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Employee Benefit Plan Auditing and Financial Reporting Models

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Good morning and thank you for extending the invitation to participate in today's discussion regarding the scope of employee benefit plan audits and financial reporting. My name is Kerry White, and I am a Managing Director, at BNY Mellon Asset Servicing in Boston, Massachusetts, and I am pleased to appear before the Department of Labor's Advisory Council on Employee Welfare and Pension Benefit plans. For over 20 years, I have been employed in the financial services industry, and have held a number of roles including relationship management, where I had responsibility for overseeing the delivery of fiduciary trust services for large corporate ERISA plans, controller and manager of the fund accounting, performance reporting, and client service functions for pension and endowment clients for a fixed income Investment Management firm that specialized in Asset Backed securities like Collateralized Mortgage Obligations to create predictable income streams for investors.

In my current role as head of business strategy and development for the tax exempt sector at BNY Mellon, I am a member of the senior management team of our Global Product Management Department. It is my responsibility to ensure that our custody, reporting, and other ancillary services that are utilized by our Tax Exempt clients (e.g. Pension Funds, Foundations, Endowments and Religious and Healthcare Institutions) are fit for purpose, and meet the needs of our clients and their stakeholders. In this role, I work very closely with our clients, their managers and auditors, as well as our technology, information delivery and accounting teams to ensure that our product development enhancements are appropriate. Many of our recent developments have been focused on the reporting and valuation challenges of alternative assets (e.g Private Equity, Hedge Funds, Real Estate and Limited Partnerships), as well as the myriad of changes required for GASB and FASB reporting, 5500 reporting, and other requirements to provide additional transparency on the assets that are owned by our clients, and ultimately reviewed by their auditors.

While there have been a number of recent improvements over the past several years in terms of valuations, and transparency into the processes and policies that the trust banks employ to obtain prices and value portfolios, it is good to see the Advisory Council's ongoing interest in ensuring the accuracy of plan valuations, and audits. Prior to addressing the Council's questions regarding limited and full scope plan audits, I would like to share some introductory remarks. Please note that my comments represent my own opinions and are not necessarily the views of BNY Mellon.

For the purpose of this morning's discussion, I primarily will focus my comments on the forms of support that we provide to plan sponsors and their auditors in order to prepare financial statements, review pricing, and some of the challenges related to the valuation and certification of alternative investments. Since the enactment of FASB statement No. 157, which requires extensive financial statement disclosures about the valuation of plan assets, there has been a shift in how much information is available to plan sponsors and their auditors in terms of valuations. Most of the large trust banks have enhanced or added new reporting and valuation tools in order to assist plan sponsors in determining the fair value of their plan assets. These tools and valuation hierarchies are typically also readily available to the plan auditors who are engaged by our clients. This is the case for both full and limited scope audits.

Fair value and alternative assets:

Because FAS 157 and other newer accounting proclamations are relatively complex, the guidance provided on how to "fair value" plan assets has brought sunlight onto the valuation process, and in my opinion has probably made the identification of potentially riskier investments much more obvious for plan sponsors and their auditors. This is increasingly important, as the employee benefit plan environment has changed significantly since ERISA was enacted, and many plans have shifted their assets away from traditional investments toward what could be characterized as riskier, “hard to value” asset classes. All of the large trust banks have implemented policies and processes regarding the leveling of investments under FAS 157, and have developed hierarchies to determine whether an instrument is exchange traded, priced using observable inputs, or if in the case with alternative investments there is not a readily determinable fair value or market.

In addition to the services that have been developed by the Trust banks, there have also been a whole host of other firms that provide capabilities to asset owners and asset managers that have developed products including specialist pricing or valuation capabilities, due diligence services regarding alternative assets, and even independent valuation services, such as those provided by Duff & Phelps, and Houlihan and Lokey. What both FAS 157 and the Madoff fraud have done, has turned what I would have characterized as a “cottage industry” in terms of independent valuation, into a more readily utilized service. What should be mentioned here though, is that those services typically come at a very high price tag which would be extremely difficult for most plan sponsors to absorb.

