DOL ERISA Advisory Council
Employee Benefit Plan Auditing and Financial Reporting Models

August 31, 2010

Testimony presented by Peggy A. Bradley, Senior Vice President,
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Good morning and thank you for extending an invitation to join this important discussion related to the scope of employee benefit plan audits. My name is Peggy Bradley, and I am a Senior Vice President at Northern Trust Company in Chicago, Illinois. Over the past 30 years, I have served as relationship manager overseeing the compliance and delivery of fiduciary trust services for Fortune 500 ERISA plan sponsors, as manager of the fund accounting, transfer agency, and regulatory filing functions for common and collective funds, and as product manager of Treasury Services for the Federal Reserve Bank of Chicago.

In my current role as financial and regulatory reporting consultant for our trust and custody clients, I serve as an intermediary between our clients, their auditors, and our product development team. I have been focused on the valuation challenges of alternative assets, as well as the limited scope exemption issues in general, for some time now, and have had the opportunity to present the custodial bank perspective on the topic to this group in July, 2008. A copy of that testimony is attached to my written comments.

Prior to launching into the discussion of the Council's current questions related to the scope of plan audits, I would like to share a few introductory comments. Please note that my comments represent my perspective and not necessarily the position of the Northern Trust Company. For the purpose of this morning's discussion, I will focus my comments on the challenges primarily related to the valuation of alternative investments. You will notice that I am use the term "custodian" and "trustee" interchangeably for today's discussion purposes.

I am pleased to see the Advisory Council continue the pursuit of the accurate plan asset valuations, especially given the changes that have occurred on the valuation front since the hard-to-value-asset discussion was raised by the Council two years ago. Noteworthy changes that impact the valuation and audit of hard-to-value assets, some negatively and others positively, include:

- **Improved Valuation Information –** Financial statement preparers today enjoy the benefit of greater transparency of pricing inputs and methodologies from pricing vendors, and access to a growing field of valuation experts to assist with more complex valuation needs.
- **Enhanced Custodial Information** - Significantly expanded reporting around how the pricing vendor data is used by custodial banks has led to the development of reporting tools that allow financial statement preparers and auditors to effectively use the information to compile financial statement disclosures.
- **Greater Education –** Elevated understanding of the realities of fair valuation across investees, financial statement preparers, their auditors, and stakeholders has helped to further the understanding that the custodial information primarily serves as the starting point, not the ending point, for compiling the financial statement disclosures.
- **Expansion of the Hard-to-Value Asset Pool** - Increase in market inactivity has led to a wider recognition of the lack of transparency for certain fixed income products as well, and has actually increased the pool of assets that fall into the hard-to-value category and around which financial statement preparers may be required to perform a deeper dive.
- **Clarity of Concepts** - Issuance of clearer guidance from the Financial Accounting Standards Board ("FASB") as to what constitutes fair value, along with examples of what should be included in the required fair valuation disclosures, has made the task of reaching conclusions about fair value easier, not harder.

The recent improvements in best practices addressing illiquid and hard to value assets provide a useful backdrop for viewing the employee benefit plan valuation and audit issues. How does today's process of preparing and auditing employee benefit plan financial statements compare to the best practices for other asset pools, such as endowments, foundations, investment companies, or the balance sheet assets of public companies? Specifically, we can look at the employee benefit process in light of the following three questions:

1. What does it take to derive fair value of an alternative investment and what does best practice look like? (Kerry White will expand on this in more detail in her comments.)

2. Does the scope of the audit change the financial statement preparer's process for deriving fair value, more specifically, does the trustee/custodian certification itself alleviate the plan sponsor's need to conduct appropriate fair valuation analysis?

3. Does carving out certain assets from the trustee certification process really address the heart of the issue?

What does it take to derive fair value of an alternative asset?

Any discussion of how best to audit fair values should begin with a discussion of what it takes to derive the fair value of the assets that are being audited. FASB's release of Accounting Standards Update 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)* ("ASU 2009-12") provides a useful framework. This ASU dispels some of the confusion around when and how to rely on or otherwise adjust the net asset value ("NAV") or its equivalent price for assets without readily determinable values. FASB has clarified that adjustments to the NAV may be required under such circumstances as:

- If the NAV of the investment is not calculated in a manner consistent with FASB Codification™ Topic 946 (for investment companies)
- If the NAV of the investment is not as of the reporting entity's balance sheet date
- If redemption restrictions exist at the reporting date
- If other evidence exists of current transaction prices
- If as of the reporting entity's balance sheet date, it is probable that the reporting entity will sell the investment for an amount different from the reported NAV.

