Investments and Fair Value
Maryland State Society

May 8, 2012
Diane Wasser

The Fair Value Measurement Topic, ASC 820, continues to challenge financial statement preparers, service providers and auditors.

During this session we will address the nature of certain common plan investments as well as common reporting issues, including transfers between levels, proper disclosure of asset classes, and disclosures related to investments that are reported at fair valued based on net asset value.
Fair Value Measurements and Disclosures

• Plan management is responsible for valuation of investments and presenting the financial statements in accordance with GAAP
  – Requires sufficient understanding of the nature of the plan’s investments
  – May use outside service provider or pricing service
• Auditor should obtain an understanding of entity’s process for determining
  – Fair value of investments
  – Fair value disclosures, including fair value hierarchy levels
• Limited scope audit
  – Certification does not change management’s responsibilities

Plan Financial Statements
Adoption Timeline - Fair Value Measurements

- FAS 35
  Plan investments valued at fair value
- ASU 2010–06 (adopt 2010)
  - Disaggregate hierarchy disclosures by “nature and risk” class for all FV assets and liabilities
  - Disclose transfers between L1 and L2
  - Other new disclosures
- ASU 2010–06 (adopt 2011)
  Expanded disclosure of L3 activity
- ASU 2011–04 (adopt 2012)
  - Description of valuation processes for L3
  - Unobservable inputs table (quantitative) for L3
  - Public entities to disclose all L1 and L2 transfers
  - Public entities to provide narrative description of sensitivity of FV to changes in unobservable inputs (qualitative)

- FAS 157 (adopt 2008)
  - Apply new FV definition
  - Hierarchy disclosures
- FSP FAS 157–4 (adopt 2009)
  Disaggregate hierarchy disclosures by “nature and risk” category for equity and debt securities
- ASU 2009–12 “NAV” (adopt 2009)
  - Use of NAV as a practical expedient for valuation
  - Additional disclosures and hierarchy
### Summary of Fair Valuation Guidance

<table>
<thead>
<tr>
<th>ASC 820 Guidance</th>
<th>Summary of Changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAS 157, Fair Value Measurements and Disclosure</td>
<td>• New FV definition</td>
</tr>
<tr>
<td></td>
<td>• Initial requirement for hierarchy table</td>
</tr>
<tr>
<td></td>
<td>• Initial requirement for level 3 roll-forward</td>
</tr>
<tr>
<td></td>
<td>• Disclosure of g/l attributed to change in unrealized g/l of level 3 investments held at year end</td>
</tr>
<tr>
<td></td>
<td>• Transfers in &amp; out of Level 3</td>
</tr>
<tr>
<td>ASU 2009-12, Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)</td>
<td>• NAV as practical expedient</td>
</tr>
<tr>
<td></td>
<td>• NAV hierarchy guidance, require major category</td>
</tr>
<tr>
<td></td>
<td>• NAV disclosures: Investment strategy, redemption requirements, unfunded commitments</td>
</tr>
<tr>
<td>FSP 157-4, Fair Value Measurements</td>
<td>• Fair value when volume and level of activity have significantly decreased</td>
</tr>
<tr>
<td></td>
<td>• Disaggregate FV hierarchy table by nature and risk &quot;category&quot; for equity and debt securities</td>
</tr>
<tr>
<td>ASU 2010-06, Improving Disclosures about Fair Value Measurements</td>
<td>• Disaggregate FV hierarchy table by nature and risk &quot;class&quot; for all FV assets and liabilities</td>
</tr>
<tr>
<td></td>
<td>• Description of Level 1 and 3 investment valuation techniques and inputs</td>
</tr>
<tr>
<td></td>
<td>• Amount and reason for significant Level 1, 2, &amp; 3 transfers</td>
</tr>
<tr>
<td></td>
<td>• Policy for determining transfers</td>
</tr>
<tr>
<td></td>
<td>• Level 3 reconciliation – gross presentation of purchases, sales, issuances, settlements (effective 2011)</td>
</tr>
<tr>
<td>ASU 2010-12, Reporting Loans to Participants by Defined Contribution Pension Plans</td>
<td>• Participant loans are no longer a fair value measurement and therefore no longer required on FV hierarchy table</td>
</tr>
<tr>
<td>ASU 2011-04, Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS</td>
<td>• Tweaks to FV measurement</td>
</tr>
<tr>
<td></td>
<td>• Narrative description of the sensitivity of FV to changes in unobservable inputs (qualitative)</td>
</tr>
<tr>
<td></td>
<td>• Description of valuation processes for level 3 investments, how policies are decided, changes</td>
</tr>
<tr>
<td></td>
<td>• Unobservable inputs table (quantitative) for Level 3 investments</td>
</tr>
<tr>
<td></td>
<td>• “Nonpublic” entities are exempt from qualitative discussion of Level 3 sensitivity and Level 1 &amp; 2 transfers</td>
</tr>
</tbody>
</table>