Real Estate, Private Equity and Other Alternative Investments

We perform accounting and reporting services as well as performance analysis for clients who invest in hard to value assets such as real estate, private equity and other alternative or private market investments. Activity which is reported to us from the appropriate investment manager is reflected on the month end accounting reports. Transactions that occur throughout the month (e.g., cash distributions, expenses, etc.) are processed on a daily basis.

Real estate/private market investment pricing is updated as the statements are received from the managers, or on a quarterly basis. One big challenge with these types of assets is that it is not unusual for those managers to report as late as a quarter in arrears. In the case where an investment is not priced in a timely manner, preliminary prices can be entered until the final price is received. At that time, accounting and performance records will be updated simultaneously, reflecting the effective date price of the plan's investment.

We also have the flexibility to account for these investments as a single line item that represents a combination of properties, or to show the individual properties themselves and account for all related income and expenses associated with each property. This type of treatment is all decided by the plan sponsor, and their elections are sometimes driven by price. For example, we have some clients that will direct us to hold multiple line items, representing numerous partnerships into one account. This type of arrangement will certainly result in reduced fees from us, but it could make the identification of riskier assets more difficult for the auditors because they may be bucketed together with a number of investments which are equally opaque. On the flip side, we have other clients who want to see these alternative assets in very different ways, each independently recorded in its own account, with deeper information about the components of the fund.

For these types of clients, our Performance & Risk Analytics Group offers an application to our clients to use in the management and analysis of alternative investments like real estate, private equity, and natural resources. We offer these clients a product called Private Exchange, which was created by a firm that we partner with called The Burgiss Group, and consists of their software called Private i and a data utility that will move information from our Institutional Accounting System (IAS) into Private i. Private Exchange will collect partnership transaction and pricing data from IAS and move the data onto the client's network where the data will be translated and imported into Private i. These tools sit right on the client's desktop, so they have a great deal of flexibility in how they report on alternative assets, and likewise they can provide the generated output to their auditors to assist in plan audits. Private i is essentially a Windows-based information management system designed to provide portfolio managers with the primary tools required to manage and analyze alternative investments. We have the ability to license Private i through an agreement with The Burgiss Group, the developer of Private i.

Private i can calculate:

- Vintage year composites
- Cumulative internal rates of return (IRR) since inception
- Returns net of fees, expenses, and carry to the limited partner.
- Disclosure of the type of investment, investment strategy, and changes in the general partner which could be immensely helpful in disclosure reporting

We can also provide a holdings-level view of private equity partnerships by using the Private Informant service. This capability enables the client to view, analyze, and report on the holdings-level detail across all private equity portfolios.

Access to sector and geographical information is available to the client as often as the general partner of the fund can provide the information (typically quarterly). The underlying data is administered and kept up to date through our relationship with the Burgiss Group. We believe that these types of tools are a great way to improve the transparency into alternative assets, which are known to be notoriously opaque.

Limited versus Full Scope Audit:

In a limited scope audit, there will be less valuation testing of plan assets, but I believe that there is still merit to allowing the exemption because there are certainly still a very large number of health and welfare plans and DC plans in existence today who do not own these types of "hard to value assets" that would be described as a level 3 asset, under FAS 157. When considering the topic of whether a plan should engage in a limited or full scope audit, I think the key here really begins at the stage of setting the terms of engagement between the plan sponsor and the CPA firm. As long as the Plan Sponsor has an intimate knowledge of the plan investments, including complex investments, they should be able to easily determine whether or not they can avail themselves of the limited audit exemption. If they do not have this type of knowledge, they may enter into an engagement for a limited scope audit, which would not suitably cover them.

It is critical that the financial statement preparer's due diligence in assessing the plan's current investment portfolio is done accurately, and likewise that they understand the valuation process and know how the prices have been derived

This means that the financial statement preparer must not only understand the source and veracity of the values which they use to represent the fair value of their plan assets, but they should also be able to provide evidence of the processes and methodologies which have been utilized in order to reach their final valuation decisions. It is not suitable to simply assume that they have effectively "outsourced" this function to their Trustee/Custodian.

