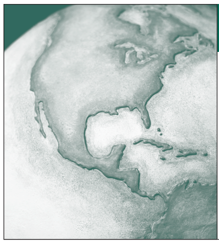

Insights on...

FAS 157 FAIR VALUATION DISCLOSURES

NAVIGATING THE FAS 157 CHALLENGES

How prepared are you?

For many institutional investors, December 31, 2008, will mark the close of the first reporting period for which they must prepare the new FAS 157 Fair Valuation disclosures. Along with that will come the audit of those disclosures. Is your organization prepared to pass the rigors of the audit? Northern Trust held a panel discussion titled *Navigating the FAS 157 Challenges* in July 2008, where industry experts suggested valuation oversight steps. The distinguished panel included:

- **Mary Strauch**, Financial Analyst, Nestle USA
- **Denise O'Neal**, Financial Analyst, Nestle USA
- **Elizabeth Duggan**, Vice President, Interactive Data Pricing and Reference Data, Inc.
- **Dr. Susan Mangiero**, President, Pension Governance LLC
- **Robb Armour**, Managing Director, Huron Consulting Group
- **Sean McKee**, Audit Sector Leader – Asset Management, KPMG
- **Debra Clayton**, Vice President, Northern Trust Product Management

GETTING USED TO THE NEW WORLD ORDER

The process of preparing financial statement disclosures and auditing the information has now completely changed – and not only as a result of the FAS 157 adoption. Take, for example, the July 2006 *AICPA Practice Aid on Auditing Alternatives*. Although it was written as a guide for your audit team, it served to remind financial statement preparers that, while they can outsource the mechanics of valuing their investments, they nonetheless have to maintain control and ownership over the resulting disclosures. This responsibility also carries over to the preparation of the fair value tables under the new standard.

Whereas accounting staffs in the past could prepare investment-related disclosures with rather limited input from their investment colleagues and service providers, they will now have to collaborate more closely. Mary Strauch, analyst of investments for Nestle USA's retirement assets, explained, "I originally saw this as an accounting problem and it's not. It's an investment problem. FAS 157 has ushered in an era of greater attention to investment oversight responsibility. We are now tasked with making sure that our investment committee feels confident and comfortable that they have met their fiduciary responsibility when it comes to valuations, particularly in a very deep way for the Level 3 hard-to-value asset."

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When considering the process involved in making final fair value decisions, experts suggest you ask yourself: Is my accounting staff prepared to make these determinations, or should this be an expectation I have for my internal investment professionals? Do we have the in-house expertise to properly address these areas, or do we need external resources, at least for the inaugural reporting period?

Panelists recommended that the components of the decision-making process include:

- **Understanding the nuances of how assets are priced** – not just the mechanics of how the custodian selects the winning price for each asset, but also the pricing theories, models and evaluation techniques of pricing vendors;
- **Understanding the complexities of the structure and valuation of commingled investment vehicles** – not just the alternative investments, but more traditional funds as well – to assess the effect valuation frequency, liquidity and any redemption restrictions may have on fair value and level determination;
- **Performing formal valuation oversight procedures** – not just to verify one vendor's prices against another, but to demonstrate that the designated pricing committee has the requisite level of expertise to carry out the oversight responsibilities and to formally review and sign-off on valuation disclosures; and
- **Documenting valuation procedures and policies** – not just to capture the new and perhaps complex valuation processes employed to reach your final valuation, but also to provide evidence that you followed your internal control procedures.

UNDERSTANDING ASSET PRICING … EFFECTIVELY DIVING INTO THE DETAILS

More than likely, your custodial statements will serve as the basis for your two new FAS 157 disclosure tables:

- The Level Determination table, which sorts your assets by Level 1, 2 or 3, depending on the degree of observability of the pricing inputs; and
- The Rollforward table, which provides beginning-period to ending-period values for the Level 3 assets.