### ASU 2010-06 Fair Value

**New Disclosures for Level 3 Measurements**

- For calendar year plans, effective January 1, 2011
- Entities must separately disclose the following in the Level 3 activity rollforward
  - Purchases
  - Sales
  - Issuances
  - Settlements
- Formerly these could be netted
- In period of adoption, comparative disclosures not required
Fair Value Measurement Disclosures

- Divergence in practice, and incomplete or missing disclosures
- Examples
  - Failure to breakout investments by class
  - Changes to leveling as a result of errors vs. changes in observability, etc.
  - When NAV used as a practical expedient, missing required additional disclosures (strategies, restrictions, unfunded commitments)

**EXAMPLE DISCLOSURE: by “class”**

<table>
<thead>
<tr>
<th>Level 1</th>
<th>Level 2</th>
<th>Level 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Energy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Healthcare</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Consumer goods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Open ended mutual funds:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• US Large Cap Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• International Stock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Fixed Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Balanced</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Asset-Backed Securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Residential Mortgage-Backed Securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Commercial Mortgage-Backed Securities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Other Asset-Backed Securities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Leveling Changes

• Certain changes result from true transfers due to a decrease or increase in observability
• Certain changes result from new guidance
• Certain changes result from errors in prior year leveling
  – Reclassification footnote
  – Consider restatement if material

ASU 2009-12

• Additional guidance on fair value measurements of investments in certain entities that calculate net asset value per share
• Classification as level 2 or 3 requires judgment based on ability to redeem at NAV at the measurement date
  – If have ability to redeem at NAV at measurement date—level 2
  – If never can redeem at NAV—level 3
  – If cannot redeem at NAV at the measurement date, but the investment may be redeemable at a future date, consider length of time until redeemable (if it is not known when able to redeem or cannot redeem in the near term at NAV—level 3)
ASU 2009-12

- Requires additional disclosures for level 2 and 3 whether or not NAV is used as fair value measurement
  - Strategies, restrictions and unfunded commitments
- Watch if the entity has a different year end/different measurement date than the plan’s year end
  - Look at past history of estimations of NAV vs. final NAV
  - Test underlying values at interim date
- Watch redemption restrictions

Example disclosure for investments reported at NAV

ASU 2009-12

The following table for December 31, 2011 sets forth a summary of the Plan’s investments with a reported NAV.

<table>
<thead>
<tr>
<th></th>
<th>Fair value</th>
<th>Unfunded commitment</th>
<th>Redemption Frequency</th>
<th>Other redemption restrictions</th>
<th>Redemption notice period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Trust Funds (1)</td>
<td>$xxx</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>STIF fund (2)</td>
<td>$xxx</td>
<td>immediate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity index pooled</td>
<td>$xxx</td>
<td>quarterly</td>
<td></td>
<td></td>
<td>60 days</td>
</tr>
<tr>
<td>separate accounts (3)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Venture Capital Funds (4)</td>
<td>$xxx</td>
<td>$xxx,xxx</td>
<td>Semi-annually</td>
<td>No redemptions in initial 3 year holding period</td>
<td>120 days</td>
</tr>
</tbody>
</table>

1. Common Trust Funds: Common trust funds are comprised of shares or units in commingled funds that are not publicly traded. Underlying assets in these funds primarily include publicly traded equity securities and fixed income securities and are valued at their Net Asset Values (“NAVs”) calculated by the fund sponsor and have daily or monthly liquidity.
2. Short-term investment fund strategies seek to invest in high-quality, short-term securities.
3. Equity index fund strategies seek to replicate the movements of an index of a specific financial market, such as the Standards & Poor’s (S&P) 500 Index, regardless of market conditions.
4. Venture capital funds invest in companies at their start-up phase primarily focused on the technology, telecommunications, industrial and life sciences sectors.
Fair Value Measurements and Disclosures

• Whose job is it?
  – Custodians – provide the data
  – Clients – review the data and conclude
  – Auditors – validate and opine

• SAS No. 73 (AU 336), Using the Work of a Specialist
  – Provides guidance that applies when an auditor uses the work of an actuary in the audit of a defined benefit plan or a health and welfare benefit plan. The SAS also applies if specialists are used to value investments in an employee benefit plan’s financial statements.