Trustee/custodian certification:

There has been a fair amount of discussion over the years about what a custodian's certification covers and entails. What a custodian certification covers is the information which is provided in the course of performing the custodian's "ordinary business" functions. This is one area that is not always well understood because when it comes to topics like obtaining prices for our clients' alternative assets, we typically only have one source- the managers themselves. We use care and diligence, in accurately recording the prices which we receive directly from the manager or limited partnership, but we do not have a systemic way to verify the veracity of those prices ourselves..

Likewise, the plan's custodian would not be performing additional steps, in order to determine whether those prices could be considered fair value, or whether additional adjustments to the price would be needed in order to derive a price that one could consider fair value. If a plan needed such a valuation, they could hire a specialist in the relevant asset class to do so, which would involve having this specialist deal directly with the Alternative Asset Managers to validate the veracity of the fund holdings and the valuation of portfolio companies which might make up the fund holdings, in say a Private Equity fund.

The certifications which are permitted under the limited scope exemption provide comfort that the custodian completely and accurately recorded the price for each asset, from the designated source. We have many different designated sources. Typically we use industry-recognized vendors; and in many cases we will buy the same security prices from multiple vendors so that we can compare and contrast the quality of those prices and make comparisons to how they look relative to actual trading activity which we can observe. This allows us to make price challenges to the vendors, and provides back up pricing if there is a problem with a vendor. In certain asset classes we will employ a boutique or specialty vendor. This is often the case where our clients own unique assets like bank loans, or securities which are thinly traded. When it comes to the topic of alternative assets, however, we typically only have one source, and that is manager or fund's periodic statement. The certification is not an indication that the custodian performed additional validation, in accordance with the fair value accounting guidance, around that price, particularly for a hard-to-value asset.

What we have found, is that the users of our custodial statements may decide that this process in and of itself delivers to them a scrutinized, and well-vetted price, at least for their marketable securities. We know from experience, that many have taken the decision that employing such a process gives them the comfort in order to declare them to be recorded at a fair value price under U.S.

GAAP. It is the financial statement preparer's discretion to do so, and this should only be done so in adherence of their entity-specific fair value pricing policy.

Carve out of certain asset classes:

I would not necessarily agree that there is a need to carve out certain asset classes. Because the certification is not intended to certify that the asset prices represent fair value, it seems that carving out alternative assets would accomplish little.

If the intent behind this is to readily identify any plan assets which might require greater scrutiny (i.e., the alternative assets), all of the major custodians already provide reporting which easily facilitates segregation of assets by those that are priced independently and those that are not priced independently. Likewise, all of the major trust banks have electronic reporting systems, which allow the sponsor (or their auditors for that matter) to download that information into excel and other applications for further manipulation which would be helpful in terms of maintaining a record of their diligence done during the fair value process.

Financial statement preparers and their auditors today have access to a wide universe of information about their investments, and the valuation policies and procedures utilized to value those investments. This in turn, should allow them to easily identify assets which are priced by an independent source like well-known industry vendors, versus those that are self-reported by the manager or fund. For those reasons, rather than changing the certification process it may make more sense to focus on the education process.

I endorse the DOL's objectives to improve plan asset reporting at "fair value," and the consistency of plan audits whether they are full scope or of a limited scope nature. Because it is ultimately the plan sponsor / plan fiduciary's responsibility to make a good faith determination of the fair or current value of all assets, including those where there may be no readily ascertainable value, it may be helpful if the Department of Labor continue to educate the Plan Sponsor community on that very topic. Because FAS 157 requires that fiduciaries have an adequate understanding of the characteristics of their investments, and the valuation process in order to determine whether certain valuations are indeed reasonable, many sponsors have really taken an active role in becoming educated on the topic. I would suggest to the council that there is not universal understanding in the community, and that is something that would benefit all plan sponsors and their ultimate stakeholders – the plan beneficiaries. In the wake of the implementation of FAS 157, there were many firms helping the preparers of financial statements understand the new requirements, including the CPA firms. At that time, BNY Mellon hosted numerous webinars for our clients that covered many topics related to the standard including our valuation policies, our pricing vendors, the leveling process, and how to identify "hard to value" and thinly traded assets. I know that our peer institution here today, hosted similar educational sessions as well. These types of activities are something that I would suggest that the Trust banks will continue to do in order to assist with plan sponsor education.