In addition to FASB's accounting guidance, financial-statement preparers now have ready access to a myriad of other resources to help guide their valuation oversight process or to provide inputs into their fair valuation determinations. Examples include: the AICPA's Practice Aid on Auditing Alternative Investments, websites such as PensionGovernance.com, or literature from independent valuation service providers, such as Duff & Phelps.

In general, best practices dictate that the valuation process starts with the due diligence of the financial statement preparer in assessing the current investment portfolio and in knowing where the prices come from. This requires the financial statement preparer to have an intimate knowledge of the plan investments, including complex investments; have thorough valuation policies and valuation frameworks to validate the reasonableness of values; have an independent process that uses alternative sources to validate the reasonableness of values; acquire expertise as needed to assist in the validation of assets that are not independently priced or that rely on complex modeling; and, provide evidence of the processes for reaching final valuation decisions

Does the scope of the audit change the financial statement preparer's process for deriving fair value, including those outlined above?

I would suggest that the answer to this question is "no". It is my understanding that the limited scope exemption compels the amount of asset valuation and ownership testing the *auditor* has to perform over the investment-related information presented in the plans' financial statement. It does not, however, limit or exempt the *financial statement preparer* from complying with U.S. GAAP requirements. Financial statement preparers still would be required to follow the fair value accounting rules set forth by FASB, including the well-documented guidance under ASU 2009-12 regarding when adjustments to the NAV may be appropriate, even if they elected to engage the auditor to perform a limited scope audit.

More pointedly, does the trustee certification itself alleviate the plan sponsor's need to conduct appropriate fair valuation analysis? The answer would again be "no", because the certification covers the information provided in the course of performing the custodian's "ordinary business" functions. As it relates to pricing of alternative assets, the custodian, with all care and diligence, is accurately recording the prices received directly from the investee (i.e., the fund manager, the general partner). The custodian is not performing additional steps, such as those outlined under ASU 2009-12, to determine whether those prices could be considered fair value as a practical expedient, or whether additional adjustments to the price should be applied in order to derive a price that would be more reflective of fair value.

Certifications permitted under the limited scope exemption provide comfort that the custodian completely and accurately records the price for each asset, taken from the designated source or sources. 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 hard-to-value or illiquid assets.

It would be worthwhile to pause at this point and mention the custodial pricing operations around marketable securities, where prices are received from and compared against multiple sources, and tolerance-checked. Users of the custodial statements may decide that at least for marketable securities in active markers, this process yields a well-vetted price, worthy of being deemed fair value under U.S. GAAP. This decision, however, is left to the discretion of the financial statement preparer, as dictated by their entity-specific fair value pricing policy. Kerry will touch on this in her comments.

Does carving out certain assets from the trustee certification process really address the heart of the issue?

Not necessarily. The regulations do not require that the banks certify to the completeness and accuracy of *fair value*, nor are banks sufficiently geared up to routinely perform fair value procedures over every custody asset. Removing alternative investments from the certification will leave you with the independently-priced assets, which, like the alternative assets, are certified to be 'complete and accurate', but not necessarily fair-valued.

If the desire is to quickly identify which assets should be subject to greater scrutiny (i.e., illiquid or hard-to-value assets), the major custodians today provide adequate reports to facilitate segregation of assets by those that are independently priced and those that are not. We can thank the fine folks at FASB for giving us more rigorous disclosure requirements under what was FAS 157, which has opened wide the doors to greater transparency and more detailed reporting around custodial pricing sources. Auditors and financial statement preparers now have unprecedented access to information which allows them to accurately identify assets priced by investees, versus those that are priced by industry vendors.

