

This Year's Benefit Plan Audit Headache: FAS 157

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What's in store as plan sponsors and service providers gear up for the annual benefit plan audit season? For 2006 plan years, the implementation of SOP 94-4-1 affected financial statements for defined contribution plans investing in fully benefit responsive contracts. [See *asap* 07-13.] While reviewing 2007 financial statements, auditors increased scrutiny of internal controls and DOL intensified its attention to alternative investments. [See *asaps* 08-19 and 08-29.] For 2008 plan years, you need to become familiar with FAS 157.

What is FAS 157?

The FASB Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("FAS 157") establishes a framework for measuring fair value and expands disclosures about fair value measurements in the notes to a plan's financial statements. As a practical matter, FAS 157 must be implemented for all plans that prepare financial statements, without regard to whether the auditor is engaged to perform a full scope or limited scope audit. FAS 157 applies for fiscal years beginning after November 15, 2007.

The full text of FAS 157 is available at <http://www.fasb.org/pdf/fas157.pdf>. The AICPA's Employee Benefit Plan Audit Quality Center has developed several very useful FAS 157 tools that provide additional information for plan sponsors and service providers trying to understand the new rules.

How does FAS 157 define "fair value?"

Fair value is in the eye of the beholder - either the buyer's, as an acquisition or entry price, or the seller's, as a sales or exit price. FAS 157 defines fair value as the price from the perspective of the seller - the price that would be received to sell an asset in an orderly transaction between market participants as of the valuation date.

While FAS 157 defines fair value differently than in the past, in many cases there will be no difference in the fair value amounts reported on the plan's financial statements. The most visible change is the added disclosures that will appear in the notes to the audited financial statements.

It is important to note that, as has always been the case, the plan's management retains the ultimate responsibility for the oversight of the fair values reported in the plan's financial statements, including determining the adequacy of the related note disclosures. Plans that invest only in mutual funds and equity securities with readily determinable fair values should generally find it easier to implement FAS 157 than plans investing in assets such as limited partnerships, private equity funds, real estate and the like for which there is little or any market activity at the measurement date.

Do you understand where the numbers come from?

This is the question auditors will pose to plan sponsors and that might come back to you as the service provider. FAS 157 establishes a fair value hierarchy that distinguishes between quoted market prices and

investment values based upon *observable* inputs compared to fair values established based on the plan's own assumptions about the factors - or *unobservable* inputs - that market participants would take into account in pricing the asset, based on the best information available in the circumstances.

These categories, then, translate into Level 1 Inputs (Quoted Prices), Level 2 Inputs (Observable Inputs) and Level 3 Inputs (Unobservable Inputs) and each plan investment must be dropped into one of these buckets.

By far, the easiest classification is the Level 1 Input. If the value of an asset is based on prices quoted on the NYSE, NASDAQ or the Chicago Board of Trade - national recognized pricing services - that investment belongs in the Level 1 Input category. Exchange traded mutual funds and equity securities fall into this group. However, even if a price is quoted on a national exchange, a lightly traded security may not meet the test for Level 1.

Level 2 Inputs are inputs other than quoted market prices included in Level 1 that are either directly or indirectly observable for the asset. This is why it's important to understand where the numbers come from. For example, common/collective trust funds (CCT) and pooled separate accounts (PSA) generally follow written procedures for establishing the unit value on a periodic basis (i.e., daily, monthly, etc.) although the CCT or PSA is not, itself, traded on an established market as described above. It also is important to know whether there are liquidity restrictions and whether the funds are open to new investors. The inputs, then, are observable but do not solely rely on quoted market prices to establish fair value.

Plans investing in CCTs and PSAs will want to review the audited financial statements of the fund to consider that fund's FAS 157 disclosure. In addition, those financial statements may provide additional information to aid the plan's management in designating its own FAS 157 input level.

Level 3 investments are based on inputs that are termed *unobservable*. Limited partnerships, hedge funds,

and venture capital investments most likely fall into this category because of limited trading. Values reported on the custodial statement may be merely a pass-through of the values set by the issuer or fund manager, which may not be fair value or may not be as of the plan's year end. In this case, the plan's management needs to understand how the value was determined so as to evaluate whether it is a reasonable estimate of the investment's fair value.

Are participant loans subject to FAS 157?

Yes, loans are considered *investments* and thus are subject to FAS 157. For practical reasons, loans are typically recorded on the financial statements as the remaining outstanding balance (as a proxy for fair value) on the assumption that the two values are not materially different. In theory, though, the outstanding loan value is not *fair value* because market interest rates often change daily. A common fair value method for loans would discount the cash flow of the loan based on an assumed interest rate; therefore, unless the assumed interest rate used in the valuation was exactly the same as the interest rate charged on the loan that is being fair valued, fair value does not equal the outstanding balance.

Beyond the issue of establishing fair value, though, what is an *exit price* for a participant loan? There really is no market (quoted prices or observable inputs) for participant loans, and so it's likely these assets fall into the Level 3 Input category. This is a highly debated issue right now, so expect there will be arguments made that consumer interest rates are observable and so participant loans might be cast as Level 2.

How should service providers prepare for FAS 157?

Most trustees and custodians are anticipating the need to assist plan sponsors in evaluating the various investments of plans in light of FAS 157. Many service providers are expanding their audit packages to include a *recommended* FAS 157 fair value hierarchy.

For service providers who rely on other institutions or alliance partners for investments, start gathering all of the information you can about the pricing

mechanisms applied to assets held by your clients' plans. This may include audited financial statements, annual reports, or prospectus information. Custodians generally have a written description of pricing sources and methods for each type of investment, so be sure to capture that information.

More complicated investment vehicles, such as private equity funds and venture capital investment companies or partnerships and limited partnerships typically utilize written agreements spelling out call commitments and withdrawal restrictions. Due to these fund's potentially illiquid nature, they may employ a valuation specialist to report on projected cash flows and produce an industry analysis.

Steps for the plan sponsor

Any plan sponsor drafting its plan's financial statements would be well advised to contact their auditors to begin a dialogue about the requirements of FAS 157 and to learn how their auditors will approach this subject during the audit process. The plan's management also should review any FAS 157 related materials provided by their service providers and ask for more information, if necessary.

The plan sponsor must classify all plan assets according to the FAS 157 fair value hierarchy and draft notes to be incorporated into the plan's financial statements to appropriately disclose such determinations.

In Conclusion

Each year, the employee benefit plan audit work becomes more complex causing plan sponsors and service providers to devote more time and resources to the effort. Get acquainted with FAS 157 now to save yourself from headaches this summer!