Applying Accounting Rules for Measuring and Reporting Fair Value of Plan Investments

March 2016

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AICPA Employee Benefit Plan Audit Quality Center

Considerations for Employee Benefit Plan Compliance with FASB Accounting Standards Codification® (ASC 820), *Fair Value Measurement*

Employee benefit plans are required to comply with the FASB ASC 820 accounting rules for valuing and reporting the fair value of their investments in the plan's financial statements. FASB ASC 820 defines fair value; discusses acceptable valuation techniques; provides a framework for measuring fair value, including a fair value hierarchy; and requires certain financial statement disclosures about fair value measurements. The EBPAQC has prepared this document to help plan sponsors and administrators comply with the requirements of FASB ASC 820.

Complexity varies 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 comply with the requirements of FASB ASC 820 than plans that hold investments for which there is little, if any, market activity at the measurement date, such as investments in limited partnerships and hedge funds, real estate/real estate funds, certain investment contracts with insurance companies, and certain fixed income securities. FASB ASC 820 allows investments in certain entities such as hedge funds, private equity funds, bank collective investment funds and pooled separate accounts, to use net asset value (NAV) per share (or its equivalent) as a practical expedient. When NAV (or its equivalent) is available as of the reporting entity's measurement date, these investments are not as challenging to value. FASB ASC 962 and 965 allows for fully benefit-responsive contracts and insurance contracts in defined contribution retirement plans and health and welfare plans to be measured at contract value; therefore, these investments would not be included in the FASB ASC 820 disclosures.

Valuing certain investments may present plan sponsors and administrators with significant challenges, including understanding whether the valuation techniques and inputs used are appropriate under the FASB ASC 820 fair value definition, whether the values are as of the plan's year end (for example, the NAV of an investment in a limited partnership may be reported by the trustee or custodian as of the partnership's year-end and not as of the plan's year-end), and obtaining the necessary information about the valuation inputs to make the appropriate note disclosures required by FASB ASC 820. Because many plans outsource investment management activities to service organizations, 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.

Considerable time may be required to prepare and audit the investment information.

Plan management responsible for financial reporting should expect to spend considerable time to fully understand the valuation process for their plan investments and whether those investments are properly reported in the financial statements as of the plan's year end under FASB ASC 820. Similarly, the plan's independent auditor will need to assess whether the plan has established proper internal controls, used appropriate valuation techniques and inputs, and made the necessary disclosures.

Below are steps that you as a plan sponsor or administrator should take to determine that your plan complies with the requirements of FASB ASC 820.

1. Understand how FASB ASC 820 affects your plan's financial statements

You should be familiar with the requirements of FASB ASC 820, including the definition of "fair value." 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).

FASB ASC 820 also specifies 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 specifies that market participant assumptions should include assumptions about risk and the effect of a restriction on the sale, transfer or use of an asset.

In addition, FASB ASC 820 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 benefit plan's investment in a bank collective investment fund is the plan's unit interest in the fund (not the underlying securities held by the fund), while the unit of account for a defined benefit plan's derivative investment generally is the entire contract.

2. Identify the financial statement disclosures that are required and what information you will need to prepare these disclosures.

FASB ASC 820 includes significant financial statement disclosure requirements related to fair value measurement. These disclosures are intended to help users of the employee benefit plan financial statements assess the valuation techniques and inputs used to measure fair value, and the effect of recurring fair value measurements determined using significant unobservable inputs (i.e., Level 3) on changes in net assets for the reporting period.

ASC 820 requires certain disclosures related to plan investments that are measured at fair value both on a recurring and nonrecurring basis. The required disclosures include information about fair value measurements affecting the financial statements, the levels of the fair value hierarchy within which the fair value measurements are categorized in their entirety, and additional disclosures for measurements using significant unobservable inputs. In addition, reporting entities are required to disclose the inputs and valuation technique(s) used to measure fair value and any changes in those technique(s) during the period, transfers between levels within the hierarchy, and fair value disclosures for each class of assets and liabilities measured at fair value.

Disclosures that focus primarily on Level 3 fair value measurements, including quantitative information about significant unobservable inputs used, a description of the valuation processes in place, and a qualitative discussion about the sensitivity of recurring Level 3 fair value measurements, also are required. Additional disclosures are required for investments for which NAV (or its equivalent) is used to measure fair value as a practical expedient.

This summary of ASC 820 disclosures is not intended to be all-inclusive. You should consult ASC 820 for a complete description of all disclosure requirements.

3. Establish responsibility at the plan level for complying with FASB ASC 820 and participating in the audit process

Plan management is responsible for determining the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation techniques, identify and adequately support any significant inputs used, and determine that the fair value measurements and disclosures are in accordance with FASB ASC 820. *This responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the plan's management.* Although plan management may look to its service organization to assist in the mechanics of the valuation—and some trustees and custodians may also provide preliminary FASB ASC 820 level designations for plan management to use as a starting point for disclosure purposes (see Item 5 below)—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.

Management must have sufficient information to evaluate and independently challenge the valuation and FASB ASC 820 level designations, including a sufficient understanding of the nature of the plan's investments and the valuation techniques, key assumptions and inputs used to determine fair value. Plan management needs to understand the inputs used by the trustee or custodian to value the investments and then determine whether these inputs are appropriate for measuring and reporting the fair value under FASB ASC 820.

