PRAG

PENSIONS RESEARCH ACCOUNTANTS GROUP

Guidance

on

Investment Valuations

Guidance on investment valuations

Introduction

1. This purpose of this paper is to provide guidance to the preparers of pension scheme financial statements on considering the valuation of investments.

2. Pension schemes typically invest in a range of investments some of which are straightforward to value, for example quoted securities, and some of which are more difficult to value, for example property or private equity. Recently the investment markets have experienced unprecedented conditions that have caused illiquidity in hitherto liquid securities, for example asset backed securities. The increasing use of alternative investments and recent market conditions present challenges to the preparers of pension scheme financial statements when applying the market or fair value requirements of the SORP.

3. This guidance recognises that the valuation of many of the more complex investments held by pension schemes require specialist skills and therefore does not seek to provide detailed guidance on valuation methodologies since this is the remit of specialist valuation experts. However, the preparers of pension scheme financial statements, and ultimately the trustees of the pension scheme who have responsibility for the preparation of the financial statements, have to be satisfied that the valuations of investments provided by these specialists comply with the investment valuation requirements of the SORP. This guidance therefore seeks to provide a framework for considering the valuation of investments and some suggestions as to the due diligence enquiries the preparers of pension scheme financial statements can make to the specialist valuers in order to make a reasonable assessment of whether the requirements of the SORP have been met. The due diligence enquiries also form a useful framework for investigations which can be performed prior to making an investment in a particular asset class or with a particular investment manager; establishing an appropriate governance framework is in place prior to investment assists in understanding the reliability of the future valuations provided. This guidance does not expect the preparers of financial statements to audit the investment values but rather to ascertain that an appropriate framework is in place to ensure the valuations provided are on a fair value basis.

Fair value accounting and the Pensions SORP

4. The Statement of Recommended Practice (SORP): Financial Reports of Pension Schemes (revised May 2007) incorporated aspects of Financial Reporting Standard 26 Financial Instruments measurement into pension scheme financial reporting and created consistency between investment valuations for pension scheme and corporate reporting and also with the wider reporting of investments by other investment institutions and funds in the UK.

5. FRS 26 introduces the concept of fair value accounting with fair value being defined as *"the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction"*. This definition is incorporated into the revised SORP (2.95) *"investments should be valued at market value or the trustees' or manager's estimate thereof and where market value is not readily ascertainable, this should be the fair value. Fair value is the amount for which an asset could be exchanged, or a liability settled, between unrelated willing knowledgeable parties in an arms length transaction.*

6. The revised SORP goes on to give guidance on the valuation of the principal categories of investment:
   - quoted securities in an active market should be included at closing prices; these prices may be the last trade prices or bid prices depending on the convention of the stock exchange or other market on which they are quoted. The SORP goes on to say that "*An investment is regarded as quoted in an active market if quoted prices are readily and regularly available or calculated and these prices represent actual and regularly occurring market transactions on an arm's length basis*".
   - unquoted securities should be included at a fair value estimated by the trustees, based on the advice of an investment manager or other appropriate professional adviser;
   - pooled investment vehicles should be included at the closing bid price or if no bid price, fair value;
   - properties should be valued in accordance with the Royal Institution of Chartered Surveyors' Valuation Standards; and
   - derivatives should be shown at fair value in the net assets statement.

7. The SORP does touch on valuing illiquid investments, in paragraph 2.95 it says ' if the market for an investment is not active, an estimated market value can be established using valuation techniques. The objective of a valuation technique is to establish what the price

would have been at the year end date in an arm's length transaction, in normal circumstances. The estimated market value is not the amount the scheme would receive or pay in a forced transaction or distressed sale'. However, whilst the SORP provides guidance on the type of valuation that should be used in normal market conditions it does not provide guidance on what represents fair value in market conditions where there is illiquidity.

