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ASC 820 Methodology – Fair Value Testing

Objective:

The objective of this white paper is to describe a methodology for the review, verification, and testing of ASC 820 levelling of investments. (NOTE: Our Fair Value Testing methodology was approved for one of our public company clients by one of the nation's largest audit firms. Our methodology is provided below.)

Descriptions of Level Inputs:

Level 1 inputs include quoted prices (unadjusted) in active markets for identical assets or liabilities that a reporting entity can access at the measurement date for the instrument or security to be valued. A commonly cited example is a stock exchange closing price, such as one from the NYSE, NASDAQ, Chicago Board of Trade, or pink sheets.

Level 2 inputs include inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Topic 820 and IFRS 13 provide several examples of level 2 inputs, including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; interest rates and yield curves observable at commonly quoted intervals; implied volatilities; credit spreads, and market-corroborated inputs.

Level 3 inputs are unobservable inputs for the asset or liability used to measure fair value that rely on a reporting entity's own assumptions about the assumptions used by the market participant in pricing the asset or liability. Topic 820 and IFRS 13 state: "Unobservable inputs shall be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing for situations in which there is little, if any market activity for the asset or liability at the measurement date."

Typical investment firm classification defaults by Category/Level:

Asset-Backed Securities
Bank Loans
Cash Equivalents
Collateralized Mortgage Obligations
Corporate Bonds and Loans
Equities
Futures
Money Market Funds
Mortgage-Backed Securities
Municipal Bonds

Non-U.S. Government Bonds
Options on Indices
Options on Securities
Private Equities Securities/Holdings
Private Investments in Public Entities (PIPEs)
Regulated Investment Companies (RICs)
Short-Term Obligations
Swaps
U.S. Agency Securities
U.S. Treasury Securities

Testing Methodology:

- Download files from the investment firm that contain the level assignments (Fair Value Hierarchy Positions)
 - Filter Level 1 items from the report
 - Review Level 1 items for reasonableness; select 2 sample items for testing
 - Verify that Level 1 items include evidence to support Level 1 rankings
 - Corroborate with market data
 - Reuters, FT Interactive, Bloomberg
 - If traded:
 - Frequency (liquidity)
 - Amount/day
 - Price range
 - Volume
 - Time period
 - Bid/ask prices
 - Filter Level 2 items from the report
 - Select a sample of Level 2 items for testing (sample size: 35; 10 investment grade and 25 non-investment grade) – investment grade securities have a rating of BBB (S&P) or Baa (Moody's) or higher; non-investment grade securities generally have higher yields and a significantly higher probability of default
 - Verify that Level 2 items include evidence to support Level 2 rankings
 - Corroborate with market data
 - Reuters, FT Interactive, Bloomberg
 - If traded:
 - Frequency (liquidity)
 - Amount/day
 - Price range
 - Volume
 - Time period
 - Bid/ask prices
 - If market data isn't available, give sample items to the investment firm; they will perform a deep dive
 - Document the evidence gathered by the Company to make the final determination about Level 2 items
 - Filter Level 3 items from the report
 - Select a sample of Level 3 items for testing (sample should consist solely of limited partnerships; sample size to be determined)
 - Verify whether each Level 3 item selected meets the widely accepted definition of alternative investment; examples: private investment funds

(such as hedge funds), private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, funds of funds, and bank collective investment funds

- Request fund investment statements (NAV Summary, benchmark information, etc.) or Limited Partnership financial statements, or fund values of hedge funds from Investment Group
- Review fund investment statements for the following items:
 - Investment category
 - Redemption restrictions (apply ASU 2009-12)
 - NAV calculations/current value
 - Benchmark data
 - Statement end date matches Plan's year-end date
- Review limited partnership financial statements for the following items:
 - If statements are audited, obtain opinion
 - Verify whether there were changes in valuation procedures
 - Statement end date matches Plan's year-end date
- Where applicable, review financial websites for pricing/trading activity:
 - Corroborate with market data
 - Reuters, FT Interactive, Bloomberg
 - If traded:
 - Frequency (liquidity)
 - Amount/day
 - Price range
 - Volume
 - Time period
 - Bid/ask prices
- If 10+ of the Level 3 sample items are determined to be Level 2, designate the entire Level 3 population as Level 2 to the extent possible
- For items that are determined to be correctly ranked Level 3 items, describe the valuation methodology provided by the investment firm and obtain valuation procedures (if any) used by the investment firm to value such alternative investments (for example, use of a pricing service)
 - Additional documentation for each investment should address:
 - Nature of the underlying investment
 - Portfolio strategy for alternative investments
 - Method and significant assumptions used to value the underlying investment
 - Initial due diligence procedures performed on the investment
 - Ongoing monitoring (procedures performed after acquisition)
 - Financial reporting of the investment
 - Interview fund managers (or plan trustees) if possible to learn about the nature, strategy, and assumptions related to the alternative investment
- Obtain and review the SOC 1 Type II report of the investment firm's pricing service (if used for alternative investments) for the reporting period
- Document the process taken by the Company to make the final determination regarding Level 3 items, including an assessment of the risk of material misstatement of financial statements related to the valuation of alternative investments
 - Use information obtained above to document the process and assess the risk of material misstatement

NOTE: More and more plans now hold alternative investments, and plan sponsors are probably not aware of the fact that prices presented by custodians are generally “best available” prices, and not “full fair value valuation” prices. In other words, the custodians are simply passing through prices to plan sponsors. It’s possible to obtain a full valuation for each investment (using a valuation advisor), but doing so would probably be cost-prohibitive. The best option appears to be gaining a good understanding of the nature, strategy, and assumptions used by fund managers to value alternative investments.