It is important to have a designated individual from plan management who is knowledgeable about the nature of the plan's investments, the valuation process and financial reporting to take an active role in the financial statement preparation and audit processes. This is 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 FASB ASC 820 and the significance of plan investments may require individuals in the financial accounting and/or treasury departments to take an 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. Determine whether a limited scope audit makes sense for your plan

The limited scope audit exemption is available to plan administrators, assuming the qualifying institution holding the assets certifies to the accuracy and completeness of the investment information (as detailed in 29 CFR 2520.103-8 of the DOL's Rules and Regulations under ERISA). However, because plan management is responsible for properly reporting the fair value of the plan's investments in the plan's financial statements—a responsibility that cannot be outsourced or assigned to another party—management will need to have a sufficient understanding of the nature of the plan's investments and the valuation techniques, key assumptions and inputs used to determine fair value. This responsibility does not change even in situations in which the plan's trustee or custodian certifies the completeness and accuracy of the plan's investments for a limited-scope audit. As such, it is important that the plan administrator consider whether a limited-scope audit is appropriate given the nature of the plan's investment portfolio and their knowledge of how the values, as certified by the trustee or custodian, have been measured.

If the plan administrator determines that the certified values are incomplete, inaccurate or otherwise unsatisfactory (for example, they do not reflect the fair value of plan assets within the framework established by FASB ASC 820), the plan administrator may request the trustee or custodian to (a) recertify or amend the certification for such investments using the appropriate fair value or (b) recertify or amend the certification to exclude such investments from the certification. If the trustee or custodian amends the certification to exclude such investments from the certification, the plan administrator is responsible for valuing such investments as of the plan's year-end and engaging the auditor to perform full scope audit procedures on the investments excluded from the certification.

5. Communicate with your plan trustee, custodian or other investment service organization 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 determining 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 organization and understand the information they are providing in periodic investment reports and certifications. The type of services you have engaged the trustee or custodian to perform will dictate what information you receive. The plan sponsor should look to the Trust Agreement or Custodial Agreement to determine what services the plan sponsor has engaged the trustee or custodian to perform.

The typical services given by a service organization 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 organization 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 organization by the issuer or fund manager. In these situations, the values provided by the service organization may or may not be an appropriate measure of fair value. As such, you need to understand how the service organization's values were determined so you can evaluate whether the value is a reasonable estimate of fair value under the framework provided under FASB ASC 820 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 FASB ASC 820.

It is important to understand the source, type, and age of the prices that are reflected on the statements you receive from your trustee and/or custodian. Contact your service organization with any questions you may have about the specific investments held in your plan so you get the information you need in a timely manner. Following are some questions you should consider discussing with your service organization(s):

- Which investments, if any, are valued using quoted prices in active markets for identical investments?

- Which investments, if any, are valued using an NAV per share (or its equivalent) that has been calculated in a manner consistent with FASB ASC 946, *Financial Services—Investment Companies?*

- Which investments, if any, are valued using inputs other than quoted prices in active markets? (For these investments, ask your service organization to give you the information made available to them so that you can determine whether the valuation provided by the service organization 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 in conformity with ASC 820? (In these situations, ask the service organization 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.)

- 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.)

Your trustee and/or custodian may provide information 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. In addition, your trustee and/or custodian may provide information summarizing the changes in fair value for such investments.

6. Talk to your plan auditor about how FASB ASC 820 affects the audit and what information they 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 valuation techniques and inputs 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. The auditor's responsibilities for any investments covered by the limited-scope audit exemption are to (1) obtain from the plan administrator and read a copy of the certification; (2) determine whether the entity issuing the certification is a qualifying institution under DOL regulations; (3) compare the certified investment information to the financial information in the financial statements and related disclosures; (4) perform the necessary procedures to become satisfied that any received or disbursed amounts (for example, contributions and benefit payments) reported by the trustee or custodian were determined in accordance with the plan provisions; and (5) determine whether the form and content of the financial statement disclosures related to the investment information prepared and certified by a qualifying institution are in accordance with GAAP and are in compliance with DOL rules and regulations.

Although the auditor is not required to audit certain investment information when the limited-scope audit exception is applicable, if the auditor becomes aware that the certified information is incomplete, inaccurate, or otherwise unsatisfactory, further inquiry may be necessary, which might result in additional testing or modification to the auditor's report. In certain instances, a limited-scope audit may no longer be appropriate.

Your plan auditor can help you better understand the requirements of FASB ASC 820 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.

7. Pay special attention to investments with no observable inputs

Valuing your plan's investments that do not have readily available market prices continues to present challenges. Investments with no observable inputs (as described in FASB ASC 820) are subject to more comprehensive disclosure requirements and require a more robust valuation process. These may include private equity funds, hedge funds, real estate/real estate funds, derivatives, fixed income securities, 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 hard-to-value investments, especially as they comprise a larger portion of the plan's investment portfolio. You should, to the 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 hard-to-value 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 hard-to-value 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 the valuation of your plan's investments.

8. 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. Complexities 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 hard-to-value 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 techniques, assumptions and related inputs. In such cases, you still have the responsibility to evaluate and independently challenge the valuation.

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 for proper authorization of, accounting for, and reporting of plan investment transactions. These policies and procedures may include:

- 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 organizations.
- Controls at all service organizations used by the plan and user entity controls are reviewed and monitored throughout the year.
- Testing the values provided by the service organizations using an alternative pricing service.

Effective controls reduce the risk of asset loss, help determine that plan financial information is complete and accurate, financial statements are fairly stated in accordance with an applicable financial reporting framework, 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 FASB ASC 820 and provide accurate financial information and disclosures as required by FASB ASC 820 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;* and *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, under FASB ASC 820, the NAV of a hedge fund is considered in its valuation 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.

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