Whether the certification was provided, and regardless of whether the limited scope exemption was invoked, plan sponsors would still be expected to perform the fair valuation rigors, certainly over the investee-priced assets. Rather than changing the certification process, auditors and plan sponsors could begin to think in terms of stratifying plan assets into three categories:

- Independently-priced assets,
- Investee-priced assets whose values have been independently validated;
- Investee-priced assets whose values have not been independently validated

Concluding Comments

I support the DOL's goal to close the gaps in the reporting and scrutiny of fair value of plan assets and would offer that the best way to accomplish this would be to ensure that plan sponsors are well-educated in the fair valuation requirements under U.S. GAAP, and to ensure that in the audit process, there is validation that independent valuations have been performed in all cases, since these fair valuation steps still need to be employed by the plan sponsor regardless of the level of the audit. As you may be aware, the pension plan assets are subject to two audits: once, under the full-scope audit required of the pension disclosures contained in the sponsoring entity's financial statement footnotes, and again later in the year when the plan files the Form 5500 with the stand-alone plan financial statements attached. Assuming similar levels of materiality, and the same scope of audit, one would expect to see similarities between the full scope conducted under the PCAOB audit of the sponsoring entity's plan disclosures, and the audit conducted over the pension plan financials themselves. A closer look at what occurs under similar sponsoring entity audits of hard-to-value plan assets may be useful.

Providing plan sponsors with adequate examples of best compliance practices, detailed due diligence check lists, and valuation oversight polices and frameworks would also help them reach the desired level of oversight and control over how their plan assets are being valued.

Thank you for your time.

Department of Labor

ERISA Advisory Council Questionnaire

Employee Benefit Plan Auditing and Financial Reporting Models

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Responses presented by
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1. **If a plan's financial statements are misstated (example: assets are 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?**

While these questions are best posed to the AICPA which provides guidance to auditors regarding practices under full-scope and limited-scope audits, I can offer you my observations.

Assuming that the risk of misstatement of plan values is more likely with respect to the alternative investments or those hard to value assets whose values cannot be or have not been independently validated by the plan sponsor, then the question shifts to whether the auditor will (1) become aware of the existence of such assets, and (2) challenge the plan sponsor's reliance on the non-validated values.

It is my understanding that in a limited scope engagement, the auditor has no duty to challenge or to perform additional testing, unless they "become aware of " any hard-to-value asset valuation issues. They can become aware of potential areas of concern in two ways:

1. The plan sponsor informs the auditor
2. The auditor discovers that plan assets include hard-to-value assets

Plan Sponsor as the Source

Plan sponsors who (1) understand the complexities of their plan investments, (2) understand their responsibilities related to fair valuation requirements set forth by the Financial Accounting Standards Board (FASB), and (3) understand the conditions under which the custodial certification is issued, will generally be able to more effectively engage their plan auditor in a discussion on the valuation of their hard-to-value assets.

The success of the limited scope exemption provision clearly starts with the plan sponsor's due diligence in assessing the plan's current investment portfolio and knowing where the prices come from:

- ✓ Do I have material holdings in hard-to-value assets as of this reporting period?
- ✓ If so, where do the values on my trust statement come from?
- ✓ Do I consider the values to be reflective of fair value?
- ✓ Are the values that ultimately need to be reported on my financial statement (i.e., fair value) the same values that are certified by the trustee or custodian?

If the answer is "Yes" to the first question, but "No" to the last question, the plan sponsor would be expected to conduct more rigorous pricing validation procedures, which more than likely could yield a value other than the one presented in the certified trust statement. When a plan uses a value that differs from the certified statements, this would become apparent to the auditor as they compared the draft financial statement values to the valued contained in the certified trust statements. The auditor would conceivably undertake a closer look at the level of engagement and perhaps consider the need for additional testing.

<u>Auditor's Ease of Detecting Alternative Investments in a Limited Scope Audit</u>

If the plan sponsor should overlook the need to perform more rigorous pricing validation procedures and to engage the auditor in a discussion about the resultant differences in certified trust values, how likely is it that the auditor might discover this in the normal course of the audit?

In a limited scope audit, the auditor will generally verify that the values on the financial statement correspond to the certified source. Their probe need not extend further, unless they "become aware of" any issues with the certification. In practice, we see that generally the experienced auditors engaged to audit plans with alternative investments quickly "become aware of" potential valuation issues even when performing the basic comparisons of values on the financial statement, to the values on the certified custodial statements under a limited scope audit.