ASU 2011-04 Fair Value
Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP

• Effective for annual periods beginning after December 15, 2011
• Prospective application
• Objective to converge U.S. GAAP and IFRS in this area
• Expanded Level 3 investment disclosures
“Nonpublic entities” are exempt from certain disclosure requirements:

- A qualitative discussion of the sensitivity of the FV to changes in unobservable inputs and the interrelationships between those inputs.

- Transfers between Levels 1 and 2 of the FV hierarchy

- Info required for public companies when FV is disclosed but not recognized in the financial statements

“Nonpublic entity”, as defined by the codification, is any entity that does not meet any of the following conditions:

a. Its debt or equity securities trade in a public market either on a stock exchange...

b. It is a conduit bond obligor for conduit debt securities that are traded in a public market...

c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.

d. It is required to file or furnish financial statements with the Securities and Exchange Commission.

e. It is controlled by an entity covered by criteria (a) through (d)
FASB Exposure Draft: Technical Corrections
(issued Oct 14, 2011): ASC 960, 962, 965

- Net Change in Appreciation/Depreciation
  - Para 280 and 290 of exposure draft – proposes to disclose net appreciation (depreciation) by investment class for each Level 1, 2 and 3.
  - Why this is a challenge: Levels stored at the asset level, not at the transaction (purchase or sale) level
- No transitional guidance
  - Changes would be made as soon as issued with no provision for adoption

Comment period ended Dec 13, 2011 - See AICPA/FinREC letter
http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1175801893139

Deficiencies-Fair Value-PCAOB Inspection Findings

- PCAOB released several public documents citing fair value auditing deficiencies noted in their inspections:
  - Firms used external pricing services or external valuation specialists to corroborate the values used by management but failed to:
    - understand the methods or assumptions used by these external parties
    - evaluate valuation methods or adequately test controls over issuers’ valuation processes
    - obtain a sufficient understanding of the valuation methods used by the parties providing these external valuations
    - test the operating effectiveness of internal controls over various aspects of issuers’ valuation processes to support the degree of reliance placed by the firms on those controls
PCAOB inspection findings – Fair Value

- PCAOB released several public documents citing fair value auditing deficiencies noted in their inspections:
  - Dec 6, 2011 PCAOB Staff Audit Alert No.9
    http://pcaobus.org/Standards/Pages/Guidance.aspx
  - Sept 29, 2010 Rule 4010 Report On Observations… Audit Risk Areas Affected by the Economic Crisis
  - 2007-9 PCAOB Staff Audit Alerts Nos. 2, 3, 4
    http://pcaobus.org/Standards/Pages/Guidance.aspx

Deficiencies-Investments-DOL Reviews & AICPA Peer Review

- Failure to test year end market values
- Failure to obtain proper certification for a limited scope audit
- Inadequate or missing disclosures related to investments
- Failure to adequately understand the type of investments the plan holds
Deficiencies-Investments-
AICPA Professional Ethics Division & Peer Review

- Disclosures related to fully benefit-responsive investment contracts
- Investments that represent 5 percent or more of the Plan’s net assets
- Adjustment to contract value
- The net change in fair value of each significant type of investment
- Fair market value (ASC 820) disclosures
- The certified information incorrectly included non-investment information, or improperly excluded information that was certified

Audit Objectives and Investments

- Limited vs. Full scope procedures
- **Full** (existence and valuation)
  - Investment confirmation
  - Purchases and sales testing throughout the year
  - Year end market value testing
  - Investment income testing - Interest & dividends
  - Portals – active response from third party
- **Limited**
  - Certification
- Alternative Investments – investments without a readily determinable market value
- **Limited scope and full scope:**
  - Determine that the Plan’s financial statements and disclosures are in compliance with GAAP
Audit Objectives and Investments

