



Fair Value Measurements

What you need to know about FAS 157
and how it will affect your audit

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Agenda

- Overview of the standard
- Sample disclosure for an EBP
- Implementation issues for your organization
- What to expect from service providers
- Audit considerations

SFAS 157 – Overview

- Issued on September 15, 2006.
- FAS 157:
 - Establishes framework for measuring fair value under generally accepted accounting principles (GAAP).
 - Clarifies the definition of fair value within that framework.
 - Expands financial statement disclosures about fair value measurements.
- Generally effective for fiscal years beginning after November 14, 2007.

New Way to Look at “Fair Value”

- Exit pricing rather than entry pricing.
- A change in focus:
 - Fair value is the price that would be received to sell the asset, or paid to transfer the liability (an exit price).
 - Not the price that would be paid to acquire the asset, or received to assume the liability.
- This change in focus may change valuation practices for some investments.

Definition of Fair Value

- “Fair value is 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.”

Definition of Fair Value

- An orderly transaction is:
 - A transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities.
 - Not a forced transaction (for example, a forced liquidation or distress sale).

Definition of Fair Value

- Market participants are:
 - Independent (not related parties).
 - Knowledgeable (due diligence).
 - Able to transact for asset or liability.
 - Willing to transact for asset or liability (not forced).

Definition of Fair Value

- **Measurement assumes:**
 - An orderly transaction in the principal market (or most advantageous market).
- **Principal market**
 - The greatest volume or level of activity.
 - Maximizes the amount that would be received, considering transaction costs.
 - If there is a principal market for the asset or liability, the fair value measurement shall represent the price in that market, even if the price in a different market is potentially more advantageous at the measurement date.
- **In absence of a principal market, then the most advantageous market for asset or liability.**

“Unit of Account” Concept in Fair Value

- Unit of account
 - “Determines what is being measured by reference to the level at which the asset is aggregated or disaggregated.”
- Typically the unit of account is:
 - An individual investment transacted (purchased or sold) by the plan. But not always...
- Think of a “mutual fund” versus “self-directed brokerage” in a 401(k) plan.

Valuation Techniques Under FAS 157

- FAS 157 discusses three acceptable valuation techniques.
 - Market approach
 - Income approach
 - Cost approach

Valuation Techniques Under FAS 157

- Market approach – uses prices and other relevant information from market transactions involving identical or comparable assets, e.g.:
 - Equities
 - Bonds
 - Direct investments in companies

Valuation Techniques Under FAS 157

- Income approach – uses valuation techniques to convert future amounts to a single present amount (cash flows or earnings, Black-Scholes).
 - Real estate
 - OTC options
 - Swaps

Valuation Techniques Under FAS 157

- Cost approach – based on the amount that currently would be required to replace the service capacity of an asset.

Framework for Measuring Fair Value

- Two concepts
 - Inputs
 - Levels (Hierarchy)

