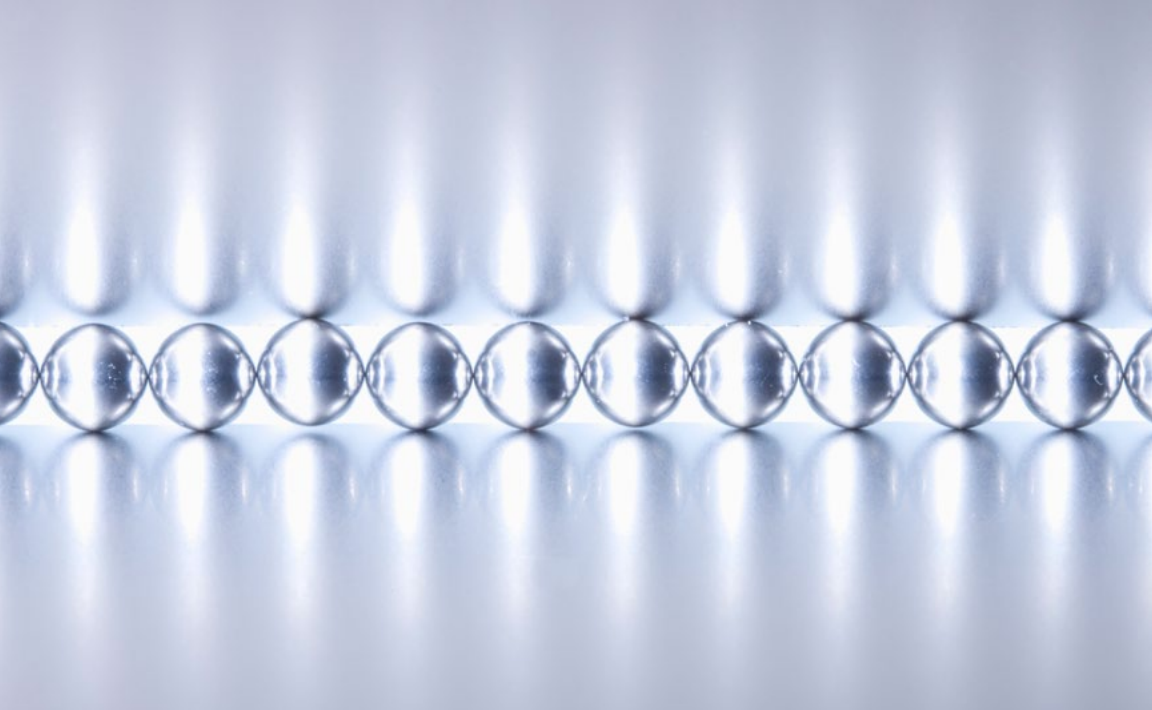




Employee Benefit Plan
Audit Quality Center

Plan advisory



Valuing and reporting plan investments

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Introduction

The AICPA Employee Benefit Plan Audit Quality Center has prepared this advisory to assist you as a plan sponsor in understanding your responsibilities for valuing and reporting plan investments.

This advisory discusses:

- Your responsibility for reporting plan investments
- How plan investments are reported
- Investment valuation and related disclosures
- Your responsibility for valuing investments and establishing internal controls
- Special considerations for alternative investments
- Investment information you should request from the plan trustee or custodian and investment manager
- How your independent auditor can assist you
- Where to obtain additional information

This advisory also includes examples of suggested controls that plan management may wish to consider related to the financial reporting of investments.

Investments are the most significant asset in a benefit plan. Plan investments often consist of marketable securities, such as common or preferred stocks, bonds, notes, or shares of registered investment companies. Other plan investments may include so-called alternative investments, which are not readily marketable. These investments include private investment funds, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles and funds of funds, as well as some bank collective investment funds. Each of these different investments has unique valuation and disclosure considerations.

Your responsibility for reporting plan investments

As a plan fiduciary, you are subject to certain responsibilities – With these responsibilities come potential liability: Fiduciaries who do not follow the ERISA standards of conduct may be personally liable to restore any losses to the plan arising from inaccurate estimates of investment values. For example, if distributions have been made to participants of a 401(k) plan based on an inflated estimate of the value of plan investments, you could be required to make the plan whole by contributing to the plan the amount of such excess distributions.