If the DOL were to provide plan sponsors with salient examples of what you believe to be best practice standards in terms of compliance, and valuation oversight, that could assist them reach a level of understanding, and improved level of oversight in how their plan assets are being valued. I believe this would be beneficial to plan sponsors of all sizes, and relevant to plans who engage in either a full scope or limited scope audit. This type of guidance might also help them better understand when a limited scope audit would not be sufficient to cover the types of plan assets they oversee.

I will conclude by stating that I feel strongly that there is a real need for us to continue to engage the plan sponsor community in the dialogue about best practices, and pension governance responsibilities. This educational responsibility lies with those of us who represent the custodian community, but it is not our responsibility alone. There are ongoing educational needs, and they should be supported by the custodians as well the plan auditors, regulators, and the pricing vendors themselves.

Thank you.

Written Response Submitted by Kerry A. White

Before the U.S. Department of Labor Advisory Council
On Employee Welfare and Pension Benefit Plans

Employee Benefit Plan Auditing and Financial Reporting Models

August 31, 2010

1. **If a plan's financial statements are misstated (example: assets not properly stated at "fair value"), what is the risk that such misstatements would not be identified in a limited-scope audit? Would such misstatements be identified and corrected in a full-scope audit?**

These are questions, which may be better addressed by members of the audit community, or the AICPA, but I can share some commentary based on my own experiences. If a plan's financial statements are misstated or inaccurately valued and are not in compliance with generally accepted accounting principles, and the plan has engaged a firm to perform a limited scope audit, there is a risk that the errors may not be discovered. The crux of the issue is that in a limited scope audit, the auditor will test balances and controls in order to account for those assets, but they may not take a deeper look at the source of those valuations.

Irrespective of whether a plan's auditor conducts a limited or full scope audit, the plan sponsor still is required to gather the "fair value" of their asset values in order to prepare their GAAP compliant financial statements. If the sponsor has alternative assets in their plan, they should be making a disclosure to the audit firm about the "hard to value" assets which they own.

When considering the topic of whether a plan should engage in a limited or full scope audit, and whether misstatements would be more likely to be identified and corrected in a full-scope audit, I think the key here really begins at the stage of setting the terms of engagement between the plan sponsor and the CPA firm. As long as the Plan Sponsor has an intimate knowledge of the plan investments, including complex investments, they should be able to easily determine whether or not they can avail themselves of the limited audit exemption. If they do not have this type of knowledge, they may enter into an engagement for a limited scope audit, which would not suitably cover them.

Experienced auditors are generally aware of the fact that custodian banks don't certify values for assets that we do not hold. The certification is for accurately reflecting activities in our "ordinary business records," which does not include "fair value." The valuations are generally derived through the utilization of pass through pricing, which we acquire from vendors or the managers themselves. These prices are readily available from respected industry specialist pricing firms, for listed securities, but that is not the case for holdings for which there is no independent pricing or a liquid market. (eg hedge funds, private equity funds and other alternative asset classes)

2 Have any participants ever been harmed by a Plan having a limited-scope audit? Are there any examples or scenarios where this could happen, but would not happen if there had been a full-scope audit?