• The objectives of auditing procedures applied to investments and related transactions are to provide the auditor with a reasonable basis for concluding:
  – Whether all investments are recorded and exist
  – Whether investments are owned by the plan and are free of liens, pledges and other security interests or, if not, whether the security interests are identified.
  – Whether investment principal and income transactions are recorded and investments are properly valued in conformity with generally accepted accounting principles
  – Whether information about investments is properly presented and disclosed
  – Whether investment transactions are initiated in accordance with the established investment policies

• **Full Scope** (existence and valuation)
  – Obtain all information requested with the confirmation
    • Trade date or settlement date
    • Liens or encumbrances, or lack thereof
    • Certification ≠ Confirmation
    • Portal access – document active response from a third party
  – Separate Alternative Investment Confirmation
Audit Objectives and Investments

• Confirmation
  • Portal access – document active response from a third party
  • In a highly automated environment auditors may face challenges in the confirmation process and therefore must carefully manage the confirmation process and refrain from accessing information available to clients.
  • It is important to note that an auditor’s online inquiry of a third party’s database does not meet the auditor’s confirmation responsibility under AU section 330. Instead, such online inquiry constitutes an alternative procedure.
  • Refer to the full text of AU section 330 and 9330 for guidance when using electronic confirmations.

• Confirmation
  • In addition to challenges with confirmation inquiries, when confirming investment existence and ownership with third party custodians or trustees in a full scope audit, auditors are often faced with challenges regarding the method of response. The challenges relate to electronic responses and those that generally do not address all requests contained in an auditors’ inquiry. AU Section 330, The Confirmation Process, requires an active response from a third party. Guidance, related to this, is available in AU Section 9330, The Confirmation Process – Auditing Interpretations of Section 330. AU Section 9330 states that electronic responses are not precluded and highlights considerations to assist auditors with their determination of the reliability of the information obtained through the confirmation process, including consideration of the risk that
    – the information obtained may not be from an authentic source;
    – a respondent may not be knowledgeable about the information to be confirmed; or
    – the integrity of the information may have been compromised.
Audit Objectives and Investments

- **Limited Scope**
  - **Scope of the Audit (Limited vs. Full Scope)**
    - Determined ONLY by where investments are held
  - **Limited Scope Audit** permitted for plans with assets held by a qualified trustee/custodian:
    - Bank
    - Trust Company
    - Similar institution
    - Regulated savings and loan association
    - Credit union
    - Insurance company (do not refer to as custodian or trustee)
    - Supervised and regulated and is subject to periodic examination by state or federal agency
    - Election is available only if the Custodian certifies both the **accuracy AND completeness** of the investment information – at **year end AND during the year**

Auditors’ Responsibility – Limited Scope Audits

- Obtain and read a copy of the certification
- Determine whether the entity issuing the certification is a qualifying institution under DOL regulations
- Compare the investment information certified to the financial information contained in the plan’s financial statements and related disclosures
- Perform the necessary procedures to become satisfied that any received or disbursed amounts reported by the custodian were determined in accordance with the plan provisions
- Determine whether the form and content of the financial statement disclosures related to the investment information prepared and certified by the plan’s custodian are in conformity with GAAP and are in compliance with the DOL’s regulations
Audit Objectives and Investments

• Certification should be worded similar to:
  “We hereby certify to the best of our knowledge the information contained in this report pursuant to 29 CFR 2520.103 is complete and accurate”

• Does not apply to investments held by:
  – Broker/dealers
  – Investment company (mutual fund companies)
  – UNLESS they have set up a separate Trust Company or eligible institution that has custody of the assets.

• Unusual wording is a problem

Audit Objectives and Investments

• Is the ENTIRE period under audit certified?
• Are all the investments certified?
• Are notes receivable from participants certified?
• Was there a change in trustee/custodian?
  – If Yes:
    • Assure opinion refers to all certifying institutions for the proper time periods
    • Certifications NEVER cover participant level information
Audit Objectives and Investments

• Every certification is NOT reliable
• Unqualified institutions try to certify
• Qualified institutions sometimes provide unreliable certifications
  – Be aware of hard-to-value assets
  • Is certification appropriate (custodians only need to certify what is
    best available in their ordinary books and records)
  • Is certification at year end
  • Has value changed since prior year
  • Is the custodian merely a conduit and not able to certify
• Watch for agency relationships
  – Not an automatic no-no but additional information needed to verify the
    agency relationship