Even in a limited scope audit, the alternative investments are generally readily apparent to the auditor, and the fair value issue is hard to pass over. There are several signposts along the way that provide an opportunity for the auditor to take pause if need be and reconsider whether they have been engaged to perform the requisite level of audit over the right set of assets within the plan, or whether there may be a need to challenge the prices that the plan sponsor has chosen to reflect in their financial statements are being fair value:

- ✓ **Custodial Certifications:** Auditors are generally aware that the standard custodial certification indicates that the asset prices have been "completely and accurately" reflected on the trust statements. They are aware that the custodial prices are generally pass-through prices, whether they are extracted from an independent, third-party pricing vendor, or directly from the investee, such as the general partner or the fund company, as part of the custodian's "ordinary business records". The inherent limitations of the custodial certification (i.e., certifying to best-available prices, which may be representative of fair value in some, but not all, cases) is well known to the experienced auditor.

- ✓ **Asset Segregation within Custody Reports:** Certified custodial statements will generally sort assets by investment category, and the Form 5500 Schedule H certainly sorts commingled investments according to the legal structure of the investment vehicle. Even a quick glance at the certified statement or the custodian's Form 5500 reports will generally isolate limited partnership investments, hedge funds, real estate holdings, and unregistered funds.

- ✓ **New Financial Statement Footnote Disclosures:** FASB ASU 820 requires increased tabular and narrative footnote disclosures which more prominently identify hard-to-value assets (both what may be considered level 2 and level 3). The disclosures will (1) sort the assets into finer categories, including alternative investment categories if material, and (2) include an indication of the level assigned to the fair value based on the observability of prices, and (3) provide a narrative describing the pricing methodology and other factors that warrant an adjustment to the NAV or its equivalent for certain alternative investments. The Form 5500 reports and the certified asset statements help to identify alternative assets, and a glance at the plan sponsor's draft financial statements should provide information about the source and methodology of the prices used for these assets and whether they are deemed to be representative of fair value. If in a limited scope audit, the auditor is reviewing the footnote disclosures related to plan investments, they should be able to identify any potential fair value concerns related to alternative investments that may not have previously been brought to the auditor's attention by the plan sponsor.

- ✓ **Fair Value Transparency Reports:** The larger custodians routinely provide reports to support these fair value hierarchy disclosures required under ASU 820 and ASC 715. These tools provide excellent transparency to the source and methodology of the prices reported by custodians, down to the specific security level, making it readily apparent which assets were priced by independent sources and which ones were not. The assumption is that the auditor is reviewing

> the footnote disclosures, even in a limited scope engagement, and thus they would have access to these useful fair value transparency reporting tools so that they can compare the values to alternative sources.

When the auditor has been engaged to do a limited scope audit under the assumption that there were no hard-to-value assets, but they encounter a certified trust statement, or a Form 5500 report, or draft footnote disclosure that tells a different story, it has been my experience that the auditor may adjust the scope of the audit, for some or all of the plan assets, and more importantly, may challenge the client's fair valuation process.

<u>Ability of Full-Scope Audits to Identify Potential Misstatements</u>

Regarding the second question of whether full-scope audits afford greater security over identification of assets that are not priced at fair value, we believe that auditors (and financial statement preparers) have the benefit of vastly more information today to help in this process. Auditors and plan sponsors dealing with the larger custodial banks have at their disposal detailed reporting that provides transparency to the source of the price, the type of vendor, the type of price provided by the vendor, and the age of the price, for every asset in the plan. Detailed summaries of the methodologies employed by the primary industry vendors are also generally available.

Auditors can quickly segregate plan assets into those that are valued based on independent prices, versus those that are not based on independent prices. This allows them to easily identify the asset prices that may require additional testing and comparison to alternative pricing sources.

To the extent that these tools increase the ability of the auditor to quickly identify alternative assets in a sea of other plan assets, then auditors are much better equipped today to hone in on assets that may be stale-priced, or that may have come directly from the fund company without any further fair value validation, or to challenge the plan sponsor's choice of a limited-scope engagement and to construct more targeted valuation assertion testing plans around such assets.

Another way to approach this question is to look at the current full-scope audits of pension assets that occur under the audit of the sponsoring entity's financial statements. Auditors will audit the FSP FAS 132R-1 pension disclosure footnotes, which entails gaining comfort that there are no material misstatements in the plan asset values that are reflected in the sponsoring entity's footnote disclosures. How comfortable is the industry with the practices employed by the auditors regulated by the PCAOB, when the plan asset values are material to the sponsoring entity's balance sheet?