Illiquid investment market challenges

8. Recent global economic conditions have been unprecedented and have important implications for the valuation of investments. Alongside volatile global equity markets there has also been a liquidity/credit crisis. Increases in the default rate of the market led to reductions in the capital reserves of banks and increasing risk aversion. A direct consequence of this was banks drastically reducing their market making role in various asset classes, especially corporate bonds, resulting in extreme illiquidity in the corporate bond market and illiquidity in the markets for many asset backed securities. Indirect consequences include many institutions experiencing short term liquidity issues as credit facilities were restricted.

9. The SORP's guidance for the valuation of quoted securities relies on an active market and further, the definition of fair value implies the presence of an active market in there being prices which are "*readily and regularly available*". In the absence of such active markets the SORP recommends "…*an estimated market value can be established using valuation techniques*". In these circumstances the 'fair value' approach to valuation becomes more complex with greater reliance on market indicators and estimates. This problem has arisen not only in the pensions industry but in the investment accounting community as a whole.

IASB Expert Advisory Panel

10. In response to these issues the IASB Expert Advisory Panel published a paper on 'Measuring and disclosing the fair value of financial instruments in markets which are no longer active' in October 2008. The paper confirms that when the market for a financial instrument is no longer active, the fair value should be measured using a valuation technique (commonly referred to as 'mark-to-model') which maximises use of observable market inputs.

11. These valuation techniques should reflect the appropriate risk adjustments that market participants would consider in pricing the instrument in order to arrive at an estimate of 'a current transaction price on the measurement date'. To this extent even where an observable transaction price is available it may be necessary to adjust that price to arrive at a price at which an orderly transaction would take place between market participants; this would be the case if the price was in relation to a 'forced' transaction ie the seller was under some unavoidable obligation to make a sale.

12. The paper also notes that different valuation models may be adopted for the same instrument by different valuers; with both valuers thereby arriving at different valuations. As long as the valuation techniques adopted, and inputs used, in both circumstances meet the objective of fair value measurement then neither answer is deemed to be incorrect.

13. To aid in the fair value measurement of instruments in inactive markets it is also recommended that valuations are calibrated against observable market data as frequently as possible. This allows adjustments to the valuation model and inputs to be made to arrive at a more accurate and up to date valuation.

14. The paper provides guidance on evaluating available market information for inactive markets as follows:

- prices for the same instrument – a current transaction price can be used unless there is evidence that it does not represent fair value, for example, there is a timing difference between the transaction and reporting date or the transaction is forced or distressed;similar instruments – recent transactions in similar instruments might provide evidence of fair value, although adjustments may need to be made for differences between the two instruments, for example, timing, terms, related transactions and the correlation between the price of the instrument that is the subject of the observed transaction and the price of the instrument being measured.
- indicies – it may be possible to price an instrument against an observable index. In this case the suitability of the index needs to be considered, for example, is it appropriate to use a 'basket' of securities to value a single security?
- Information from brokers– prices obtained from brokers may provide evidence of fair value. A broker quote is generally an indicative price and not a binding offer and in an illiquid market a single broker quote is unlikely to be sufficient evidence of fair

value. Generally several quotes are required and they should be considered for consistency with general market information and conditions.

- Information from pricing services –pricing services can use a proprietary model to estimate a price. If a model is used consideration should be given to using more than one model to allow cross-checking of results, calibrating the model against the market, keeping the model up to date for changes in market conditions and adjusting the results of the model for factors that impact market price which are not captured by the model, for example model deficiencies identified through calibration testing or credit risk adjustments where the model does not take into account counterparty risk.
- Information from pricing services – pricing services can provide prices using a consensus approach where pricing information is obtained from several market participants (the subscribers) on a confidential basis and the ‘consensus’ price, typically based on an arithmetical average, is determined by the pricing service provider using this information and provided back to the market participants. The appropriateness of prices obtained in this way will depend on a number of factors including the quality and presence in the market of the subscribers and the number of subscribers participating.