You also may be subject to certain monetary penalties if you fail to meet your responsibilities for the plan's financial reporting. Under the Employee Retirement Income Security Act of 1974 (ERISA), your responsibilities include plan administration functions, such as maintaining the financial books and records of the plan, and filing a complete and accurate annual return/report for your plan (Form 5500 Annual Return/Report of Employee Benefit Plan). Certain financial information about your plan, including information about the plan's investments, must be reported on the Form 5500 and the related schedules. Generally, if the plan has 100 or more participants, audited financial statements must also be included with the plan's Form 5500. Additionally, plans that have fewer than 100 participants, but which hold non-readily marketable assets may also be required to include audited financial statements. The U.S. Department of Labor (DOL) may assess penalties on plan sponsors of up to \$2,097 a day for failure to file a proper Form 5500.

How plan investments are reported

Investments are reported in the form 5500 at current value¹ — If your plan is required to submit audited financial statements with the Form 5500, plan investments must be reported in the financial statements following generally accepted accounting principles (GAAP), which require investments generally to be reported at fair value. Fair value² for GAAP purposes is defined in Financial Accounting Standards Board (FASB), Accounting Standards Codification® (ASC) 820, *Fair Value Measurements and Disclosures*. Generally, current value and fair value will be the same.

Investment valuation and related disclosures

FASB ASC 820 provides a fair value framework for valuing investments in your plan’s financial statements and requires extensive financial statement disclosures about the valuation of plan investments — It discusses acceptable valuation techniques, which include a market approach, income approach and cost approach. The selection of a valuation technique, or a combination of valuation techniques, for each investment will depend on the particular circumstances. FASB ASC 820 also discusses inputs to valuation techniques—which are the assumptions market participants would use in pricing the investment—and establishes a fair value hierarchy that prioritizes the inputs.

Level 1 inputs—are quoted prices in active markets for identical assets that the plan has the ability to access at the measurement date (for example, prices derived from NYSE, NASDAQ and the Chicago Board of Trade). If a Level 1 input is available for a particular investment, it should be used to value that investment.

Level 2 inputs—are inputs other than quoted prices included within Level 1 that are observable for the asset, either directly or indirectly. Observable inputs are those that reflect the assumptions market participants would use in pricing the asset, developed on market data obtained from sources independent of the plan (for example, matrix pricing, yield curves and indices).

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1. ERISA section 3(26) defines the term “current value” as fair market value where available and otherwise the fair value as determined in good faith by a trustee or a named fiduciary pursuant to the terms of the plan and in accordance with regulations of the Secretary, assuming an orderly liquidation at the time of such determination.
 2. FASB ASC 820 defines “fair value” as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Level 3 inputs—are unobservable inputs for the asset. Unobservable inputs are those that reflect the plan’s own assumptions about the assumptions that market participants would use in pricing the asset, developed based on the best information available in the circumstances (for example, investment manager pricing for private placements, private equities and hedge funds).

The FASB ASC 820 disclosure requirements are detailed, specific, and include, among other things, information that enables readers of the financial statements to assess the inputs used to measure fair value.

Your responsibility for valuing investments and establishing internal control

Plan management is responsible for investment valuations and financial statement disclosures — Even if you 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. This responsibility cannot be outsourced or assigned to a party other than plan management. 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 your plan’s investments and the methods and significant assumptions used to value them, especially for investments for which readily determinable market values do not exist.

This Advisory includes suggestions to assist you in fulfilling your responsibilities with respect to valuing and reporting plan investments and establishing related controls, such as the need to develop systems, controls, processes and procedures. Because each plan is unique, it is not practical to provide detailed examples. Contact your plan auditor to discuss specific ways in which you may implement some of these suggestions, as his or her experience with your plan and the industry may provide you with valuable insights.

Effective internal control at the plan level can help ensure that plan investments are properly valued — As part of fulfilling your responsibility for complete and accurate financial reporting of plan investments, you need to establish processes for determining the fair value measurements and disclosures, selecting appropriate valuation methods, identifying and adequately supporting any significant assumptions used in preparing the valuation, and ensuring that the presentation and disclosure of the fair value measurements are in accordance with Form 5500 reporting requirements and GAAP. Your valuation process doesn't need to include the recalculation of estimated fair values for your plan investments, but it should ensure that you have an adequate understanding of the characteristics of the investments and the valuation process to determine if those valuations are reasonable. For example, where an outside pricing service is used by the plan custodian or trustee, it is important that you gain an understanding of the pricing methods used by that pricing service. It also is vital to document your understanding.