Ability of Full-Scope Audits to Correct Misstatements

Perhaps the first step in the audit of alternative investments is to determine whether the financial statement preparer:

A. Relied on prices that came directly from the GP or fund company, or
B. Sought out and performed procedures to garner an independently verified price.

If the financial statement preparer followed Option A and used the GP or fund company price, the second step is to review how they gained comfort that the investee's price is reflective of fair value, or whether it warrants an adjustment. Similarly, under Option B, the auditor would want to become familiar with the validation techniques employed by the party verifying the price.

In either scenario, the ability of the audit to detect misstatements of fair value of alternative investments is driven by the auditor's understanding of the principles behind how the investment was priced by the investee, or how it was validated by the independent source, as well as the auditor's knowledge about the market conditions that drive the value of the investment. Custodial reports can more easily identify assets that are priced by the investee, but the real work begins when the auditor launches the deeper dive into the valuation oversight process of the plan sponsor. If a robust valuation oversight process is not imbedded on the plan sponsor's end, then the auditors might have valid reasons to suspect that corrections to the alternative asset values may be required.

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?

The potential for harm could conceivably result from an overstatement of plan asset values. Simply put, over-statement of plan asset values becomes a tangible problem when the music stops, that is, if the plan has to be liquidated to fund entitled benefits, but the assets cannot be liquidated at the values reflected on the current trust statement. If plan assets values were inflated due to reliance on over-zealous pricing of hard-to-value investments and the plan was terminated or otherwise taken over by the PBGC, the result might be insufficient funds to cover full distribution of benefits. To our knowledge, this scenario has not occurred, nor are we aware that any such occurrence has been causally linked to the level of the audit performed just prior to the plan termination.

That said, we acknowledge that plan valuations need to be accurate regardless of any looming termination or assumptive action by the PBGC. The integrity of the private pension system rests heavily on accurate measurement of funding levels, which is intimately tied to reasonable levels of precision in the calculation of both the plan's assets and the liabilities. Confidence in defined contribution schemes is also reliant upon accurate valuations to support the redemptions of participants' contributions.

In the case of pension plans, the accurate estimation of funding levels is obviously of keen interest to the DOL and the PBGC. It is also an issue of importance to investors and stakeholders of the sponsoring entities, as evidenced by FASB's more recent requirement of sponsoring entities to improve the granularity of pension disclosures within the entities' annual financial statements, per ASC 715 (formerly, FSP FAS 132R-1). For public companies, this information finds its way into the SEC's 10-K filings.

These footnote disclosures require the sponsoring entity to disaggregate plan assets into significant asset categories, including alternative assets, and present the fair values of each category according to the level of observability of the inputs to the values. Assets whose values fall into the unobservable range (Level 3) require additional tabular and narrative disclosures.

Related to your second question (would a full-scope audit guarantee against misstatement of plan asset values due to inflated prices of hard to value assets?), perhaps the task becomes one of comparing the effectiveness of the full-scope audits of the pension disclosures performed by the auditors under the PCAOB audit, to the full-scope audits of stand-alone pension plan financial statements. I would suspect that the ability of a full-scope audit to guard against misstatement of plan values would depend on the rigors of the audit performed by the auditor to assess the plan sponsor's due diligence in complying with the fair value standards under US GAAP, whether the auditor was auditing the sponsor's footnote disclosures, or the plan's financial statements.

Please refer to comments to Question #1 above for comments regarding the ability of full-scope audits to identify and correct misstatements.

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?**

<u>Not all Plans Invest in Complex Instruments</u>: While there are indeed complex investments held by plans, not all plans utilize them in their investment line-up. There are still plans whose investment portfolios are comprised solely of registered mutual funds, exchange-traded equities, high-grade debt instruments, or regulated collective funds or common funds that hold the aforementioned investments. These types of portfolios clearly do not share the same risk of overstating plan values as might occur in plans holding more complex investments. For plans with simpler investments, the limited scope audit would appear to provide useful relief from performing rigorous investment valuation testing.

