FASB 157 And The Importance Of Establishing Fair Value

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, or FASB 157, sheds a new light on the determination of fair value. It also establishes a framework for classifying benefit plan assets based on the certainty with which fair values can be calculated.

As a plan fiduciary, you are legally responsible for accurately establishing fair value for the investments in your plan — including alternative investments such as hedge funds, private equity funds, real estate funds and insurance accounts. Fiduciaries who don't follow ERISA standards of conduct may be personally liable for losses arising from an inaccurate estimate of investment values.

Of particular concern are hard-to-value alternative investments, which may contain underlying instruments that are not publicly traded. Here, it doesn't have to be some exotic investment that causes valuation challenges. Many 401(k) plans provide a "stable value fund" as one of their investment offerings. These are typically a contract with an insurance company guaranteeing a particular rate of return. Unfortunately, plan administrators may have no idea how the insurance company is valuing these types of assets.

To that end, FASB 157 seeks to establish a fair value framework for valuing investments in your plan's financial statements. It outlines acceptable valuation techniques — including market approach, income approach and cost approach.

A New Definition

FASB 157 establishes 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. In other words, fair value is now an *exit* price rather than an entry price. In the real world, this means the price that an entity pays for an asset can't always be assumed to be its fair value. Just as important, fair value must be based on assumptions that are considered by market participants, as opposed to simply a "willing party."

Creating A Fair Value Hierarchy

FASB 157 also establishes a "fair value hierarchy" of inputs that are to be used for valuation:

Level 1 Inputs — These are the quoted prices found in active markets (e.g., NYSE, NASDAQ and the Chicago Board of Trade). If a Level 1 input is available for a particular investment, it must be used to value that investment.

Level 2 Inputs — These are inputs other than quoted prices that are *observable* for the asset. These reflect the assumptions that market participants would use in pricing the asset using independent market data such as matrix pricing, yield curves and indices.

Level 3 Inputs — These are *unobservable* inputs that reflect the plan's own assumptions about the assumptions that market participants would use in pricing the assets. Level 3 inputs are developed based on the best information available in the circumstances (e.g., investment manager pricing for private placements, private equities and hedge funds).

Ultimately, under FASB 157, readers of the financial statement should be able to fully understand what inputs were used to determine an investment's value and into which value hierarchy each investment falls.

Why the Change?

Prior to FASB 157, different definitions of fair value existed, and the limited guidance available for applying those definitions was dispersed among the many accounting pronouncements that require fair value measurements. Differences in that guidance created inconsistencies that added to the complexity in applying generally accepted accounting principles.

The hope is that a single definition of fair value, together with a framework for measuring it, will result in increased consistency and comparability in fair value measurements.

Your Responsibilities

Understanding what investments you have in the plan and how they are valued is critical for plan administrators. FASB 157 makes it clear that a plan administrator can't outsource that responsibility. In short, the valuation process should ensure that those charged with governance and administration of the plan understand the pricing methods used by any third party in order to determine if those valuations are reasonable.

Steps To Take

By implementing these basic steps at the plan level, you can help ensure that plan investments are properly valued:

- Communicate regularly with your investment manager.
- Review monthly/quarterly trust reports.
- Compare quotation sources and appraisal reports with recorded values.
- Compare values of pooled separate accounts and common/collective trusts to net asset values calculated by the issuer and understand any adjustments that were made to net asset values.
- Obtain the financial statements (preferably audited) of pooled separate accounts and common/collective trusts and compare unit information contained in the financial statement for reasonableness to the unit values reported to the plan and understand any adjustments that were made to net asset values.
- Document valuation methods in the trust agreement or plan committee minutes.
- Have the plan committee approve the basis for good faith estimates, including independent appraisals, if any, and document the basis used.
- Obtain documentation from pricing services about the pricing methodologies and sources used by asset classes.
- Ensure that the trustee and/or custodian has adequate internal control over processes used to value plan investments.

Solid Guidance

Establishing accurate values — especially for hard-to-value alternative investments — can be challenging. Fortunately, FASB 157 provides solid guidance on the matter.

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