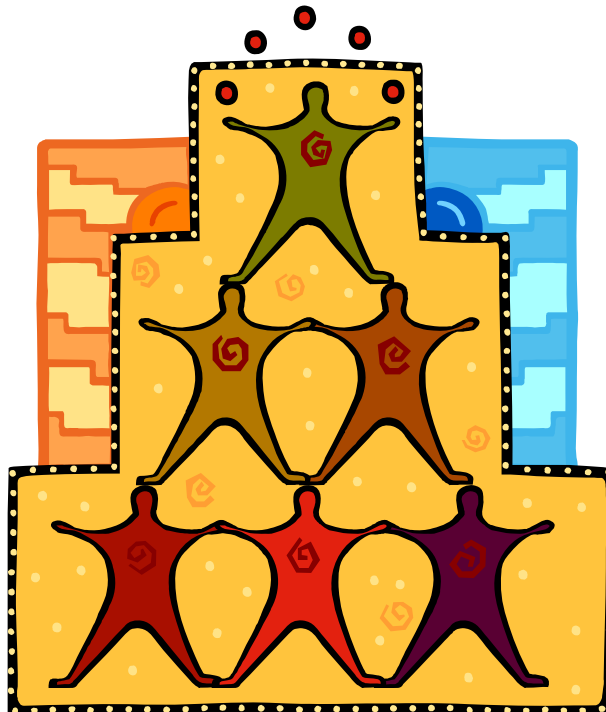
Framework for Measuring Fair Value



- Inputs - assumptions that market participants would use in pricing the asset or liability.
- They may be:
 - **Observable inputs** - assumptions market participants would use based on independent market sources.
 - **Unobservable inputs** - the reporting entity's own assumptions market participants would use in pricing the asset or liability based on the best information available.
- Think in terms of “reliability.”

Levels - Fair Value Hierarchy

- Three-tier hierarchy for the measurement of fair value.



Fair Value Hierarchy

- The hierarchy is not prescriptive and was intended to apply to all enterprises.
 - Level 1: “quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.”
 - Level 2: “inputs other than quoted prices that are observable.”
 - Level 3: use of “unobservable inputs.”

Fair Value Hierarchy

- Level 1 inputs
 - Quoted prices (unadjusted) for identical assets or liabilities in active markets.
 - Most reliable source of fair value.
 - E.g., prices derived from NYSE, NASDAQ, Chicago Board of Trade, pink sheets.