IASB Exposure Draft on Fair Value Measurement

15. In May 2009 the International Accounting Standards Board (IASB) published an exposure draft on Fair Value Measurement (‘The Exposure Draft’). The objectives behind the Exposure Draft are:
    a. to establish a single source of guidance for all fair value measurements;
    b. to clarify the definition of fair value;
    c. to enhance disclosures about fair value; and
    d. to increase convergence with US GAAP.

16. The Exposure Draft was open for public comment until 28 September 2009. The Exposure Draft is likely to become an international accounting standard in 2010. The Accounting Standards Board has issued proposals to bring UK GAAP into line with international accounting standards in 2012. Therefore the requirements of the Exposure Draft could be applicable to UK entities that report using fair value principles, including pension schemes, in 2012.

17. The Exposure Draft defines fair value as *“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". The draft continues that in the absence of actual transactions a hypothetical transaction should be considered taking into account the characteristics of the asset that market participants would consider when entering into the transaction.

18. A hypothetical transaction implies the use of estimations supported by underlying assumptions. The exposure draft categorises such assumptions as observable, being developed on the basis of available market data, and unobservable, being developed on the basis of the best available information. Further to this, the valuation technique should be appropriate "*maximising the use of relevant observable inputs and minimising the use of unobservable inputs"*.

19. So, in the absence of an actual transaction, arriving at a fair value for an investment may involve a number of assumptions/estimations based on observable or unobservable inputs. In order to help readers of financial statements better understand the approach taken to valuation of investments the Exposure Draft introduces the concept of a fair value measurement hierarchy. This mirrors the requirements of US GAAP under Statement of Financial Accounting Standards No. 157 Fair Value Measurements (SFAS 157 recently renamed Accounting Standards Codification Topic (ASC) 820).

20. Three levels of inputs are defined, with highest priority being given to quoted prices in active markets ie actual transactions and lowest priority to unobservable inputs. The fair value measurement is categorised entirely at the level of the lowest input to the valuation. Whilst these disclosures are not currently recommended for pension schemes they will be required under IFRS 7 and FRS 29 for all reporting periods beginning 1 January 2009. Therefore they will apply to UK listed companies and unlisted companies applying fair value accounting under FRS 26 for 31 December 2009 year ends.

21. ***Level 1 inputs –*** quoted prices in active markets for identical assets that the entity can access at the measurement date. An active market is defined as "*As a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis."* where "*sufficient frequency and volume"* are a subjective measure that will vary from asset to asset.

22. ***Level 2 inputs -*** inputs observable directly (ie as prices) or indirectly (ie derived from prices)
    - quoted prices for similar assets in active markets,
    - quoted prices for identical assets in markets that are not active,

- inputs other than quoted prices that are observable (interest rates, yield curves, volatilities)
- inputs derived principally from, or corroborated by, market data.

23. ***Level 3 inputs*** **-** inputs that are not based on observable market data (unobservable inputs).

24. The use of this valuation hierarchy could assist pension scheme accounts preparers and trustees focus on hard to value investments and understand pricing risks within their investment portfolios. Another way of expressing these categories could be:

Level 1 – easy to price; there is a liquid market for these securities;

Level 2 – moderately difficult to price; limited visible market parameters eg. swaps priced by reference to interest rate curves which are derived from observable market data;

Level 3 – difficult to price; difficult to verify parameters used in valuation eg. private equity which uses information not available in the market.

These categories could be applied to the typical investments held by pension schemes as follows:

Sources of investment valuations

25. Pension scheme accountants typically obtain investment valuation information from investment managers or, where appointed, global custodians. At present the pricing hierarchy set out above is not typically provided by these organisations in their standard reporting. However, it became a requirement under US GAAP in 2007 and for entities reporting under IFRS and FRS 26 adopters in 2009. In addition, the implementation of the Exposure Draft will become a requirement under international standards and ultimately UK GAAP when UK and international standards convergence as expected in 2012. Therefore more and more financial institutions will require this information from their investment valuers and it may therefore become more readily available.

