

New Developments in Accounting for Employee Benefit Plans:

Valuing Alternative Investments after Madoff

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DOL's perspective

- Protecting the interests of the plan and its participants and beneficiaries;
- Requesting disclosures from investment managers, fund managers, and other investment intermediaries regarding the plan's potential exposure;
- Seeking advice regarding the likelihood of losses due to investments that may be at risk;
- Making appropriate disclosures to other plan fiduciaries and plan participants and beneficiaries; and
- Considering whether the plan has claims that are reasonably likely to lead to recovery of losses that should be asserted against responsible fiduciaries or other intermediaries.

DOL and Other Guidance

- March 21, 1996 letter to the Honorable Eugene A. Ludwig
- February 5, 2009 EBSA Statement "Duties of Fiduciaries in Light of Recent Events Regarding Bernard L. Madoff Investment Securities"
- ERISA Advisory Council Report on Hard to Value Assets
- July 1, 2008 DOL Audit Letter

ERISA Form 5500 (Annual Report) Reporting

- Form 5500 (Annual Report) requires:
 - Reporting of current value of assets directly held .
 - "Current value" means:
 - fair market value, where available, or
 - as determined in good faith under the terms of the plan by a trustee or named fiduciary (assuming an orderly liquidation)
 - Audit for plans with more than 100 participants
 - Reporting of current value of "plan assets" in:
 - collective trusts and group trusts,
 - insurance company pooled separate accounts, and
 - hedge funds and other private funds that are treated as plan assets,

unless alternative filings are made by these commingled funds as a DFE.

Auditor's perspective

- Plan Sponsor financial statements
 - Pension assets and liabilities
 - No defined contribution assets or liabilities
 - Retiree medical obligations
- Regulatory audits filed with Form 5500
 - Full-scope
 - Limited-scope

Benefit Plan financial statements

“Balance sheet”

- Investments at fair value
- Benefit obligation (DB)

“Income Statement”

- Investment return:
 - Interest and dividends
 - Realized gains (losses)
 - Unrealized gains (losses)
- Benefit payments
- Contributions

Limited Scope Procedures

- Compare information certified by custodian/trustee with financial statements
- Test contributions and benefit payments reported by the custodian/trustee
- The decision of whether to authorize the auditor to look behind the certification lies solely with the plan administrator. Absent such authority, the auditor has no right to demand such information.

Auditor reporting

- Report on financial statements
 - Opinion
 - Limited scope report
 - Explanatory paragraph (e.g. hard to value investments, going concern)
- Internal controls
 - Sarbanes 404 internal controls opinion
 - ERISA regulatory audits: no internal control opinion
 - Material weakness, Significant Deficiencies, Deficiencies
- Governance communications
 - Beginning of audit
 - End of audit
 - Internal Controls

Auditor responsibility for fraud

Professional auditing standards:

- Obtain “reasonable assurance” that financial statements are not materially misstated whether caused by fraud or error
- Consider risk of material misstatement of financial statements due to fraud and plan audit accordingly
 - May use a fraud specialist to assist in risk assessment and designing audit procedures

How does an auditor test investments?

AU sections 332 and 328 are the principal auditing standards for investments (AICPA, *Professional Standards*, vol. 1)

- Interpretations No. 1 to AU sections 332 and 328, issued in July, 2005: *“Auditing Investments in Securities Where a Readily Determinable Value Does Not Exist”* and *“Auditing Interests in Trusts Held by a Third-Party Trustee and Reported at Fair Value”*
- *ALTERNATIVE INVESTMENTS-AUDIT CONSIDERATIONS, A PRACTICE AID FOR AUDITORS* was issued in July, 2006, which addresses the Interpretations

AICPA Alternative Investments Practice Aid

- ✓ Addresses challenges associated with auditing investments for which a readily determinable fair value does not exist
- ✓ Focuses on the existence and valuation assertions associated with alternative investments

FASB Statement No. 157, Fair Value Measurements

- New definition of fair value
- Fair value hierarchy
- New disclosures of investments by hierarchy level
- Change in the presumption that transaction value equals fair value (use of “exit” price)

SFAS 157, *Fair Value Measurements*

Disclosures

Table:

Fair value of major categories of assets

By category of measurement hierarchy

Gains and losses for each category

Additional disclosures:

Information regarding fair values based on Level 3 (unobservable) inputs, including a roll-forward analysis of FV and of unrealized gains and losses for Level 3 items

AICPA Employee Benefit Plan Audit Quality Center Website

aicpa.org/EBPAQC

A wealth of information for you and your clients

- Educate your clients
- Educate yourself

ERISA: General Background

- ERISA is the federal law applicable to pensions and investments.
- ERISA includes fiduciary duties and reporting and disclosure obligations.
- ERISA fiduciary duties include:
 - the duty of prudence,
 - the requirement to act solely in the interest of plan participants and beneficiaries, and
 - in accordance with the written plan documents.
- ERISA reporting and disclosure obligations include Form 5500 (Annual Report) reporting obligations