I am not personally aware of any situations where a plan participant has been harmed because of the use by the sponsoring entity of a limited scope audit rather than a full-scope audit. However, I can envision how a participant could be harmed, and that might play out as a scenario – for example if plan assets were overvalued due to inaccurate pricing, or plan expenses were under-reported, this in turn could result in a plan having insufficient funds to pay out accrued benefits. Since the limited scope exemption is available to the plan only, I would envision that if there were a material issue related to the plan assets versus liabilities, that this would become evident in the pension footnote disclosures reported in the audited financials of the sponsor themselves. These financial statements (and footnote disclosures) are subject to a full scope audit, and are not entitled to exemption. Therefore, I would suggest that if the level of pension funding (or more likely underfunding) were material in nature, relative to the sponsor's overall balance sheet, that this would be obvious to the auditors

Because I am not aware of any specific examples of this occurring, this question might be better posed to the audit community, or to the PBGC to determine if there were plans in the past that may have been assumed by the PBGC where prior to the PBGC takeover a limited scope audit had been undertaken, and plan assets were overstated.

3 To what extent does the exception remain useful in today's complex environment of available investments and structures of certifying entities? Are there assets being included in limited-scope certifications at values that do not reflect "fair value" under ERISA? Are we certain these values are getting properly adjusted for Plan and Participant reporting?

I believe that the exception remains useful, particularly to smaller plans who may not invest in terribly complex asset classes that can be characterized as "hard to value assets." While the range of investments available to asset owners today is vastly different and more complex than it was 30 years ago, the fact remains, that not all investors own complex assets, which would be characterized as "hard to value." A fair number of our clients do utilize the exception because their plans are relatively simple, and their assets are highly liquid and are exchange traded, which means that the pricing for their assets is readily available from respected pricing vendors.

Regarding the second question about “fair value” and asset certifications – I think it is worth noting that the banks and trust companies are certifying to the completeness and accuracy of the records produced in our “ordinary business.” Preparers of financial statements that rely upon financial records derived from accounting systems that are maintained within a bank, trust company, or similar institution under governmental regulation and examination, can assume that the books & records as reflected in the client’s trust statement, are properly certified by the bank / trust company, or similar organization as being accurate and complete, but that does not normally include fair value testing. As the landscape has changed over the years, we certainly do have many more sources for pricing than we did previously, which is a real bonus for plan sponsor’s since we have the ability to compare and contrast prices provided by different vendors for the same security. This is the case with listed securities for which there is an active market. Unfortunately, however, that is not the case in the instance of Alternative assets, like Hedge Funds and Private equity for which there is no active market, nor independent prices.

In terms of the third question, I would not be able to say with certainty that all plans are making the proper adjustments for “fair value,” but I can say that a large proportion of our client base do employ a number of different procedures to make adjustments. One very common policy amongst our clients, is to hold open the books at year end in order to update valuations for Alternative Assets, which typically arrive on a quarter lag. This can have a significant impact on a client’s financial statements, particularly if they have significant exposure to alternatives. Clients will also make certain adjustments if they own hedge funds with gates, or lock up periods in place.

4. **Should the criteria of what types of investments that can be certified or what types of entities can certify be updated for today’s complex environments? Should hard-to-value assets be certified or subject to full-scope audit procedures?**

I don’t believe that the certification process needs to be changed. As owners of more complex investment types elect to invest in such investments, they should be aware of what it is that custodians are certifying, and what limitations exist in terms of verifying assets that we don’t hold. Many of our plan sponsor clients undertake their own due diligence with respect to alternative assets. This takes place, not just at the time of initial investment, but throughout the life of those investments. In my opinion, this is a prudent process, and could be an area where the DOL might consider giving guidance to the plan sponsor community. I would suggest that the “hard to value assets” are generally readily identifiable on the books and records of the major trust banks, and therefore available to sponsors and their auditors. One alternative to automatically requiring a plan to enter into a full scope audit, might be to define procedures to determine which assets on the books of the custodian have been independently priced and veracity verified. This would allow sponsors and their auditors to then verify the “fair value” of those particular assets for which there is not an independent price. This is an area that most custodians would likely be interested in collaborating with both the DOL and the audit community to create common practices.