26. Existing arrangements for obtaining investment valuation information can be considered within this hierarchy and the balance of this guidance sets out how this can be approached for the typical classes of pension scheme investments. The starting point for this is to consider whether the information received by the scheme accountant is 'fit for purpose' for inclusion in the scheme financial statements.

27. Investment manager valuations are often provided as part of the overall investment portfolio reporting however, whilst useful, they may not have been prepared by the investment manager for the purposes of scheme financial reporting. In these cases the scheme accountant should make enquiries to the investment manager to determine whether the investments have been valued in accordance with the SORP's fair value requirements.

28. Global custodian investment valuations are normally provided for the purposes of scheme financial reporting. The global custodian will typically price investments independently of the investment manager and compare their valuations with those of the investment manager and investigate significant variances. This provides a good control over investment pricing and is helpful to the scheme accountant in considering pricing issues. For example, the scheme accountant could ask the global custodian for information on significant pricing differences, their reasons and how they have been treated in the investment reporting information.

29. However, not all scheme investments can be repriced by global custodians, for example, unquoted pooled investment vehicles (including hedge funds and private equity funds), certain OTC derivatives (where the custodian does not offer pricing services), property and illiquid securities. The scheme accountant should therefore make enquiries to the global custodian to ascertain for which investments they rely on manager pricing.

Approach to pooled investment vehicles

30. The question arises as to how to treat pooled investment vehicles for the purposes of the pricing hierarchy. There are two possible approaches; either regarding the units in pooled vehicles as the investment or looking through the unit wrapper to the underlying investments.

31. The Exposure Draft does not provide guidance on which approach should be adopted. However, guidance has recently been issued in the US in relation to FAS 157 which, as noted above, is broadly consistent with the Exposure Draft. The guidance for entities that calculate a net asset value per share (or equivalent), ie pooled investment vehicles, is that if the investment is redeemable at the net asset value at the measurement date the fair value measurement should be classified as level 2. Where investments cannot be redeemed at net asset value at the measurement date but may redeemed at a future date

(for example, investments subject to a lockup period or gate) trustees and pension scheme accountants should evaluate the length of time until the investment will become redeemable. If it possible to redeem in the "*near term*" the fair value measurement would be categorised as level 2, whereas if the redemption term is not known, or longer term, it may indicate a level 3 categorisation.

32. The US guidance does not seem to envisage any pooled vehicles being regarded as 'level 1' investments. However, this seems a little unfair for daily priced pooled funds that invest in liquid securities as a 'fair value' price at which schemes could transact is readily available.

33. Many pension schemes have significant amounts of their investments held through pooled investment vehicles and considering the pricing risks at a unit level may not provide useful insight into the valuation challenges of the underlying investments. Therefore this guidance suggests that the look through approach is more useful to scheme accountants and trustees when considering pricing risks within their investment portfolios. In many cases this would result in the same classification as if the US guidance had been followed.

34. It would appear that the treatment of pooled funds is likely to need more guidance under IFRS/UK GAAP as the disclosures under IFRS 7/FRS 29 become more widely required.

35. A practical issue of adopting the look through approach is that pooled vehicles may have investments that fall into more than one pricing level. It may not be practical to allocate the investment in the pooled fund across pricing levels as detailed information of the underlying portfolio may not be available or may not have been analysed into the pricing levels. This guidance therefore suggests that a pooled investment vehicle is allocated to the pricing level which provides the best fit to the predominant pricing characteristics of the underlying investments ie the pooled fund is not split between pricing levels. This should be reasonably straightforward to ascertain for most pooled vehicles through general knowledge of the fund; portfolio information; audited accounts and/or enquiries to the investment manager.

Valuation Due Diligence

36. Using the pricing hierarchy set out in the Exposure Draft pension scheme accountants and trustees can quickly and easily focus their attention on the moderately difficult and difficult to value investments in their investment portfolio. Most of these types of

investments require specialist valuation skills and therefore it is not reasonable to expect pension scheme accountants to be able to reperform the valuations. Some possible due diligence actions and enquiries are set out below.