<u>Certifying to 'Fair Value' or 'Best Available Value'</u>?: Regarding the second question of whether banks are certifying values that do not reflect "fair value" under ERISA, it is conceivable that certain asset values within the certified statements may not be considered to represent fair value. As you may recall, custodian banks and trust companies are certifying to the completeness and accuracy of investment information, including asset values that are "… contained in their ordinary business records". The 'ordinary business' of custodians does not normally include fair value testing or validation of alternative investment prices for which there are no independent pricing sources. The values for alternative investments reflected on the certified trust statement are generally pass-through values provided by the investee entity (general partner, fund manager, or in some cases, the investment manager), and may or may not be reflective of fair value.

Testimony provided by Northern Trust and the Department of Labor at hearings on Hard to Value Assets in July 2008 provide further explanation of the what the certification by banks and trust companies entails.

<u>Adjustments to Certified Values</u>: The question has been posed regarding the certainty that plan sponsors are properly adjusting values for alternative investments in order to capture the fair value that is required to be reported under ERISA. While I cannot speak to the extent of the certainty, I can share anecdotally that many of our clients do indeed make adjustments to the final values that they elect to use in their financial statements.

Adjustments are made for two primary reasons:

- Lagged valuations – the GP has not yet supplied current period ending market values
- Values that are not compliant with ASU 2009-12 and therefore require the investor to make adjustments to the NAV for lockups, etc.

We see plan sponsors employing a number of different approaches to adjusting the values of their alternative investments:

- ✓ The director of investments will contact the investees for the funds that have an elongated reporting cycles (30 days, 45 days, or longer), and requests that the investee provide the plan with preliminary year-end values. The plan sponsor then reflects the adjusted values in their draft financials. The custodian may or may not be made aware of these preliminary adjustments. This is a fairly popular approach particularly for sponsoring entities who are preparing their pension disclosures and are trying to meet their 10-K filing deadlines without the luxury of having months to await updated statements from the investee

- ✓ Some sponsors request that the custodian make a one-line adjustment for the total adjustment for all LPs, or individual adjustments to each LP, which are processed as a net unrealized gain or loss.

- ✓ Some sponsors request the custodian to hold open the year-end plan accounting and await the final LP statements, which may not arrive until 2nd or 3rd quarter.

- ✓ Some sponsors elect to utilize the independent price validation services offered through the custodian, or engaged independent of the custodian. These adjusted values are then used by the sponsor to represent fair value for their alternative investments.

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 environment? Should hard-to-value asset be certified or subject to full scope audit procedures?**

To the extent that the custodians are currently certifying to available values, and not necessarily certifying to fair value, it is not necessary to exclude the alternative investments from the certification. Hard to value assets can be both certified (as in, continuing to certify that the available price was completely and accurately extracted from the GP's capital account statement and recorded on the plan's trust statement) and, at the same time, be subject to a full-scope audit procedure. I do not see these as mutually exclusive expectations.

Isolating hard-to-value assets for the purposes of performing full scope audit procedures can be easily accomplished today without requiring the custodians to change the certification process. As previously mentioned under Question #1 above, fair value transparency reporting tools make it easy to locate the hard-to-value assets within the sea of other plan assets.

Carving out hard to value assets from the certification process seems to me to be an unnecessary step, when tools already exist to allow auditors and plan sponsors to identify assets within the certified statements that require additional fair value scrutiny, or for which, hopefully, the plan sponsor has already performed additional validation. Perhaps a meaningful segregation would be to divide assets between those with independently verified prices, versus those that are not independently priced. Custodial banks would be happy to collaborate further on the best way to define and help auditors use the existing reporting tools to facilitate identification of assets that may need to move under the full-scope audit process.

<u>Fair Values are Required Regardless of the Level of Audit</u>: Whether a plan is subject to a full scope or a limited scope audit shouldn't be the primary driver to whether the financial statements of the plan contain fair value or best available. In my mind, the limited scope exemption compels the amount of valuation and existence testing the *auditor* has to perform over the investment-related information presented in the plans' financial statement. It does not, however, limit or exempt the financial statement preparer from complying with US GAAP requirements and the fair value accounting rules set forth by FASB, including the well-documented guidance under ASU 2009-12 related to reliance on NAV as the practical expedient, and when adjustments to the NAV may be appropriate.

