



Three Questions that Retirement Plan Managements Will Be Asking Their Auditors About Who is Responsible for Determining the Fair Value of Alternative Investments

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Introduction

On-going research by Axiom Valuation Solutions indicates that the percentage of retirement plan investments allocated to alternative investments (AI) ranges between 5% and 75% of total assets with the average around 31%. Because these investments are opaque and illiquid, establishing their fair value is complex, particularly given the information requirements of Topic 820 (formerly FAS 157) and the implementation guidance and information requirements set down by the AICPA in its Practice Guide on Alternative Investments. Because of the Madoff scandal and the inability of several institutional investors to sell AI interests at values close to what had been reported as fair value, plan managements and their auditors are under pressure to ensure that the values shown as of the audit date reflect values that would be obtained if the interests were hypothetically sold under normal market conditions. As we have reached out to plan managements and fiduciaries to help them create a “best practice process” that is auditable and validates the fair value of AI, there are three questions that we are routinely asked by retirement plan managements about what they need to do to ensure the correctness of AI values and the role their auditors play in what is often a complex and confusing task. We thought it would be useful to auditors if we share both the questions being asked of us and our responses. Please feel free to get back to me with any questions and comments.

Question 1: Who is responsible for establishing that fund assets are properly valued?

Answer: The AICPA Practice Guide on Alternative Assets states:

Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, **management** needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.

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Question 2: Given the answer to question 1, does this mean that my auditor may not accept values provided by AI investment managers even if the values emanate from an audit?

Answer: The short answer is YES. The values calculated by the AI manager as part of the firm's audit DO NOT represent a third party independent valuation of the underlying investments. What the AI manager's auditor is "signing off" on is the reasonableness of the process used by the AI manager and NOT WHETHER THE REPORTED ASSET VALUES ARE CORRECT. The AICPA Practice Guide states:

Although the investor entity's management may look to the fund (AI) manager for the mechanics of the valuation, *management must have sufficient information to evaluate and independently challenge the fund's valuation.*

Question 3: Where can plan management obtain the necessary information to vet AI asset values to ensure they are accurate?

Answer: The AICPA Practice Guide on Alternative Investments indicates that auditors need to understand the internal control system that management has established to ensure that AI values are accurate. An acceptable internal control system is one that includes a verifiable and structured investment evaluation process. A process meets this standard when:

1. Management has a defined framework for identifying the type of information required for validating returns and values.
2. The framework contains metrics that use the requested data inputs to evaluate whether the reported asset values meet the fair value standard.
3. The process identifies when the results in step 2, do not meet the fair value standard and indicates the nature of any additional information that the AI manager needs to supply so a conclusion of value can be reached.
4. The process yields a report that can be audited.

In summary, financial reporting standards, AICPA implementation guidance, and financial market developments have increased plan management's responsibilities as it relates to validating the fair values of plan assets in general and AI interests in particular. The audits of AI funds' financials, while necessary, do not carry the imprimatur of fair value and thus cannot be relied upon by plan management to establish fair value. Trustees and plan management must establish an independent process for determining fair value with documentation of the valuation methods used and significant assumptions made. It is this process that is then audited to determine whether the plan values are prepared in accordance with fair value.