ERISA Fiduciary Duties: Prudence

- Under DOL regulations, the prudence requirement is satisfied when "appropriate consideration" is given to relevant facts and circumstances, including the role the investment plays in the part of the plan's investment portfolio for which the fiduciary has investment duties.
- Appropriate consideration includes:
 - the investment is reasonably designed, as part of the portfolio, to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or investment course of action, and
 - considering factors such as:
 - the composition of the portfolio with regard to diversification,
 - the liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan, and
 - the projected return of the portfolio relative to the funding objectives of the plan.
- ERISA's general fiduciary duty provisions do not include specific lists of permitted or prohibited investments.

Plan Fiduciaries - Issues

- DOL (Boston letter): “It is incumbent upon the Plan Administrator to establish a process to evaluate the fair market value” of hard to value assets.
- “A process which merely uses the general partner established value for all funds without additional analysis may not insure that the alternative investments are valued at fair market value”
- ERISA Advisory Council (2008) – Boston letter “caused confusion to fiduciaries and their professional advisors.”

Fiduciary duty - process

- In principle, the process for valuation of hard to value assets is no different from other fiduciary decisions – prudent process, diligence/advice, solely in the interest of plan participants.
- One clear lesson from DOL Boston letter – doing nothing is not the right approach.
- Determine which fiduciary is responsible for valuation of hard to value assets. (ERISA Advisory Council noted that fiduciaries are often confused on who is responsible for valuation).
- Analyze significance of the assets in the plan's portfolio (materiality; cost/benefit analysis); DB vs. DC plans.

Fiduciary due diligence

- Know the valuation process:
 - Audited financial statements?
 - Third-party appraisals or other objective factors?
 - Time lag issues (date of manager valuation vs. date of plan's valuation).
- Review valuation methodology (will likely be different for different types of hard to value assets).
- Monitor/Assess valuations
 - Trustee process (pass-through only?);
 - Consultants, advisors;
 - Independent fiduciary;
 - Who has the expertise?
- Due diligence at time of investment.

ERISA Advisory Council - views

- “It has been widely advertised that failure to properly value assets will place [plan sponsors and fiduciaries] in breach of their fiduciary duties, yet in view of the Council, there has not been sufficient guidance issued to assist them in understanding the scope of those responsibilities.”
- The “complexity of this situation, in the view of the Council, requires more.”
- Any guidance should be coordinated with other gov’t agencies and financial bodies, including the GAO, SEC and AICPA.

Impact of Direct Investment vs. Fund Investment

- Direct Investment:
 - Held by plan's trustee/custodian
 - Trust agreement probably includes valuation provisions
 - Management agreement may include valuation provisions
 - Ability to verify manager valuations (when appropriate)
 - Audited by plan's auditor

Impact of Direct Investment vs. Fund Investment *(continued)*

- Fund Investments:
 - May be structured as group trusts, mutual funds, private funds (statutory trusts, partnerships, LLCs or offshore corps), insurance products, etc.
 - Assets may (not) be ERISA plan assets
 - Advisor/manager/trustee may (not) be ERISA fiduciary subject to ERISA fiduciary duties
 - Fund may (not) have a trustee, custodian or prime broker
 - Operating documents should include valuation provisions
 - "Side pockets" or "designated investments" may be subject to special valuation rules
 - Advisor/manager/trustee may have discretion to adjust valuations
 - Third party valuations may (not) be required

Impact of Direct Investment vs. Fund Investment *(continued)*

- Plan fiduciary may (not) have transparency to underlying investments and valuation policies and procedures
- The fund's fiscal year may be different from the plan's fiscal year
- Fund may (not) file a Form 5500 as a DFE
- The fund may not be audited
- Liquidity constraints and withdrawal restrictions may impact value

Investment Considerations for Private Funds

- Consider retaining independent advisor or manager
 - "Fund of one" structures
 - Assistance with initial due diligence and document negotiation
 - Assistance with ongoing monitoring, amendments, fund updates, etc.

Investment Considerations for Private Funds *(continued)*

- For fund investments, also consider:
 - Fund's plan assets status and the standard of care in fund documents
 - Exculpation and limitation of liability provisions
 - Use of trustee, custodian or prime broker
 - Valuation provisions
 - Ability to obtain asset and valuation information or SAS 70 or to audit

Investment Considerations for Private Funds *(continued)*

- Use of third party valuations
- Whether fund is audited and whether fund audit period is consistent with plan's audit period
- Whether fund files a Form 5500 as a DFE
- Diversification/materiality considerations
- Background checks
- Need for a side letter