Securities

37. Securities can fall into any of the three pricing levels depending on the valuation methodology adopted.

38. *Some due diligence enquiries to the securities valuation provider*

- Is an analysis of the securities portfolio by pricing methodology following the level 1, 2 and 3 approach available and if so how they have determined the levels to which each security is allocated? (As noted above this analysis is required by US GAAP so investment accounting providers such as the large US investment managers and global custodians may already be providing this information to their US clients).
- An explanation of their approach to pricing including whether they are using their own or externally sourced prices. For example, do they use a pricing panel to consider prices for hard to value securities?
- How do they identify illiquid equities/bonds within the portfolio where prices may be stale and what proportion of the portfolio these constitute? As guidance, a price may be considered stale if it has not changed over a period in excess of 90 days, although this should be considered on a security by security basis. Large spreads on bonds may also be indicative of stale prices.
- Are any securities priced by reference to broker quotes? If so, are these single broker quotes or the average of several brokers, and what proportion of the portfolio do these constitute? (If it is only single broker quotes consider moving into level 2 or 3 as this is likely to be a relatively illiquid security and singe broker quotes may not fully reflect all market conditions).
- Are any securities priced by reference to fair value models? (Where prices are not available in the market discounted cash flow modelling is typically applied using proxy security characteristics, this is referred to as fair value modelling. Securities valued using fair value models are normally included in levels 2 or 3).
- If fair value models are used how often are such models calibrated by reference to actual market conditions?

- Are any securities not priceable using any of the above methodologies? If so provide specific explanations of valuation methodologies adopted. (These securities are normally included in level 3).
- Certain asset backed securities are highly illiquid as a result of the credit crunch and are typically now being held in ring fenced arrangements sometimes referred to as 'side pockets'. As the underlying assets backing these securities unwind redemptions are made. The valuation of these securities on a 'fair value' basis is very difficult and investment managers should be asked to explain the process they have adopted, in particular the assumptions about the security of future cash flows from the underlying assets and the discount rate used to arrive at a present value. An alternative approach may be to price the securities by reference to similar securities whose prices are observable in the market and applying an adjustment to reflect any differences in nature.

Derivatives

39. Derivatives can be either exchange traded or over the counter (OTC). Exchange traded derivatives are normally futures and some option contracts. OTC derivatives are normally forward FX trades, swaps, options, credit default swaps and securities forwards. Some OTC derivatives may be tradable on secondary markets. Exchange traded derivatives have readily observable market prices and are normally easily priced and allocated to level 1. OTC derivatives typically do not have observable prices and require fair value models using market observable inputs (for example interest rate curves) to value them. Derivatives such as vanilla interest rate swaps and options on exchange traded securities are typically allocated to level 2.

40. *Some due diligence enquiries to the OTC derivative valuation provider*

- Is the derivative valuation methodology consistent with fair value principles and therefore the requirements of the SORP?
- Are there pricing checks between the investment manager and custodian or investment manager and counterparty? If so are there significant variances and are these investigated?
- How often are the fair value models calibrated against actual market conditions?
- For OTC derivatives with collateral arrangements is the valuation used for the financial statements consistent with the valuation used for collateral? If not why is it different?

Property

41. Property investment valuations use a specialist valuation process and market observable information and so are typically included in level 2.

42. The SORP recommends annual valuation by an internal or external valuer and independent valuations at least once every three years. In cases where the proportion of property assets within total investments justifies a less frequent valuation the SORP suggests rolling valuations over one to three years.

43. *Some due diligence enquiries to the property valuers*

- Are property valuations consistent with the Royal Institution of Chartered Surveyors' Valuation Standards, or international equivalent?
- Is the property valuation used for the financial statements as at the scheme's year end? If not need to consider if market movements and transactions between the valuation date and scheme year end should be reflected in the reported property valuation. Published property indices could be used to assess movements in the market and make portfolio level adjustments if necessary
- Has the property valuer included a caveat on the valuation opinion because of illiquid property markets? If so the valuation may not be robust enough to use in the financial statements and further inquiries will need to be made of the property valuer to determine if the extent of the illiquidity and if any disclosures need to made in the financial statements.
- For property funds ie pooled vehicles, are the underlying property valuations up to date? Are the units in the pooled fund readily realisable?
- For property funds are audited accounts produced for the fund and if so is the audited net asset value of the fund consistent with the unaudited value reported to the scheme?