The AICPA Employee Benefit Plan Audit Quality Center has issued a plan advisory, *The Importance of Internal Controls in Financial Reporting and Safeguarding Plan Assets*, which provides information about establishing cost-effective controls. Here are some example controls you may consider implementing to help ensure that investment transactions are valued properly:

- Review monthly or quarterly trust reports
- Communicate regularly with your investment manager
- Compare quotation sources and appraisal reports with recorded values
- Evaluate your appraiser
- Compare values of pooled separate accounts and bank collective investment funds to net asset values calculated by the issuer
- Obtain the financial statements (preferably audited) of pooled separate accounts and bank collective investment funds, and compare unit or other information contained in the financial statements for reasonableness to the unit or other values reported to the plan
- Document valuation methods in the trust agreement or plan committee minutes
- Have the plan committee approve the basis for "good faith" estimates including independent appraisals, if any, and document the basis used

- Obtain documentation from pricing services about the pricing methodologies and sources used

In addition to controls at the plan, the trustee and/or custodian should have adequate internal controls over its process used to value plan investments. See the “Investment information you should request from the plan trustee or custodian” section of this advisory for a discussion of this matter.

Special considerations for alternative investments

Valuing alternative investments can present unique challenges – Alternative investments are those investments for which a readily determinable fair value does not exist (that is, they are not listed on national exchanges or over-the-counter markets, nor are quoted market prices available from sources such as financial publications, the exchanges, or the National Association of Securities Dealers Automated Quotations System). The underlying assets in these alternative investments can range from marketable securities to complex and/or illiquid investments.

Valuing alternative investments may encompass a wide array of methodologies that may involve many assumptions and the exercise of professional judgment. Many alternative investments may have financial statements (unaudited or, preferably, audited) to support their valuations. If you rely on the amounts in the financial statements, it is important that those statements are as of the same date as your plan’s financial statements and that the assets are valued at fair value. If not, you may need to perform additional procedures to be certain those valuations are reliable (again, this responsibility cannot be outsourced or assigned to a party other than plan management). For example, if your plan is invested in a limited partnership with audited financial statements as of a date that is three months prior to your plan’s year-end, you would need to determine how the value of that limited partnership may have changed over the three-month period between the date of the partnership’s financial statements and the date of the plan’s financial statements.

It is important to understand the nature, strategy and assumptions used in valuing alternative investments — The nature and extent of the process for valuing investments, and the related controls, are particularly important when the plan invests in securities for which readily determinable market values do not exist. Controls related to alternative investments should include procedures for initial due diligence (that is, procedures performed before the initial investment), ongoing monitoring (that is, procedures performed after acquisition) and financial reporting. You should have in place a process and internal controls over that process to ensure that the plan's alternative investments are reported in the financial statements at fair value as required by GAAP. The process and controls include having a sufficient understanding of the nature of the underlying investments, the portfolio strategy of the alternative investments, and the method and significant assumptions used by the fund manager to value the underlying investments.

In the absence of availability of a detailed listing of the underlying investments as of the plan's year-end, you may gain sufficient understanding of the fund through other activities. These activities could include, but not be limited to, periodic interviews with fund management to understand the fund's strategy, positions, and valuation methodologies, and comparing the data obtained from the fund manager with other available information, such as sector data, indexes and cash contributions and distributions. Such data could be further corroborated with information regarding the underlying investments obtained through the annual audited financial statements of the alternative investment. See the discussion in the next section, "Investment information you should request from the plan trustee or custodian and investment manager" regarding situations where the investment custodian has not performed valuation services for the plan's alternative investments and provides plan investment information based on the "best available" information.

Investment information you should request from the plan trustee or custodian and investment manager

The plan investment trustee or custodian typically provides you with monthly reports that detail your investment balances — It is important that you review these reports to ensure that they are accurate and complete and report appropriate investment values based on current or fair value as of the date of the report.

