Fair Value of Assets in the Context of Accounting for Employee Benefit Plans

– A Practitioner's Perspective

Seminar on Current Issues in Employee Benefits

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- ✓ Implications of fair value accounting
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Asset valuation methodologies followed by Trusts

- Valuation methodologies widely followed by Trusts:
  a. Cost-based valuation – DC PF & SAF Trusts
     i. Amortization of premium / discount
     ii. Write-off of premium / discount in the year of purchase
     iii. Write-off of premium / discount in the year of redemption
     iv. Combination of above
  b. Market-to-market based valuation or fair valuation – DB GF Trusts

- Fair value defined:
  - Fair value represents the amount for which an asset could be exchanged in market between knowledgeable and willing parties

Implications of fair value accounting

- Financial statement will reflect realizable value of assets under worst case scenario[1]

- Better indicator of solvency of Trusts

- However,
  - May make financial statement of the company relatively volatile
  - Estimating fair values difficult for illiquid instruments thereby increasing the scope for manipulation
  - Notional gains & losses may over / understate net liability

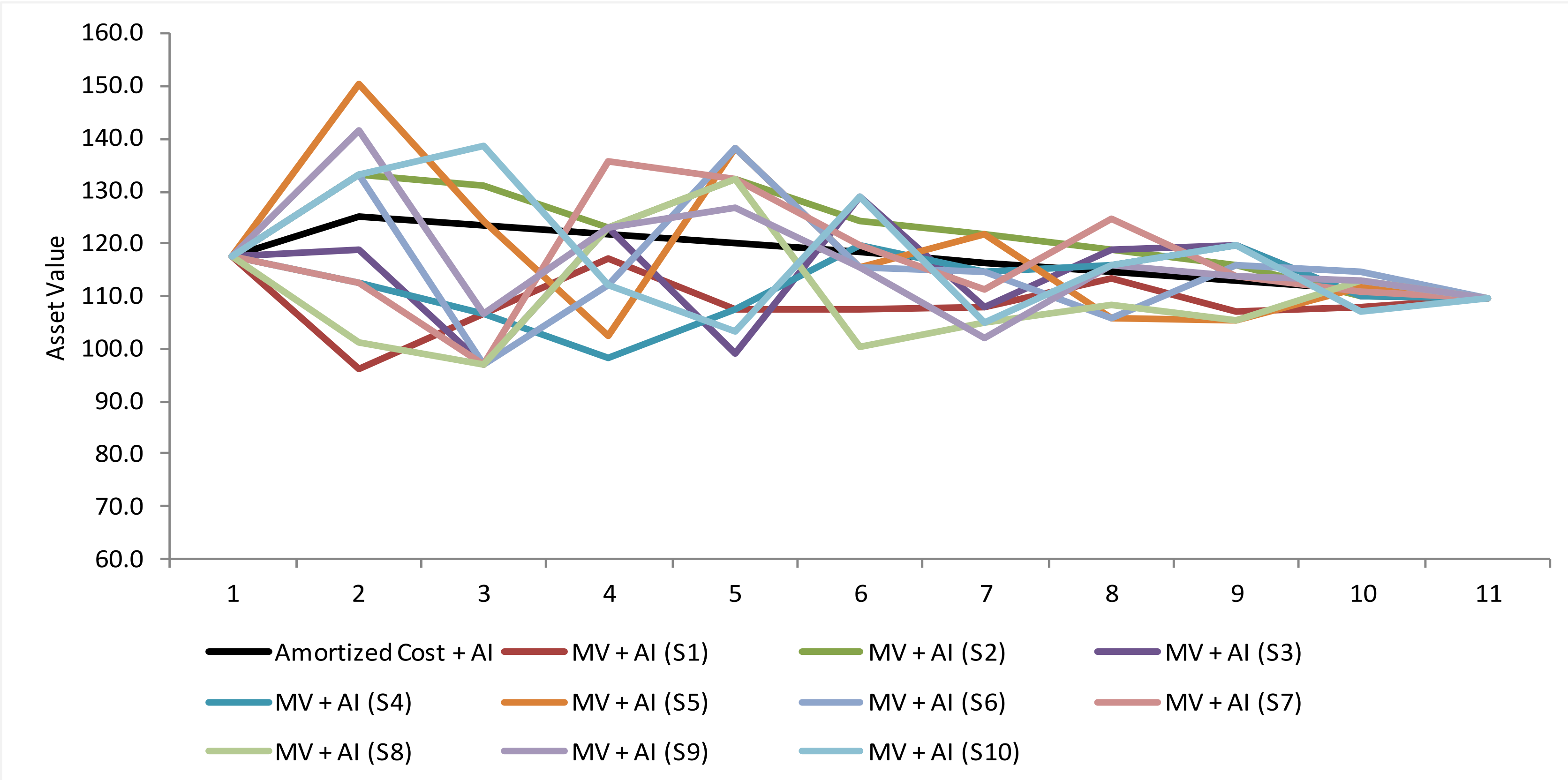
Note:

1. Market valuation of all the assets of a EPFO-regulated PF Trust will test the worst case scenario as Para 28 of the EPF Scheme, 1952 provides for part transfer of Govt. securities and govt. guaranteed bonds at purchase price while transferring the corpus to EPFO.

Does fair/cost value accounting matter? ...1

- Exempt PF Trusts permitted to invest only in fixed income instruments
  - Hold-to-maturity investment regulation will have the impact of convergence of assets values to par (in the long-run) irrespective of accounting methodology followed
    - Chart on the next slide provides an illustration

Does fair/cost value accounting matter? 2.



Simulation assumptions:

1. Portfolio consists of only one bond having 10-year maturity, with a coupon rate of 9.50% being bought at 7.00% YTM & is held till maturity.
2. Market yields fluctuate between 4% to 12% over the bond tenor.
3. Asset value being Amortized Cost / Market Value (MV) plus Accrued Interest (AI).

Challenges in fair value estimation

1. Illiquidity associated with eligible instruments (refer analysis)

2. Absence of guidelines for valuation for assets held in Retirement Trusts
   - Existing guidelines issued by regulatory bodies such as the RBI, SEBI are not applicable to Retirement Trusts

   - Existing guidelines issued by regulatory bodies make implicit assumption on lot sizes of assets
     - Trusts may not hold assets in those lot sizes (for example, bonds held in multiples in INR 5.0 crs. of face value)

Appropriateness of fair value accounting

- Fair value accounting may be appropriate under following circumstances:
  - Possibility of permanent impairment of bonds due to credit events
    - However, historically defaults in India have remained low (refer slide)
  - Possibility of mass outflows due to corporate actions

Concluding thoughts…

- Accounting practices should not influence investment decisions
  - Fair valuation of assets of Exempt PF Trusts may make functioning of Trusts expensive to companies
  - Owing to fair valuation, self-managed Gratuity Trusts may be at disadvantage over Traditional Funds offered by Insurance companies
- Accounting practices should be uniform across the industry
  - Institutions such as the EPFO and LIC do not either mark their portfolios to market or disclose market values (of their portfolios) to investors thereby influencing investor behavior

Thank You

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Liquidity assessment of instruments

Sl. No.	Asset	Exempt PF Trust - Incremental Investment Allocation	Liquidity	Access to Traded Market Value
1	Central Government Securities	25% to 55%	High	May be difficult
2	State Government Securities	15% to 45%	Moderate	May be difficult
3	Government Guaranteed Bonds	15% to 45%	Low	May not be available
4	PSU / PFI Bonds	30% to 60%	Moderate	May be difficult
5	Private Sector Bonds	0% to 10%	Moderate	May be difficult
6	Fixed Deposits	30% to 60%	High	Readily available
7	Special Deposit	0%	Moderate	Readily available
8	Gilt Mutual Funds	0% to 70%	High	Readily available