Hedge Funds

44. Hedge funds invest in a wide range of investments and some have investment strategies that involve frequent and significant changes to their investment portfolios. Hedge funds can also be opaque arrangements, investing in other hedge funds (fund of funds) or not disclosing their underlying investments due to commercial sensitivities; typical structures include feeder funds and master funds. Using the look through approach to determine the

appropriate pricing level can therefore be present challenges. As a general guide, if the hedge fund invests in exchange traded securities then the hedge fund could be regarded as level 1 since the valuation of its underlying investments is straightforward. If the hedge fund invests in illiquid investments, for example distressed debt, then it may be level 2 or 3 is appropriate as the valuation of the distressed debt is more complex.

45. If the hedge fund invests in other hedge funds, ie a fund or funds, it may be impractical to obtain information on the valuation of the underlying funds and therefore due to its opaque nature it could be regarded as level 3. Using the unit price redemption for pooled investment vehicles for the fair value hierarchy, as a general guide, if the hedge fund can be redeemed at net asset value at the measurement date this is categorised as level 2. If the hedge fund, or fund of funds, cannot redeem units at the measurement date this is typically categorised as level 3.

46. Helpfully most hedge funds prepare audited financial statements and if prepared under US GAAP will include the level 1, 2 and 3 pricing hierarchy analysis for the fund's underlying investments. This may be a helpful source of information to the scheme accountant when considering the pricing risks within hedge fund portfolios.

47. *Some due diligence enquiries to the hedge fund valuation provider*

- Does the hedge fund have separate investment manager and administrator? If so are net asset values provided by the administrator and do these differ from those provided by the manager? If there is no segregation between the investment manager and the administrator what other internal checks are there at the manager over net asset valuations? Is there an internal controls report that covers the valuation of holdings and the processes surrounding preparation of the net asset value?
- Do the investment valuation policies of the hedge fund comply with fair value principles?
- Does the hedge fund prepare audited financial statements? If so is the audit report unqualified and does the audited net asset value agree to the unaudited net asset value advised to the scheme by the hedge fund administrator? Does the accounting policy state that investments are valued on a fair value basis?
- If audited financial statements are not available what is the pricing policy of the fund manager and is it consistent with fair value principles.
- If there is a significant gap between the date of the latest available audited financial statements of the hedge fund and the scheme year end can the hedge fund administrator

demonstrate the reasonableness of the movement in net asset value between the two dates using relevant market indices to carry out 'drift analysis'? (This is generally only to check the direction of market movement of the fund against the market rather than quantify any movement and may only be possible for certain hedge fund strategies).

- Do the hedge fund manager and administrator prepare internal controls reports such as SAS 70 or AAF 01/06 reports?
- A number of hedge funds have closed to redemptions and may have, or have introduced, redemption penalties (both based on timing and size of redemption) meaning that the latest NAVs may not represent the levels at which investors could actually redeem their holdings. As such enquiries should be made as to whether NAV is the fair value of the fund or whether this requires a liquidity adjustment. Note this is an area that is currently under debate. The debate centres around whether fair value should be different for two NAVs of hedge funds that are in all respects identical other than one is more liquid than the other. In theory a purchaser would pay less for the more illiquid unit. Whilst managers of hedge funds adjust for illiquidity in the valuation of the underlying investments they do not build in a further liquidity adjustment to their NAVs if they have suspended redemptions.
- In some cases hedge fund managers refuse to disclose their underlying investments to avoid the risk of competitors gaining access to their investment strategies. In these circumstances trustees and scheme accountants may be able to enter into non-disclosure agreements with the hedge fund manager in order to gain access to information that will assist in understanding the pricing risks in the fund. The hedge fund manager may also be able to provide an analysis of how the fund is invested based on the investment valuation hierarchy without disclosing the underlying investments.
- Do ring fenced arrangements ('side pockets') for illiquid investments or investment balances that are in dispute, for example balances with Lehman exist? If so how have they been valued?

