

February 4, 2008

FAS 157 Audit Tests of Security Pricing

A recommendation to insurance companies and their auditors

As an insurance asset manager, we have the following goals for the pricing of securities for our clients. Our primary goal is to develop a process that provides the most accurate price possible as of a given date, whether or not the pricing source is an electronic feed from one of the leading providers or other observable inputs. In addition, we stand ready to support valuations directly to clients for their own benefit or to support their audit and/or regulatory reviews. Our discussions with several accounting firms in conjunction with their 2007 audits suggest an increased focus on the pricing of securities as a direct result of FAS 157 and its implementation. Although FAS 157 is not effective until the fiscal year **beginning** after November 15, 2007, auditors seem to be testing as if it was effective at calendar year end 2007. We have observed a varied testing approach to year-end pricing among different audit firms and across different offices of the same audit firm. This is not unusual in the first year after the adoption of a new FASB statement. Our concern is the audit community, in its attempt to document pricing adequacy, may permanently impact the ability of the investment management industry to achieve its primary pricing goal of pricing accuracy. A recommended solution is outlined below.

Background

Securities are priced at AAM using a fully documented process consistent with FAS 157 that begins with a feed from leading pricing services. For securities that are not priced by the services, we obtain an observable input from a third party source, generally the broker-dealer that was the primary underwriter or is a lead market maker. In addition, our sector specialists review the prices obtained from the pricing services and, if an observable input would result in a more accurate price, then the sector specialist will document the source and change the price to the more accurate price.

It is important to point out that in volatile markets the prices provided by a pricing service may not reflect the fair value of a security at that point in time. In general, their pricing assumptions tend to lag the market movements. Thus, after spreads have widened and prices have dropped, as has happened over the past few quarters, prices from the services on average tend to be higher than true market prices. The reverse is likely to be true when yield spreads contract quickly.

We have observed that our clients' auditors tend to accept the accuracy of pricing service information with little or no scrutiny. However, the process of using observable inputs to generate a more accurate price tends to result in significant scrutiny and testing. We stand ready to fully support these observable inputs and provide detail as to the source. This is fully consistent with FAS 157. We begin to have concerns when our clients' auditors

attempt to support this information with a confirmation from the broker-dealer pricing source. Our concern is that any attempt to obtain a signed confirmation from the pricing source will inevitably lead to policies by the broker-dealer community that prohibit their assistance with pricing. Broker-dealers currently provide pricing as a courtesy to their customers and will understandably avoid any legal risk associated with a signed confirmation.

In discussions with clients and third party insurance investment consultants, we have learned that at least some of the other insurance asset management providers rely exclusively on the pricing feed from a pricing service. This is understandable in light of the heightened attention associated with using observable inputs to develop more accurate prices. If this is the case, then the security prices that their clients receive may not fully reflect the decline in market value in this spread-widening environment associated with a ‘flight to quality’.

Recommendation

Most insurance asset managers undergo a SAS 70 review of operational controls so that their clients can rely on the manager’s processes and procedures. The SAS 70 reviews that were performed for 2007 covered a number of areas, including pricing. Since FAS 157 was adopted late in the year, is not effective until 2008 for nearly all of our clients and the audit testing procedures for security pricing is currently being developed by the accounting firms, 2007 SAS 70 reviews did not involve detailed and rigorous testing of pricing policies and procedures. At AAM, we plan to significantly expand our 2008 SAS 70 review to include this testing. In the meantime, we are prepared to provide documentation to clients as to the pricing source for 2007 audits. We are not willing to ask that our pricing sources sign letters for pricing confirmation. This requirement will inevitably lead to their refusal to provide observable inputs for pricing purposes. If we are not able obtain accurate observable inputs from the brokerage community, our only pricing source will be pricing feeds from a third party provider that contain prices that do not accurately reflect fair value. We do not believe this is the intent of FAS 157 and owe it to our clients to avoid this outcome.

We are distributing this to clients, prospects and third party consultants and ask them to discuss this with their auditors. We would welcome any questions or feedback.

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