According to industry experts, clients need to go beyond just knowing the price for each holding; they need to know the source, the age, the type of price and the specific methods employed by the source to derive the price. While custodians may help by providing details of how vendors price each asset class, final determination of levels rests with the financial statement preparer. The number and diversity of assets you hold in your portfolio, the number of vendors the custodian retains and the complexity of the price scrubbing or vendor hierarchy rules the custodian applies will determine the size of the task before you.

When pricing complex fixed income assets in today's challenging market conditions, the accounting team may want to seek input from others in the organization, including the investment team. Elizabeth Duggan, from Interactive Data Pricing and Reference Data, Inc., an industry leader in fixed income security evaluations, provided this perspective: "Because less than 1% of the outstanding fixed income securities trade on any given day, we generally draw parallels from current market activity to generate evaluations for the majority of issues that have not traded."

To shed more light on the evaluation process, Duggan explained the two components of observable market data that are considered – trading activity and market color. "Our evaluators are looking for trade data and other observable market information, such as dealer posts, results of bids-wanted, institutional secondary offerings and primary market offerings, throughout the day to get an indication as to how fixed income securities are being regarded in the marketplace. We use this information to run our models and group similar securities together to help generate evaluations for a wide range of fixed income securities."

FAS 157 introduces the potential need for cross functional teams to work together to determine fair valuation procedures and hierarchy levels. When you review the Northern Trust Fact Sheets* that describe the pricing vendor evaluation models, you can see that they include language you would expect your investment professionals to be more familiar with than the accounting team. The accounting team may be in a challenging position to fully understand the inputs and valuation process for certain fixed income securities and may require assistance from others in the organization, like the investment professionals, to fulfill the requirements of FAS 157. Industry best practices suggest cross functional teams may be necessary for the development of appropriate valuation procedures and the ongoing, oversight, due diligence and quality controls required for the valuation process.

UNDERSTANDING THE COMPLEXITIES OF COMMINGLED FUND STRUCTURES AND VALUATIONS

Understanding how an asset's value is derived – for all asset classes – is fundamental to complying with the new fair valuation reporting standards. While the custodian may be able to help synthesize and catalogue the pricing methods and inputs of vended prices for marketable securities, you will need to take on the task for the non readily marketable securities. These investments include private investment funds, such as hedge funds, private equity funds, direct or indirect real estate holdings, common bank or collective trust funds, and pooled separate accounts meeting the definition of an investment company under the provisions of the AICPA Audit and Accounting Guide, "Investment Companies."

But successfully vetting the valuation techniques for hard-to-value assets is not without its challenges. Susan Mangiero of Pension Governance, creator of the syndicated pension blog, www.pensionriskmatters.com, and author of *Risk Management for Pension, Foundations, and Endowments* (John Wiley, 2005), outlined several industry-wide challenges:

- Do you know where specific responsibility lies for the investment's valuation, and does it yield an independent objective assessment of the value? In the case of hedge funds, for example, the fund administration contracts may indicate that the valuations are based on pass-through pricing from the traders, absent even quality reviews by the fund administrator. For private placements, you may be surprised to find the valuation details lacking in the offering memorandum.

* Fact Sheets are part of a FAS 157 "toolkit" that Northern Trust has developed which provides a comprehensive review of how vendors price each asset class. Other tools that comprise the FAS 157 "toolkit" include the Price Detail Report which includes the specific pricing information for each holding, the Pricing Guidelines which details the rules for how a winning price is selected, and the FAS 157 Level Determination Matrix which summarizes the suggested FAS 157 levels sorted by asset class. For more information on Northern Trust's FAS 157 toolkit please contact your Northern Trust relationship or business development manager.

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- How do you gain confidence in the model that is being used? Reliance on a mark-to-model approach needs to include some measure of systematically testing and vetting the model for integrity. This is especially true when applying it over the tail ends of the price distribution model, assuming the distribution is straightforward to estimate in the first place. In some cases, you must simulate a price distribution, which first requires an estimation of parameters you will use to generate various price paths. Fiduciary oversight calls for a sufficient level of expertise on model selection, testing and revision, as needed.