The type of services you have hired your trustee or custodian to perform will dictate what information you receive. The typical custodial service provided by custodians and trustees includes providing values that are based on the best information available to them at the time of the report. If the plan is invested solely in assets with readily determinable fair values, such as mutual funds or marketable securities, the trustee or custodian typically obtains fair values from nationally recognized pricing services, and those values will be relatively easy to verify. However, 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 fair values for alternative investments, you may need to contract for valuation services in addition to the custodial services provided, or perform your own valuation. Collaborate with your investment fiduciary, who is more likely to be familiar with the valuation of these types of assets, in order to determine whether the value reported in the custodian statement represents fair value. In any case, it is important that you understand how the investment values are determined so you can make your own judgments about the reliability of the information in the reports.

When it is time to prepare and review the plan's Form 5500 and financial statements, be sure to check that the investments have been valued as of the plan's year-end, and that the valuation method is appropriate. In addition, you will want to inquire as to whether your custodian will provide you with the information necessary to prepare the required financial statement disclosures regarding the valuation inputs (Levels I, II and III) used to determine investment values.

Given the overall increase in the level of alternative investments held by plans, the percentage of plan investments for which values are based on the best available information is increasing. Many plan sponsors may not even be aware that custodians are providing pass-through pricing services and not full fair-value valuation services. Consequently, the best available information reported by the custodian may inappropriately be relied upon for preparing the participant statements, the plan's Form 5500 and its financial statements because it is not the true current or fair value at the plan's year-end. For example, the investment information may be reported as of the limited partnership's year-end rather than the plan's year end, or reported as of the end of the prior calendar quarter, or obtained from a source that had not performed adequate valuation procedures or used different assumptions than used by the plan for estimating current or fair value. In such cases, the investment valuation information may not meet the Form 5500 filing requirements for reporting investments. If the valuation date is different than the plan's year-end, it may be necessary to perform roll-forward or roll-back procedures to determine the proper value at the plan's year-end.

Investments certifications by banks or similar institutions do not relieve plan management of its responsibility for properly reporting fair values — ERISA allows plan sponsors to instruct the plan's independent auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution, or by an insurance carrier that is regulated, supervised and subject to periodic examination by a state or federal agency that acts as a custodian or trustee. This action is available only if a trustee or custodian certifies to both the accuracy and the completeness of the plan asset information needed for the audit engagement.³

3. Certification requirements of 29 C.F.R. § 2520.103-5 define the scope of an accountant's examination and report under ERISA section 103(a)(3)(A) and (C) and 29 C.F.R. § 2520.103-8.

If your plan elects this limited-scope approach to the independent audit, you should review the contracted level of service of the trustee or custodian (i.e., whether they fair value the investments) and assess whether investment values are properly reported based on current or fair value as of the plan's year-end. While the institution may certify that the information on the statement is complete and accurate, it does not necessarily mean that the values actually represent current or fair value as required by ERISA and GAAP (i.e., those from nationally recognized pricing services as opposed to those that are based on pass-through prices, which may not have been subject to further fair value scrutiny). If the information in the certification does not reflect current value or fair value and you use this information to prepare your Form 5500 and financial statements, the plan's Form 5500 and financial statements may be incorrect. It is your responsibility to understand whether reported investment values represent fair values. Ask the institution to provide you with a description of how each investment within the portfolio was priced, which can help you more easily identify whether the institution's statement provides the requisite current and fair values needed to prepare your plan's Form 5500 and financial statements. If a significant amount of plan investment values are based on sources that may not be indicative of fair value, then you may need to reconsider whether the auditor should be engaged to perform a limited scope audit and instead be engaged to perform a full scope audit.

As it is your responsibility to determine whether the conditions for limiting the scope of the independent audit are met, you will also need to verify that the entity certifying the investment information meets the qualification requirements discussed above, and that the entity certifies both the accuracy and the completeness of the plan asset information. It is important to note that in a limited-scope engagement, the plan auditor has no responsibility to test the accuracy or completeness of the investment information certified by the plan trustee or custodian, but if they become aware that the investment information in the certification is incorrect, incomplete, or otherwise unsatisfactory, the auditor may ask you to take certain steps, such as requesting the trustee or custodian to recertify or amend the certification to reflect proper investment values and investment income or to exclude ("carve out") such investments and investment income from the certification.