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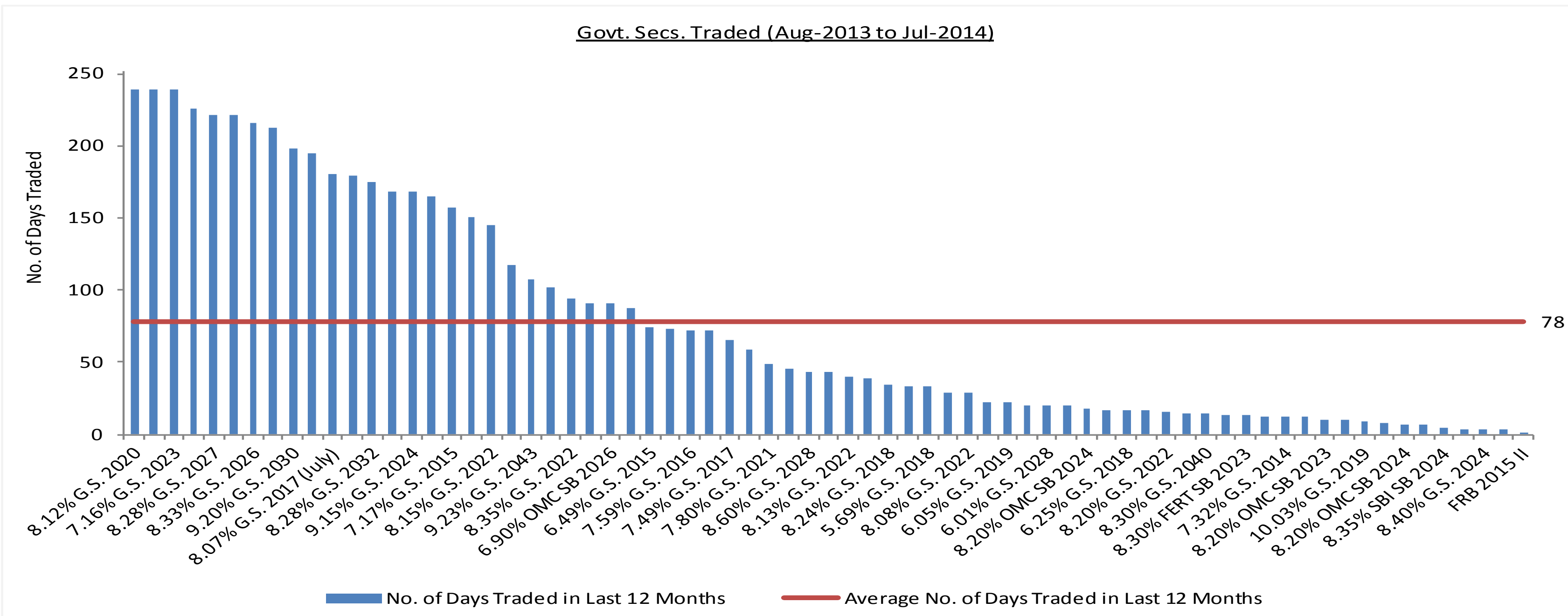
Liquidity of Central Govt. bonds

Total No. of Outstanding Dated GOI Securities as on 31-Jul-2014	No. of Dated GOI Securities Traded between Aug-2013 to Jul-2014	% of Securities Traded
109	71	65%



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25-year track record of rated issuers

Credit Rating	No. of Issuers Rated by CRISIL	No. of Issuers Defaulted	% Defaulting Issuers
AAA	14,164	0	0.0%
AA	30,341	9	0.0%
A	36,374	255	0.7%
BBB	62,714	928	1.5%
BB	75,431	3,756	5.0%
B	53,954	4,780	8.9%
C	4,642	877	18.9%
Total	277,620	10,606	3.8%

Note:
1. Data sources is the CRISIL Default Study 2013. Data taken from rating transition matrix for a period 1988 to 2013.

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