Point being, even under a limited scope audit, the plan sponsor would be expected to review the custodian's certified statements and assess whether the reported values are reflective of fair value, and to perform the procedures and prepare the disclosures required under ASU 2009-12. To reiterate what was suggested in the response above to Question #1, for each and every set of plan financials, regardless of the scope of the audit, plan sponsors today are expected to go through the following steps:

- ✓ Do I have material holdings in hard-to-value assets as of this reporting period?
- ✓ If so, where do the values come from?
- ✓ Do I consider the values to be reflective of fair value?
- ✓ What sources do I have to validate the reasonableness of the fair value?
- ✓ Are the values that ultimately need to be reported on my financial statement (i.e., fair value) the same values that are certified by the trustee or custodian?

Granted, eliminating the limited scope exemption may force financial statement preparers to pay closer attention to the fair value accounting guidance, but conversely, having the limited scope exemption should not be deemed to be the inherent barrier to accurate fair value reporting.

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?**

Custodians/trustees must meet three basic requirements in order to comply with the certification program:

1. Meet the eligibility requirements to be a certifying entity (regulated by a national agency, etc)
2. Certify to the completeness and accuracy of the information contained in their ordinary business records.
3. Hold or otherwise control the assets covered by the certification.

Eligibility: Eligibility is normally easy to verify by reviewing the information on the certifying entity's website. Northern Trust's website, for instance, will indicate that we are state bank holding company with trust powers, regulated by the Fed and the State of Il banking dept. For some certifying entities, this may be less clear, but for major custodians the eligibility status is discernible.

Certification Coverage: To the extent that we are certifying to the completeness and accuracy of the information, including the prices, and not necessarily to the fair value, it would be appropriate that all assets under the control of the trustee/custodian be certified and that banks would be in compliance with the requirements.

Assets Held Elsewhere: Regarding the certification of assets not held by the custodian, our approach is to exclude those assets from the certification that are not under our control. In defining asset that are not "held" by the custodian, we generally mean assets that are held individually or collectively at another institution, but which the plan sponsor has requested be 'shadow accounted' on our books simply to facilitate an easy roll-up of all plan assets into a single report. In these limited cases, we simply post a sundry asset as a one-line holding, with a total market value representing all the underlying holdings of the commingled investment that are "held elsewhere". The client executes a "Record Only" custody agreement with us, and we update the market value upon notification from the source that the client has directed us to use.

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

Regarding the GAAS audit question, we expect that the audit community would have a more comprehensive response.

Regarding the second question of whether additional procedures should be required, my response would be "not necessarily". FASB has set forth detailed guidance on how to assess, derive, and adjust for fair value for a range of investment types. Following this guidance more broadly across plan sponsors would go further to ensuring that financial statements contain values that are reflective of FV, without adding additional and unnecessary procedures to plans or certifying entities.

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 suggested in Question #5, 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 standard business practice.

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

Repealing the limited-scope exemption would be a burden on those plans that hold all or a large portion of marketable and liquid securities whose values are provided by independent sources. If the limited-scope exemption were to be repealed, we might expect that the full scope audit testing of investment valuation sample sizes would increase, and custodians might receive more inquiries from auditors regarding income rates, accruals, prices, and investment transactions. Should the revocation of the limited-scope audit exemption become a reality, we would like to work with the auditing community and independent valuation firms to streamline the process for communicating inquiries and resolving reconciliation differences.

Aside from repealing the limited scope exemption, all stakeholders in the audit process would benefit from collaborating to ensure that the plan sponsors can effectively answer the questions outlined above:

- ✓ Do I have material holdings in hard-to-value assets as of this reporting period?
- ✓ If so, where do the values come from?
- ✓ Do I consider the values to be reflective of fair value?
- ✓ Are the values that ultimately need to be reported on my financial statement (i.e., fair value) the same values that are certified by the trustee or custodian?

Additionally, it would be useful for all parties if we could provide clarity around the extent to which plan sponsor need to perform fair valuation procedures, whether or not they intend to engage the auditor to perform a limited scope audit. Revoking the limited scope exemption, without bolstering the plan sponsor's process for validating fair value of their hard-to-value assets and the audit around that process, would not in itself, lead to the desired improvements in the valuation of plan assets.

I would refer your attention back to my introductory remarks where I noted a plan sponsor's process should start with the financial statement preparer's due diligence in assessing the plan's current investment portfolio and in knowing where the prices come from.