Reports on controls at the service organization can help you – An effective approach to help you understand and monitor the quality and effectiveness of the trustee or custodian processes and controls related to investments and other outsourced plan administration services is to request a report on the controls at the trustee or custodian, called SSAE No. 18 reports (SSAE is an acronym for AICPA Statement on Standards for Attestation Engagements). These reports are also commonly referred to as SOC 1® Reports. SOC 1 Reports can be extremely important to you in fulfilling your fiduciary duty to monitor controls at your trustee or custodian over plan investments and other plan administration activities. A “Type 1” SOC 1 Report includes a detailed description of the trustee’s and/or custodian’s controls and an independent assessment of whether the controls are suitably designed and placed in operation. Further, a “Type 2” SOC 1 Report can tell you if the trustee and/or custodian’s controls are operating effectively. If no SOC 1 Report is available from the trustee or custodian, then it will be more difficult for you – as well as the plan’s independent auditor – to ascertain that the controls at the service organization are suitably designed and operating effectively.

Caution: SOC 1 Reports often do not address controls related to the valuation of alternative investments because most alternative investments are priced on an investment-by-investment basis. As such, there are no standard control procedures that can be tested. In addition, a custodial SOC 1 Report typically does not cover the pricing services used to value the investments. A separate SOC 1 Report for the pricing service may be available.

It is important to evaluate your appraiser – In many instances plan sponsors do not have the skills necessary to determine the “fair value” of alternative investments and turn to a professional appraiser or valuation consultant for assistance. Taking such action does not relieve you of the responsibility for ensuring that the valuations are proper. As such, it is important that you select a competent valuation advisor, review their work, and challenge any assumptions or conclusions that do not seem reasonable. It is also recommended that this process be documented.

The AICPA EBPAQC plan advisory, *Effective Monitoring of Outsourced Plan Recordkeeping and Reporting Functions*, provides more information about SOC 1 Reports and monitoring internal controls at your third-party service providers.

How your independent auditor can assist you

While your independent auditor is a valuable resource, it is important that you understand that the responsibility for investment valuation and disclosure remains with you – It is important to note that hiring an auditor to perform an audit – whether full scope or limited scope – does not relieve you of your responsibility for the completeness and accuracy of the plan's investment information reported in the Form 5500 and the financial statements.

While your independent auditor may be a good resource to consult about the adequacy of valuation techniques and the related financial statement disclosures, they cannot make the determination regarding the valuation inputs (Level I, II or III). DOL and AICPA auditor independence rules⁴ restrict what non-audit (nonattest) services auditors can perform for a plan for which they perform the annual financial statement audit (for example, DOL rules prohibit the auditor from maintaining financial records for the plan). Your plan auditor may provide advice, research materials and recommendations to assist you in making decisions about the adequacy of your investment valuations and of the related disclosures, and in establishing internal controls surrounding your investment valuations. Your auditor also may be able to provide some assistance with the financial statement preparation, unless they are prevented from doing so under SEC independence rules for Form 11-K filers.

4. DOL Interpretive Bulletin 75-9 (29 . 2509.75-9) relating to guidelines on independence of accountant retained by Employee Benefit Plan and AICPA Professional Code of Conduct Interpretation 101-3, Performance of Nonattest Service.

Additional resources

FASB ASC 820, Fair Value Measurements and Disclosures provides a framework for measuring fair value, and provides guidance on disclosures about fair value measurements. FASB ASC 820 is available at asc.fasb.org/.

PCAOB Audit Practice Alert No. 2, Matters Relating to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists, while intended for auditors, *may provide useful information about considerations* in determining whether a specialist is needed, evaluating assumptions used in fair value measurements, and evaluating the appropriateness of using the specialist's work for the purpose of financial statements prepared in conformity with GAAP. This document is available on the PCAOB's website at: pcaobus.org/Standards/QandA/12-10-2007_APA_2.pdf

The AICPA Audit and Accounting Guide, Employee Benefit Plans (the Guide), describes considerations auditors make relative to your asset valuations in their plan audits. The Guide is available on the AICPA's website at aicpastore.com.

The AICPA EBPAQC Plan Advisory, Effective Monitoring of Outsourced Plan Recordkeeping and Reporting Functions, may serve as a useful tool in monitoring internal controls at your third-party service providers. That document is available on the Center website at aicpa.org/ebpaqc.