Audit Objectives and Investments

• DOL Regulations require:
  "…such information as is contained within the ordinary business
records of the bank, trust company, or similar institution and is
needed by the plan administrator to comply with the requirements of
section…"

• "Ordinary business records" may be best-available values,
  – which may or may not be fair value
  – Which may or may not be as of year end
Audit Objectives and Investments

<table>
<thead>
<tr>
<th>Audit Procedures</th>
<th>Limited Scope</th>
<th>Full Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Confirm assets directly with custodian</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Agree the certified investment information to the Plan’s financial statement</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Year-end market value testing</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Investment Transaction Testing</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Test investment income allocation to participants</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Determine that the Plan’s financial statement and disclosures are in compliance with GAAP</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Valuation of Investments and ASC 820/FASB 157

• While management may look to a valuation service provider for the mechanics of the valuation, management should have sufficient information to evaluate and independently challenge the valuation. Therefore, it is important that plan management is familiar with the plan assets in which a plan invests and the methods and significant assumptions used to value them, especially for investments in securities or other assets for which readily determinable fair market values do not exist.

• They can outsource mechanics but can NEVER outsource responsibility.
Types of Investments

- Mutual Funds (Registered Investment Companies)
- Stable Value Funds (not mutual funds)
- Common Collective Trusts (have audited financial statements)
- Pooled Separate Accounts
- Money Market Mutual Funds
- Money Market Accounts
- Guaranteed Investment Contracts (GIC)
- Certificates of Deposit
- Limited Partnerships
- Hedge Funds
- Derivatives
- Funds of Funds
- Traditional Annuities

Unit of Account

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Unit of Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual fund</td>
<td>Mutual fund share</td>
</tr>
<tr>
<td>CCT (Common Collective Trust)</td>
<td>CCT unit</td>
</tr>
<tr>
<td>PSA (Pooled Separate Account)</td>
<td>PSA unit</td>
</tr>
<tr>
<td>Managed fund (Separate Account)</td>
<td>Underlying investments</td>
</tr>
<tr>
<td>Master Trust</td>
<td>Underlying Investments</td>
</tr>
</tbody>
</table>
Investments

• Mutual Funds
  – Registered Investment Companies
  – Plan holds units of participation in mutual funds
  – Units are valued at quoted market prices representing the NAV of the units held by the plan
  – Audited

• Common Collective Trusts
  – Generally plans acquire investment units/units of participation
  – Units represent an undivided interest in the underlying assets of the trust
  – The purchase or redemption price of the units is determined periodically by the trustee based on the current market values of the underlying assets of the fund.
  – Audited
  – If audited financial statements do not need certain disclosures
Investments

• Investments commonly associated with Insurance Companies
  – General Account Products
    • Deposit Administration/Immediate Participation Guarantee Contracts
    • Traditional Guaranteed Investment Contracts (GICs)
    • Evergreen guaranteed rate products
  – Synthetic GICs
  – Separate Accounts
    • Pooled
    • Individual

Investments

• Insurance Company General Accounts
  – Used to fund liabilities associated with various insurance products
  – Contractual guarantees for general account contracts backed by full faith and credit of the issuer
  – Specific securities within the general account are not carved out and attributed to any specific contract holder
  – Ability to satisfy contractual guarantees is dependent on the issuer’s claims paying ability
Investments

- Pooled Separate Accounts
  - Read agreements
  - Redemption restrictions
  - Unit of account

<table>
<thead>
<tr>
<th>Separate Account</th>
<th>Mutual Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit Value</td>
<td>Share price/NAV</td>
</tr>
<tr>
<td>Portfolio holdings</td>
<td>Portfolio holdings</td>
</tr>
<tr>
<td>No public price</td>
<td>Public Price</td>
</tr>
<tr>
<td>Part of investment contract</td>
<td>Held in separate custodial account</td>
</tr>
<tr>
<td>Asset/liability of insurance company</td>
<td>May be omnibus or plan level</td>
</tr>
<tr>
<td>May be audited</td>
<td>Audited</td>
</tr>
</tbody>
</table>
Valuation of Investments

- Common valuation practices
  - General Account GICs
    - Income approach, present value of future cash flows
  - Separate Accounts
    - Net Asset Value/Unit value

Alternative Investments

- Hedge funds
  - Public or not public – audited financial statements
  - Subscription agreements
  - Management agreements
- Limited Partnerships
  - Partnership agreements
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