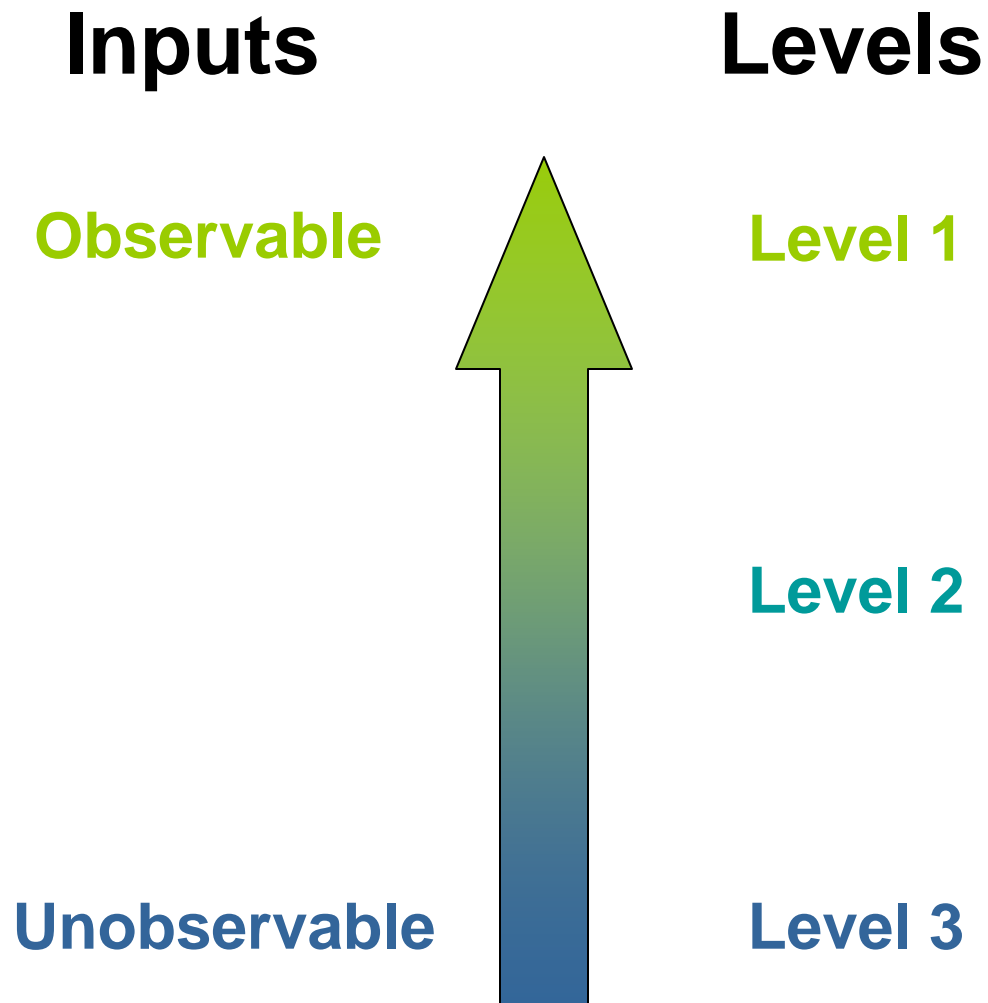
Fair Value Hierarchy

- Level 2 inputs
 - Observable inputs for:
 - Similar assets or liabilities in active markets.
 - Identical or similar assets in inactive markets.
 - Inputs other than quoted prices that are directly observable.
 - Inputs derived from observable market data by correlation or other means.
 - E.g., matrix pricing; market corroborated pricing; inputs such as yield curves and indices.

Fair Value Hierarchy

- Level 3 inputs:
 - Unobservable inputs:
 - Reporting entity's own assumptions about the assumptions market participants would use.
 - Other entity-specific inputs (historical or projected financial information) that are not derived from market data.

Input/Level Relationship



What About “Inactive” Markets?

- In September 2008, the SEC and FASB staff issued a joint press release that gave guidance on fair value in inactive markets.
- In October 2008, FASB Staff Position 157-3 was issued to provide further guidance.
- In a nutshell....
 - Use the best available inputs when there are no relevant market-based inputs available.

New Disclosure Requirements

- What is now required:
 - Fair value measurements at the reporting date for each major category of assets or liabilities.
 - The level within the fair value hierarchy each measurement falls.
 - The valuation techniques used to measure fair value and a discussion of changes in valuation techniques, if any.

New Disclosure Requirements

- What is now required for Level 3:
 - A reconciliation of the beginning and ending balances, separately presenting changes during the period attributable to:
 1. Total gains or losses for the period (realized and unrealized), segregating those gains or losses included in earnings (or changes in net assets), and a description of where those gains or losses included in earnings (or changes in net assets) are reported in the statement of income (or activities).
 2. Purchases, sales, issuances, and settlements (net).
 3. Transfers in/out of Level 3 (e.g., transfers due to changes in the observability of significant inputs).

Let's Look at New Sample Disclosures

- Changes to Significant Accounting Policy Note
 - See Tab 7 in your binder.

Let's Look at New Sample Disclosures

Disclosure for Hierarchy Levels

Description	December 31, 2008	Fair Value Measurements at Reporting Date Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Common Stock	\$ 29,742,963	\$ 29,742,963	\$ -	\$ -
103-12 Investment Entities	24,952,806		12,167,799	12,785,007
Short term Funds	687,720		687,720	
Common / Collective Trust Funds	60,644,794	-	40,933,003	19,711,791
Total	\$ 116,028,283	\$ 29,742,963	\$ 53,788,522	\$ 32,496,798

Let's Look at New Sample Disclosures

Level 3 Disclosures

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)		
	103-12 Investment Entities	Common / Collective Trust Funds	Total
Beginning Balance	\$ 12,000,000	\$ 15,000,000	\$ 27,000,000
Total realized/unrealized gains or losses included in changes in net assets	385,007	1,711,791	2,096,798
Purchases, issuances and settlements	500,000	3,000,000	3,500,000
Transfers in and/or out of Level 3	(100,000)	-	(100,000)
Ending Balance	<u>\$ 12,785,007</u>	<u>\$ 19,711,791</u>	<u>\$ 32,496,798</u>
The amount of total gains or losses for the period included in changes in net assets attributable to the change in unrealized gains or losses relating to assets still held at the reporting date	<u>\$ 350,000</u>	<u>\$ 1,500,000</u>	<u>\$ 1,850,000</u>

Challenges for Plans, Sponsors and Administrators



- The Plan must take ownership and is responsible for the valuation process:
 - Establish an accounting and reporting process for fair value.
 - Determine, understand and agree with the valuation methods and reporting “levels” applied to assets or liabilities.
 - Obtain or prepare documentation to support the valuation methods used, along with support for significant assumptions, if necessary.
 - Obtain or prepare valuations, as necessary.
 - Ensure that the presentation and disclosure of fair value are in accordance with GAAP.
 - Ensure Form 5500 is reported at current value.

