FAIR VALUE ACCOUNTING AND DISCLOSURE

NEPC Research

Introduction

There has been considerable focus recently on fair value accounting and attempts to ensure appropriate transparency on the pricing of "hard to value assets." The increased attention has generated concern among institutional investors about the impact of the new regulations on the management of their programs. These concerns are most acute in the area of alternative investments where there is a greater incidence of less liquid and hard to value assets.

We believe that alternative investments are a critical component of a fully-diversified investment program, serving to mitigate equity risk, dampen volatility and improve returns over a market cycle. For these reasons, we feel that investors should work to maintain their exposures to these strategies, despite potential valuation difficulties.

In this memo, we seek to provide some insights into the issues surrounding fair value accounting and touch on some of the more relevant components of the regulations. Importantly, we also suggest steps that investors can proactively take to minimize the impact of the regulations on their programs and reduce the administrative stress points.

Background

Fair value accounting has been the standard for reporting asset values for many years. However, the interpretation of fair value accounting has come under scrutiny recently on several fronts. Pronouncements from organizations such as The American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB) and the Department of Labor have served to intensify the focus on fair value accounting standards. While NEPC cannot provide audit advice, we can share our experience and thoughts to assist clients in understanding and navigating the new requirements. Specifically, in this memo we will address FASB Statement No. 157 (FAS 157), *Fair Value Measurements*. While much uncertainty remains regarding the implementation and interpretation of this Statement, a proactive approach will help prepare for increased reporting requirements during the year-end audit process.

A PROACTIVE APPROACH WILL HELP PREPARE FOR INCREASED REPORTING REQUIREMENTS .

FAS 157 is applicable to both for-profit and not-for-profit entities that prepare financial statements under US Generally Accepted Accounting Principles (GAAP). This includes, but is not limited to, corporate defined benefit plans, corporate defined contribution plans, endowments and foundations. For defined benefit plans, the current requirement for reporting postretirement benefit plan assets on the sponsoring organization's financial statement may change. FASB recently proposed amending FASB Statement 132 (R), *Employers' Disclosures About Pensions and Other Postretirement Benefits,* and will likely incorporate FAS 157 disclosures.

Fair Value

There are many accounting standards that require the fair valuation of assets and liabilities. These different accounting standards allow for many different and in some cases inconsistent definitions of fair value. The major goals of FAS 157 are to consolidate the definition of fair value and to expand the required disclosures related to fair valuation of assets. Importantly, FAS 157 does not require any new fair value measurements. While much of the discussion of FAS 157 focuses on investments for which a public market does not exist, the disclosure requirements apply to all investment types.

WHILE MUCH OF THE DISCUSSION OF FAS 157 FOCUSES ON INVESTMENTS FOR WHICH A PUBLIC MARKET DOES NOT EXIST, THE DISCLOSURE REQUIREMENTS APPLY TO ALL INVESTMENT TYPES.

FAS 157 retains the market-based exchange price notion from earlier definitions and 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." It focuses particular attention on the price that would be received to sell the asset (exit price) and not the price that would be required to acquire the asset (entry price). In addition FAS 157 states fair value should be measured based upon assumptions in the marketplace and not entity-specific assumptions.

FAS 157 Requirements

FAS 157 establishes a fair value hierarchy. FAS 157 uses the term "inputs" to refer to the assumptions that market participants would use in pricing an asset, including assumptions about risk. "Observable inputs" are based upon market data obtained from sources independent of the owner, while "unobservable inputs" are inputs that reflect the owner's best judgment about the assumptions market participants would use to price an asset based on available information. The following hierarchy divides fair value into three broad levels:

- Level 1 is comprised of quoted prices in active markets (i.e. NYSE, NASDAQ) and dealer marks in over-the-counter markets. Examples include exchange traded equity, actively traded debt and futures.
- Level 2 is comprised of observable, market based inputs. Examples include common stock traded in an inactive market, privately placed bonds for which there is a similar publicly traded bond, and plain vanilla interest rate swaps.
- Level 3 is comprised of unobservable inputs. This would include investments for which valuations are derived from models for which no active market exists. Examples include complex derivatives and illiquid investments such as private equity.

In addition to the new hierarchy, FAS 157 also requires new valuation disclosures for the issuers of interim and annual financial statements. FAS 157 expands and standardizes disclosure requirements related to fair value measurements with the objective of providing information to users about how and where fair value is used in the financial statements, the methods used to measure fair value and guidance on the reliability of the inputs used to determine the fair value measurements.

NEPC's Recommended Practices

The requirements and procedures of FAS 157 are new to all parties with a vested interest in the accounting and reporting of assets and liabilities. As a result, there will most likely be an evolution in the expectations and requirements of the various parties as they continue to gain comfort applying the Statement. With this as a backdrop, NEPC recommends clients take the following steps to help prepare for auditor requirements:

- Pre-audit meeting with auditor and internal accounting/auditing team(s)
  - Determine the supporting material the auditor will need to document the valuation process and procedures.

- Discuss with auditor the portfolio assets with particular focus on portfolio holdings with uncertain pricing. For example, discuss how alternative assets and vehicles such as commingled funds will be viewed within the classification hierarchy.
- For assets with uncertain pricing, identify documentation that will be required to support the fair value classification.

> **DESPITE THE ANXIETY MANY CLIENTS MAY FEEL OVER THE NEW REQUIREMENTS, WE BELIEVE CLIENTS SHOULD RESIST ANY DESIRE TO ALTER THEIR ASSET ALLOCATION TO ACCOMMODATE ACCOUNTING CHANGES.**

- Contact plan custodian
  - Gain familiarity with custodian's FAS 157 reporting capabilities. Determine whether they can assist in classifying portfolio assets. If they can assist, understand custodian practices and procedures and any limitations.
- Contact investment managers
  - Request copy of investment managers' Statement of Auditing Standards (SAS 70).
  - Request copy of managers' pricing methodology and request details on managers' classification of portfolio assets they manage on behalf of the plan. Also request details on any recent changes to valuation methodology.
  - For those assets with uncertain pricing, identify supporting documents managers can provide to satisfy auditor requirements. List may include the following:
  - Most recent audited financials;
  - Schedule of holdings and market price of holdings within fund being classified; and
  - Total shares outstanding for the fund being classified.

Summary

A single definition of fair value, together with a framework for measuring fair value, should result in increased consistency and comparability of financial statements. As with all new reporting procedures, there will be some growing pains as the various stakeholders interpret the new requirements and procedures in different ways. Despite the anxiety many clients may feel over the new requirements, we believe clients should resist any desire to alter their asset allocation to accommodate accounting changes. Alternative assets are and should continue to be a very important component of a well diversified portfolio. NEPC believes the best way to navigate this uncertainty is to take a proactive disciplined approach. Documenting policies, procedures and due diligence will go a long way in satisfying auditor requirements.

YOU DEMAND MORE. *So do we.* SM

ONE MAIN STREET, CAMBRIDGE, MA 02142 | TEL: 617.374.1300 | FAX: 617.374.1313 | www.nepc.com

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