The AICPA EBPAQC Plan Advisory, The Importance of Internal Controls in Financial Reporting and Safeguarding Plan Assets includes information that may help you better understand internal controls at your plan and why they are important. That document is available on the Center website at aicpa.org/ebpaqc.

The EBPAQC website includes information that may help you better understand FASB ASC 820 and how it may affect your plan. That information can be found under the "Resources" tab at aicpa.org/ebpaqc.

Illustrative examples of due diligence, ongoing monitoring and financial reporting controls

The following plan controls related to alternative investments include procedures for initial due diligence (that is, procedures performed before the initial investment), ongoing monitoring (that is, procedures performed post-investment), and financial reporting.

Initial due diligence

- Conduct face-to-face meetings with the investment firm's management team
- Conduct on-site visit(s), including back office and operational due diligence
- Evaluate investment strategy, process and portfolio
 - Review historical performance and attribution analysis (audited, if possible)
 - Review valuation procedures
- Request documents review by investment staff
 - Offering memorandum
 - Legal agreements
 - Pitch books
 - Information requests
 - Financial statements
 - Form ADV (used by advisers to register with SEC as investment advisers)
- Evaluate how the specific allocation fits within the asset class and the overall portfolio
- Solicit information regarding the team/firm from knowledgeable third parties
 - Inform investment committee members that a manager is under consideration and request their input if they know the manager
 - Consultants
 - Competing investment managers

Initial due diligence (cont.)

- Perform reference checks
 - Other investors
 - Investee companies
 - Service providers
 - Prior employers
- Perform third-party background checks on senior professionals
 - Verify biographical information
 - Perform criminal background search
 - Perform press search
- Review and negotiate legal agreements
- Complete a formal investment memorandum/write-up or other investment approval review

Ongoing monitoring

- Conduct regular in-person or telephonic meetings with the investment firm management team
- Conduct on-site visit, typically done on an annual basis (often substitute with attending annual meeting)⁵
- Review fund communications
 - Review fund communications, including quarterly shareholder's letters, etc.
 - Obtain and review audited financial statements, note

whether the opinion is qualified, any change in the auditor, or change in valuation procedures

- For drawdown funds, compare partners' capital statements with internal transaction records
- Review SSAE No.18 reports if available, and ensure that identified user controls are in place at the investor entity
- Perform valuation
 - Request and review, if available, the valuation of portfolio holdings for reasonableness
 - For custodial assets, reconcile with custodian's pricing
 - Request and review any changes to valuation policies and procedures
 - For hedge funds, receive estimated value from fund and final value from fund administrator; compare for reasonableness
 - Compare the institution's statement of value received as of the fund's year-end to the value based on the fund's audite financial statements, and follow up on significant discrepancies

5. Many institutions delegate this function to a third-party investment adviser or consultant.

Ongoing monitoring (cont.)

- Monitor portfolio performance
 - Compare performance to benchmark and expected returns if appropriate
 - Compare performance to publicly available data (for example, public sector indexes for hedge funds)
 - Compare cash returns to previously reported market values throughout the year
 - Inquire periodically as to the total long and short positions throughout the year (for hedge funds)
 - Review portfolio holdings regularly
 - If the investment strategy changes from the original investment approach, conduct comprehensive review of manager/team strategy
- Monitor firm/manager
 - Review press reports for significant management/structure/personnel/portfolio developments⁶
 - Obtain and review Form ADV
 - Monitor staffing levels, personnel changes
 - Monitor size of assets under management in the strategy and firm wide

Financial reporting

- Maintain a formal investment policy approved by the board of directors (or similar board that governs overall strategy, risks, authorized transactions, etc.)
- Have an investment committee of the board that is responsible for oversight of all investments and compliance with formal investment policy
- Continuously update a detailed listing of alternative investments grouped by fund or manager
- Review the most recent audited financial statement of each fund, noting basis of accounting, summary of significant accounting policies and procedures pertaining to the valuation of alternative investments, name of audit firm, and type of opinion
- Compare investment balances reported by fund manager to the general ledger
- Monitor the level of the ownership of the fund to determine proper accounting method (for certain types of investor entities)
- Perform and document an assessment of the risk of material misstatement of the financial statements related to the valuation of alternative investments

6. Often includes search for damaging information on NASD or SEC sites



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