Challenges for Plans, Sponsors and Administrators

- Biggest challenge:
 - FAS 157 is principles-based...



= judgment!

What You Need to do Now

- Understand how FAS 157 affects your Plan's financial statements.
 - Meet with your auditor / custodian.
 - Determine what will be needed to prepare the disclosures.
 - Establish responsibilities for accumulating the information (who will provide... what).
 - Custodians / Investment managers
 - Investment advisors
 - Plan trustee (investments)

What You Need to do Now

- Make sure everyone is on board.
 - Single employer plans
 - Plan Sponsor / Plan trustee / Investment custodians and advisors...meet and make sure the required information will be available.
 - Multiemployer plans
 - Board of Trustees should designate responsibility.
 - TPA / Custodian / Managers / Advisors
 - Not-for-profits and other entities—same deal!
 - Above all...keep your auditor in the loop.

What You Need to do Now

- **Alternative and Hard-to-Value Investments**
 - You will need to document
 - Valuation methods
 - Inputs and whether they are observable or unobservable
 - Risk factors (market, credit, etc.)
 - Levels
 - And most importantly...fair value as of the measurement date!

What You Need to do Now

- Establish and monitor internal controls over the valuation of plan investments.
 - Oversight committee to evaluate.
 - Trustees, fiduciaries and plan management understand:
 - The nature of the plan's investments and the methods used to value them.
 - The agreements, duties and responsibilities of custodians and other advisors.
 - Valuation and reporting controls in place at the custodians and providers.

What to Expect From Custodians

- Extremely wide range
- At one end:
 - White papers that describe their procedures, valuation concepts and default “levels.”
 - FAS 157 reports that classify investments into the disclosure levels.
- At the other end:
 - You’re on your own...
 - Custodians accepting the values provided for alternative investments without any evaluation.

What You Should Ask the Custodian

- Will they provide a FAS 157 report to support the disclosures? Will they certify it?
- How do they price each asset class?
- Who does the pricing? Internal or external?
- What does their vendor line-up look like?
- What controls do they have in place?
- Is there outside scrutiny?
- What isn't being priced?



What Types of Controls are in Place?

- Do they:
 - Obtain multiple prices and price types from providers whenever possible.
 - Automatically scrub price feeds to validate prices, leaving only exceptions and missing prices for human intervention.
 - Employ quality checks.
 - Provider comparisons: compare against like price-types received from multiple providers.
 - Percentage movement: comparisons to the previously reported price.
 - Nil or missing prices, aging/stale prices.

What Pricing Information Does the Financial Statement Preparer Need?

- Pricing sources:
 - Who priced the assets?
 - Specific vendors or sources.
- Pricing type:
 - How did they derive the price?
 - Are the prices taken from an exchange, based on models or broker quotes, etc.?
- Price as-of date:
 - How current is the price?
 - Is the price a stale price (e.g. suspended asset) or is it the most current but still lagged price (e.g. limited partnership)?
- Inputs:
 - Are the inputs to the price observable or unobservable?
 - What basic assumptions were used by the vendor or broker providing the quotes?
- Levels

Finalizing the Level Determinations

- General responsibilities
 - Custodian - provides data.
 - Client - reviews data and conclude.
 - Auditor - validates and opines.
- Does 157 change this responsibility?
 - No

What You Need for the Audit

- In a perfect world...
 - Description / documentation of
 - Valuation methods for each asset class.
 - Inputs used and whether they are observable or unobservable.
 - FAS 157 report / analysis that classifies the investments by “level.”
 - Discussion of risks (inherent, credit, inactive markets, etc.) that affected the valuations.
 - Documentation of the internal controls in place over investment valuation.

Questions?

