anything that they are asked to sign by plan auditors to ensure that they are not inadvertently making judgments about what is included by the plan sponsor in the financial statements, or classifying or approving the classification of plan investments.

Record keepers should provide information to plan sponsors that is reasonably available regarding the valuation of the investment products that it generally makes available to its retirement plan customers.

d. **Investment Providers** - Investment providers should provide information to record keepers and plan sponsors that is reasonably available regarding the valuation of their investment products. Unless the investment provider has a direct relationship with the plan, the information should be provided to the record keeper. Investment providers should direct plan sponsors that they that do not have a direct relationship with to work with their record keepers to obtain the information. Additionally, investment providers should have a good working knowledge of the information that plans will reasonably need in order to be able to categorize their investment products under FAS 157.

2. ***Sample methodologies for valuing assets under FAS 157*** - The following section provides sample valuation methodologies relating to certain types of plan investments. Plan record keepers or the investment providers should generally be able to provide the information described for each of the asset types.

a. **Mutual Funds** - Open-end mutual funds are liquid securities that are purchased and redeemed at prices established by the fund company. The funds' prices are published each day by the funds' custodians. Share prices may vary according to the share class. Detailed information about a fund's pricing and valuation techniques is available in the fund's prospectus.

b. **Publicly Traded Common Stock** - These securities are actively traded in markets where the securities are identical. Valuation inputs normally include quoted bid price in active markets for identical assets.

c. **U.S. Treasury, Government and Government Sponsored Entity Pass Through Securities** - These securities are actively traded in markets where the securities are identical. Valuation inputs normally include quoted bid price in active markets for identical assets or similar assets.

d. **Publicly Traded Bonds (including Commercial Mortgage Backed Securities ("CMBS") and excluding Treasuries and Agency Mortgage Backed Securities ("MBS"))** - The vast majority use prices received from third-party vendors (see Publicly Traded Bonds using Price Model/Pricing Committee below for circumstances where that is not the case). These vendors use data readily available to all market participants and use inputs that should be available for substantially the full term of the security. Valuation inputs normally include benchmark yields, reported trades, broker dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, reference data, and industry and economic events.

e. **Broker Quoted Publicly Traded Bonds (including CMBS)** - In certain instances, the asset managers will contact the Market Maker for a quote on a security.

f. **Commercial Mortgage Loans** - Mortgage Loans are typically valued by the asset manager using a discounted cash flow model. The inputs to the model are generally observable and include Treasury Curves, Credit Adjusted Spot Rates, Credit Quality Spreads, Contractual Cash Flows and Lehman Industry Sector Add-ons.

g. **Private Placement Bonds** - These securities are typically priced using discounted future cash flow models. They normally use readily observable inputs to arrive at pricing, including yield curves, externally sourced credit spreads and Lehman industry sector information.

h. **Manually Priced Private Placements** - In many instances, and for many reasons, the asset manager will price the issue using observable inputs such as cash flows, but may also use unobservable inputs such as knowledge of recent business events at the issuing company. The asset manager typically has a Pricing Committee, which reviews and approves prices and is charged with overseeing the accurate valuation of portfolios and securities in these vehicles.

Record keepers or the investment providers should generally be able to provide the information described for each of the asset types.

i. **Publicly Traded Bonds using Price Model/Pricing Committee** - Certain securities, particularly those that are thinly traded or distressed, may be priced by the asset manager using a model, by a pricing committee, or at the last trading price (if trading is suspended). Typically, the asset manager will have a Pricing Committee, which reviews and approves prices and is charged with overseeing the accurate valuation of portfolios and securities in these portfolios.

j. **Wholly Owned Real Estate** - Owned properties are initially recorded at the purchase price plus closing costs. Development costs and major renovations are capitalized as a component of cost, while routine maintenance and repairs are charged as incurred expenses. Real estate costs include the cost of acquired property, including all the tangible and intangible assets. Tangible assets include the value of all land, building and tenant improvements at the time of acquisition. Intangible assets include the value of any above and below-market leases, in-place leases and tenant relationships at the time of acquisition. Market value estimates are based upon property appraisal reports prepared by independent real estate appraisers (members of the Appraisal Institute or an equivalent organization) within a reasonable amount of time following acquisition of the real estate and no less frequently than annually thereafter. The Chief Real Estate Appraiser of the asset manager is responsible for assuring that the valuation process provides independent and reasonable property market value estimates. An appraisal management firm not affiliated with the asset manager is appointed to assist the Chief Real Estate Appraiser in maintaining and monitoring the independence and the accuracy of the appraisal process.

k. **Real Estate Joint Ventures/Limited Partnerships** - The underlying assets are valued based upon property appraisal reports prepared by independent real estate appraisers (members of the Appraisal Institute or an equivalent organization) within a reasonable amount of time and no less frequently than annually. The Chief Real Estate Appraiser of the asset manager is responsible for assuring that the valuation process provides independent and reasonable property market value estimates. An external appraisal management firm not affiliated with the asset manager has been appointed to assist the Chief Real Estate Appraiser in maintaining and monitoring the independence and the accuracy of the appraisal process.

l. **Other Joint Ventures/Limited Partnerships** - Equity Method investments are marked to market using information obtained from third-party sources, including appraisals, economic forecasts, geographic information, housing market data, vacancy rates, default rates, financial statements and other information from the General Partners and detailed listings of the holdings within the venture.

m. **Derivatives**

   i. Options - Over-The-Counter ("OTC") - Plain Vanilla - These are OTC traded and use quoted prices in active markets for identical or similar assets.

   ii. Treasury Futures - These are exchange traded and use quoted prices for identical instruments in active markets.

   iii. Interest Rate Swaps - These instruments are traded in OTC markets. Valuation inputs include interest rate curves, LIBOR yield curve, Foreign Exchange ("FX") spot rates, Equity prices/Equity index prices, volatility and index dividend yields.

   iv. Currency Swaps - These instruments are traded in OTC markets. Valuation inputs include interest rate curves, LIBOR yield curve, FX spot rates, Equity prices/Equity index prices, volatility and index dividend yields.

   v. Credit Default Swaps (Single Name) - These instruments are traded in OTC markets. Valuation inputs include foreign interest rate curves, LIBOR yield curve, FX spot rates, Equity prices/Equity index prices, volatility, index dividend yields and Credit default spreads - CMBX CDS.

   vi. Foreign Exchange Futures Contracts - These instruments are traded in OTC markets. Valuation inputs include interest rate curves, LIBOR yield curve, FX spot rates, Equity prices/Equity index prices, volatility and index dividend yields.

3. *Hard to Value Assets -* As noted throughout this white paper, there are a number of other categories of assets that are hard to value and classify due to the uncertainty under FAS 157. These hard to value assets include, but are not limited to, plan specific separate accounts, collective investment products, managed accounts, plan loans, insurance company general accounts, insurance company separate accounts that invest in mutual funds, and thinly traded stocks. Unfortunately, plan sponsors, record keepers, investment providers, auditors, lawyers and other experts find themselves in the same difficult position with respect to these assets. The proper valuation and classification of these assets under FAS 157 cannot be determined with reasonable certainty absent further guidance from FASB.

The proper valuation and classification under FAS 157 of "hard to value assets" cannot be determined with reasonable certainty absent further guidance from FASB.

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