- How do you deal with the inherent differences between accounting valuation standards and the standards that characterize the professional business valuation industry or the assessment of value for portfolio purposes? FAS 157 disallows some types of discounts. In contrast, an appraiser might adjust downward for any restriction on transferability. Yet a third possible approach to valuation is to ignore discounts if a fund manager has strategically set aside certain holdings as part of a "side pocket." Plan sponsors need to understand how different valuation numbers contrast with each other. From a risk management and asset allocation perspective, a plan sponsor should focus on risk drivers that could adversely affect asset values rather than take false comfort from point-in-time numbers.

Even fair value of registered investment company funds and common or collective funds sponsored by trust companies are subjected to greater scrutiny under the new accounting standard. Industry experts suggest compliance with FAS 157 requires that you dust off the prospectus or, in the case of the common or collective funds, the declaration of trust, and review the redemption and valuation clauses. This will allow you to determine whether the fund's net asset value (NAV) is reflective of an exit price as of your financial statement date.

PERFORMING FAIR VALUATION OVERSIGHT PROCEDURES

Why is having a formal oversight process so fundamental to complying with accounting standards? Sean McKee from KPMG points to the AICPA practice aid: "As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining fair value measurements and disclosures, and must select appropriate valuation methods. Notice it [the guidance] doesn't say the custodian selects appropriate valuation methods; it doesn't say the pricing services do; it says management will select those. Management must identify and adequately support any significant assumptions used."

McKee went on to share some of the methods commonly employed by management to meet these obligations, including the use of specialists. "You're not alone in this – using information provided by custodians, pricing vendors, valuation professionals and other industry experts is a logical way to gain an understanding of valuation methodologies."

Additional steps to help you conclude the prices you are using from whatever source are indicative of fair value could include:

- **Due diligence of specialists** – What due diligence is the specialist providing the prices or analysis performing, who is performing it and how does that further support your oversight program?

- **Back testing** – Back testing adds to the accuracy of recorded fair value. By comparing the prices to those realized historically in the market, adjusted for expected market movements, you can establish reasonability of the price in question, supported by actual market activity.

- **Valuation committee** – Designating oversight responsibility to a committee comprised of qualified individuals who understand the investments and know their value in the marketplace is the key to having an effective review process.
- **Ongoing monitoring of alternative fund managers** – A healthy ongoing due diligence program will follow initial due-diligence procedures that precede purchase of alternative investments. This ensures that you continue to monitor the funds' internal controls and valuation policies.

Certain investments will require even greater oversight steps. When valuing derivative financial instruments, for instance, industry best practices suggest you need to consider the counterparty credit risk and the entity's own nonperformance risk. Do your pricing sources for these instruments incorporate these additional factors? If you are relying on a broker-supplied price, that price is likely to be based on settlement value, or the value at which the broker would settle that contract absent any credit risk considerations. If your arrangements contain provisions that marginalize the credit risk, such as collateralization requirements, you may deem the credit risk to be immaterial to the fair value.

Lock-up provisions for certain private equity, real estate or infrastructure fund investments, which stipulate that participants will not have access to their share of the investments for a protracted length of time, also need to be considered when looking at fair value. These provisions pose a significant challenge for preparers of financial statements given the lack of guidance on how to factor them into the fair value. The AICPA Investment Companies Expert Panel is developing a practice aid to provide further guidance, but in the meantime, McKee recommends discussing the specific investments with your auditor to determine whether the NAV is indicative of fair value.

DOCUMENTING VALUATION PROCEDURES AND POLICIES

According to McKee, "Formalized valuation policies and procedures will have more weight than they may have had in the past. The policies aren't meant to be volumes and volumes, as they are meant to be rather wide and reaching. The procedures that support those policies are meant to be more detailed, and that's where the volume tends to occur."