Private equity and Infrastructure

48. Pension schemes typically invest in private equity and infrastructure through funds which are typically set up as limited liability partnerships. The underlying valuations are carried out in accordance with British Venture Capital Association, or equivalent, guidelines and use information that is not in the public domain eg management information. As such the valuations are opaque to the investor and not based on observable inputs and are therefore typically categorised as level 3.

49. Where the private equity investment is held in a private equity fund which uses a unit structure the ability to redeem units in the fund at the net asset value at the measurement date should be considered when classifying the valuation to a level.

50. *Some due diligence enquiries to the private equity or infrastructure fund valuer*

- Are private equity or infrastructure valuations consistent with British Venture Capital Association, or equivalent, guidelines?
- Do private equity or infrastructure investment valuations received throughout the year reconcile to the audited financial statements of the fund at the year end? A particular challenge here is that it is not always possible to reconcile values reported on statements to audited accounts without knowing the share of the scheme's investment in the private equity vehicle. Therefore additional enquiries to the private equity or infrastructure manager may be necessary in order to check the consistency of audited and unaudited information.
- Does the private equity or infrastructure fund produce audited accounts and have these been given an unqualified audit opinion?
- Are the accounting policies of the private equity or infrastructure fund as disclosed in the audited financial statements consistent with fair value principles?
- Private equity or infrastructure valuations are often provided by the private equity or infrastructure manager between three and six months after the valuation date. Private equity or infrastructure investments are therefore likely to be included in pension scheme asset portfolios at values some three to six months old. If private equity or infrastructure investments are significant, pension scheme accounts preparers need to consider obtaining more up to date valuation information from the private equity or infrastructure manager.
- Generally there are not private equity or infrastructure market indices, or they are in their infancy, so it is not possible to carry out drift analyses between the audited accounts date and the scheme year end, although as a rough sense check the main stock markets tend to be a lead indicator for private equity or infrastructure valuations.

51. Where the responses to due diligence enquiries are unsatisfactory, or draw to light a previously unidentified weakness, further discussions should be held with the relevant party to gain a full understanding of the situation and possible implications to the asset valuation. The impact of the valuation issue should then be considered in the context of

the pension scheme investment portfolio as a whole to determine whether further action should be taken; the scheme auditors may prove useful in this regard. If the issue is deemed to have a material impact of the pension scheme investment portfolio the preparers of the financial statements may wish to seek independent valuation advice from a third party.

Subsequent Events

52. Investment markets are inherently volatile and it is normal for there to be significant movements in the value of investments between the reporting date and sign off on the financial statements. These movements have been particularly extreme in recent times. However, market movements post year end are only relevant to the valuation of investments at the reporting date ie an adjusting post balance sheet event, if these events give further evidence of a condition that existed at the balance sheet date. Where the events provide evidence of conditions that existed after the year end, and they are material to the financial statements, these events and their impact should be disclosed, for example an event that results a permanent diminution in value of a material investment should be disclosed.

Summary and conclusions

53. The framework set out above and the typically annual due diligence process suggestions are intended to provide assistance to the preparers of pension scheme financial statements in considering valuation of investments in difficult market conditions. This information is therefore prepared for management purposes to support the financial statements. It is not intended that this framework is disclosed in the financial statements or trustees report, although if it were to be disclosed it would provide useful information to the readers of pension scheme financial statements on the pricing approach to investments.

54. Lastly, in considering the above the requirements of the Disclosure Regulations should also be borne in mind. These require the trustee report to include an assessment of the nature, disposition, marketability, security and valuation of a pension scheme’s assets. If the pension scheme has a significant exposure to illiquid investments this should be disclosed in the trustee report.