5 To what extent are custodians / trustees complying with the limited-scope audit regulatory requirements for certification? To what extent are entities certifying assets that they are not holding? Are auditors able to ascertain adequately that certifications are proper and comply with the regulations?

In order to comply with the limited scope audit requirements for certification, Custodians / trustees must be regulated by a national agency. All of the major custodians meet this requirement. The second requirement is that Trustee / custodians certify to the completeness and accuracy of the information which is contained in their ordinary business records. These ordinary business records would include holdings including location, transactions, and pricing to name a few. Ordinary business records would not include “fair value” of the plan assets. An additional requirement is to certify the assets which are being held by the custodian, which includes assets held or deemed to be in control by us within our network of local subcustodians. The certification does not include assets which are held elsewhere. An example would be investments held at another institution, like a commingled fund, hedge fund, or prime brokerage account. Plan sponsors will typically require us to perform a recordkeeping function for those types of assets, and to do so we will mirror image the activities that are taking place at the institution where those assets are actually being held.

At BNY Mellon, we do not certify assets that we are not holding, and those types of assets are readily identifiable by the plan sponsors and their auditors. These assets are typically reflected on our books with a “location code” of ANH which stands for “Asset Not Held.”

6 Even with a proper limited-scope certification, is a GAAS audit of a plan under the limited-scope exception enough? Should there be additional procedures required either at the Plan level or at the certifying entity?

I think the first question of whether a GAAS audit of a plan under the limited scope exception, is probably better answered by members of the audit community. Regarding the second question of whether additional procedures might be required, I don’t think that is necessarily needed. The rationale being that there has already been very detailed guidance issued by the FASB on how to derive and adjust for “fair value’ across a wide variety of investment types. Ensuring adherence to this guidance is probably the best way to determine whether or not Plan sponsors are issuing financial statements that are accurately reflecting "Fair Value."

7. **What is the potential liability, if any of a certifying entity if its certification is inaccurate as a result of an intentional act (or failure to act) gross negligence, or negligence?**

It is difficult to say what liability the certifying entity would have to the sponsor, however most custody contracts have specific language in them that the protect the sponsor from an intentional act of negligence. The certifying entity could also be subject to criminal and civil penalties under ERISA Section 501, and ERISA Section 502 respectively.

All of the large trust banks are subject to oversight and rigorous examination by a number of regulatory and oversight bodies. (the OCC, the Federal Reserve Board, the Office of Thrift Supervision, the FDIC, or state banking regulators) . This requires the banks to undergo extensive examination and oversight reviews. Depending on the type of charter that the bank holds, these exams occur at a minimum once every 12-18 months.

8. **What assets, if any, cannot be certified for any reason? What assets, if any, would not be certified as a matter of standard business practices?**

As previously noted in my response to question #5, we do not certify assets that are held away from us. (eg held by another party such as a prime broker) I believe that assets not held by the custodian would likely need to fall outside the range of assets that can or should be certified by the trustee or custodian, according to our "normal business practice."

9 **Should the limited-scope audit be repealed? If not, why? What are the positives? If not repealed, should it be modified? How? What suggestions would you have?**

I do not believe that the limited scope audit should be repealed. This could pose a significant burden to the plan administrator of an employee benefit plan, particularly those of a smaller size. If the plan administrator can show that the financial statements they are providing to their auditor have been prepared by an insurance or bank / trust company, (and subject to federal or state banking or insurance regulation) using a trust accounting system maintained by the bank as defined under the limited scope audit rules, the sponsor should be able to direct the auditor to perform a limited scope audit.

In terms of suggestions to improve the process, I think it would behoove the various participants in the entire process (custodians, plan sponsors, and the audit community) to continue collaboration to ensure that all stakeholders are aware of when a limited scope audit is appropriate, and when it is not. This should lead to better education on the challenges that “hard to value assets” pose in the audit process, and how sponsors can be certain that they are carrying out their fiduciary responsibility in terms of defining a fair value for those assets.