Consultants like Huron Consulting Group have assisted with what is often deemed to be the daunting task of establishing the policies and procedures. Preparation of written policies starts with a scoping exercise to identify all balance sheet items subject to FAS 157. The process then moves to the data-gathering phase to obtain details about the valuation inputs including any models that are used by pricing sources. These inputs are analyzed against the FAS 157 framework to determine whether they represent market-observable data that relates directly to the asset or liability in question, market-observable data that relates indirectly, or unobservable data. Description of the inputs is coupled with narration of what is done with those inputs to derive values; this includes processes used internally by the financial statement preparer as well as by external pricing vendors, modelers, brokers and investment managers. All of this information becomes the generalized pricing policies. The final step is to make (and document) the FAS 157 fair value hierarchy level determinations, perhaps starting with the preliminary bucketing provided by the custodian, but customized to fit the policies and circumstances of the specific entity.

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An additional control procedure to consider would be an independent price verification service that does not endeavor to reprice all the holdings within the portfolio, but rather provides a range of prices for the assets or asset classes in question, based on current market information. If the vendor's price falls outside the range, the verification service initiates a conversation with the vendor to understand its rationale for how it settled on the price. Once the ranges are established, this process can be performed periodically by a specialist outside the entity, or taken in-house and executed more regularly.

Robb Armour, from Huron Consulting Group, commented that while the custodian's documentation provides a substantial amount of vendor information, it is not designed to be a cut-and-paste document or a substitute for an entity's own pricing policies. Clients need to review the custodian's documents, but they need to customize their entity-specific policies as outlined above.

"In addition, clients need to be mindful of the growing list of implementation issues, and to seek help navigating those for which consensus has been reached and those that the industry is still grappling with," recommended Armour. Working with consultants experienced in FAS 157 to prepare your documentation ensures that the people responsible for preparing the financial statements have full knowledge of the valuation process and the benefit of the most up-to-date interpretations.

Armour also has seen that the valuation documentation appeals to a broader audience than originally anticipated. "We have heard from companies that they have been pressed for more and better valuation information by a wider constituency, from boards of directors, internal risk management functions, auditors and regulators. And at some point, ultimately, investors will start to display that same kind of interest," Armour predicted.

VALUATION OVERSIGHT PROGRAMS OFFER ADDITIONAL BENEFITS

Our panelists shared some final thoughts on the effect of FAS 157 that are worth repeating. Armour offered that while FAS 157 was originally intended to improve information transparency, the oversight programs will allow different parts of an organization to react to potentially troublesome valuation situations sooner than in the past.

As entities more fully embrace the new valuation standards, they are stepping up their oversight of alternative investments in an unprecedented way by challenging the traditional lack of transparency. While the industry has a way to go in the area of full disclosure, fiduciaries now at least have FAS 157 on their side. In the wake of the potential securities litigation cases and the Department of Labor's efforts to put plan sponsors on notice about their fiduciary duties to report fair values, Susan Mangiero encourages institutional investors to look on the bright side and let FAS 157 compliance activities do double duty. "Fair value accounting is here to stay, forcing companies to collect and analyze a lot of data. Why not use that information to improve pension risk management policies and procedures?"

ADDITIONAL RESOURCES

- www.aicpa.org – Alternative Investments Audit Considerations: A Practice Aid for Auditors
- www.pensiongovernance.com – Pension Governance LLC
- www.pensionriskmatters.com – Pension Risk Matters
- www.pensionlitigationdata.com/home.php
- www.huronconsultinggroup.com – Huron Consulting Group
- www.kpmg.com – KPMG International
- www.interactivedata.com – Interactive Data Corporation
- www.peigg.org – Private Equity Industry Guidelines Group
- www.mfainfo.org/–Managed Funds Association
- http://sec.gov/about/offices/ocie/complialert0708.htm – "Valuation and Collateral Management Processes"

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