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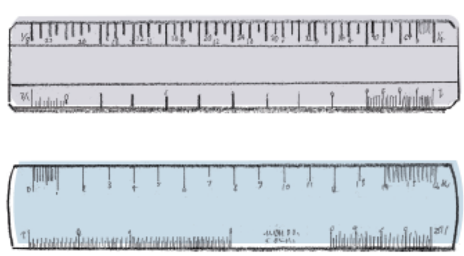
The FASB's "practical" solution for measuring fair value of alternative investments

The Financial Accounting Standards Board(FASB) issued Accounting Standards Update (ASU) 2009-12 on Sept. 30, 2009, to provide guidance on measuring the fair value of alternative investments. This ASU amends FASB Accounting Standards Codification Topic™ ASC 820, *Fair Value Measurements and Disclosures* (formerly FASB Statement 157, *Fair Value Measurements*), and provides a practical expedient for measuring the fair value of certain alternative investments[1] that do not have a quoted market price, but calculate net asset value (NAV) per share. The ability to use the practical expedient eliminates the complexities and practical difficulties investors often faced in adjusting the NAV provided by the investee in order to determine the fair value of its alternative investment under ASC 820.



Background

When determining the fair value of their investments under ASC 820, investors often had to make adjustments to the NAV reported by the investee because:

- attributes specific to the investment (such as liquidity restrictions, redemption fees or initial lock-ups) are not included in the determination of NAV; or
- the exit market of an investor for the alternative investment differs from the exit market of the investee for the underlying instruments.

The determination of such adjustment was complicated by the limited transparency of actual transactions between market participants for the investment. This ASU eliminates the need to account for such adjustments in calculating the fair value of alternative investments in accordance with ASC 820. **The ASU amends ASC 820 to permit, but does not require, a reporting entity to measure the fair value of an investment based on the investee's NAV per share or its equivalent. The ASU is important for hedge funds and funds of funds and will also affect all hedge fund feeder funds to the extent they elect to use the NAV option.**

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[1] Alternative investments include certain hedge funds, private equity funds, real estate funds, venture capital funds, common/collective funds and offshore funds.

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(continued)

Use of the practical expedient

The new measurement guidance in ASC 820 applies to alternative investments that meet both of the following criteria as of the reporting entity's (investee's) measurement date:

- The investment does not have a "readily determinable fair value," as defined in the Codification's Master Glossary. If a restricted investment has a readily determinable fair value, the reporting entity is precluded from applying the practical expedient, regardless of the length of the restriction.

- The investment is in an entity (investee) that either:
  — **Meets the criteria for an investment company** as stipulated in ASC 946, *Financial Services— Investment Companies* (formerly the AICPA Audit and Accounting Guide, Investment Companies). ASC 946-10-15-2 specifies that an investment company have the following attributes—
    - "Investment activity. The investment company's primary business activity involves investing its assets, usually in the securities of other entities not under common management, for current income, appreciation, or both.
    - Unit ownership. Ownership in the investment company is represented by units of investments, such as shares of stock or partnership interests, to which proportionate shares of net assets can be attributed.
    - Pooling of funds. The funds of the investment company's owners are pooled to avail owners of professional investment management.
    - Reporting entity. The investment company is the primary reporting entity."

  — **Does not meet the criteria to be an investment company**, but follows industry practice and issues financial statements using guidance consistent with the measurement principles for investment companies in ASC 946, including real estate funds that measure investment assets at fair value on a recurring basis.

A reporting entity must make the election to use the practical expedient on an investment-by-investment basis that must be applied consistently to its entire position in the investment, unless it is probable at the measurement date that the entity will sell all or a portion of its investment at an amount other than NAV per share. For a sale to be considered probable as of the measurement date, the following four criteria must be met:

- Management, with the authority to approve the sale, commits to a plan to sell the investment.
- An active program to locate a buyer and other actions required to complete the sale of the investment have been initiated.
- The investment is available for immediate sale subject only to terms that are usual and customary for sales of such investments (for example, a requirement to obtain approval of the sale from the investee or a buyer's due diligence procedures).
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

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A reporting entity must make the election to use the practical expedient on an investment-by-investment basis...

The FASB's "practical" solution for measuring fair value of alternative investments (continued)

Reporting NAV per share

In order for a reporting entity to utilize the practical expedient, the investee must calculate NAV per share or its equivalent in a manner consistent with the measurement principles in ASC 946, which requires that the underlying investments be measured at fair value in accordance with the guidance in ASC 820. If NAV per share is not calculated in accordance with the guidance in ASC 946, or it is not calculated as of the reporting entity's measurement date, the reporting entity must consider whether NAV should be adjusted so that it is consistent with the measurement principles in ASC 946.

Entities are required to use judgment when classifying investments that are measured at NAV or its equivalent in the fair value hierarchy (i.e., Level 2 or Level 3). ASC 820, as amended by ASU 2009-12, provides the following guidance:

- If a reporting entity can redeem its investment with the investee at NAV per share at the measurement date, it must classify the investment in Level 2 of the fair value hierarchy.
- If a reporting entity will never be able to redeem its investment with the investee at NAV per share, it must classify the investment in Level 3 of the fair value hierarchy.
- If the reporting entity cannot redeem its investment with the investee at NAV per share at the measurement date, but the investment may be redeemable with the investee at a future date, the reporting entity is required to consider the length of time until the investment will become redeemable in determining whether the investment should be reported in Level 2 or Level 3 of the fair value hierarchy.

Disclosures

The ASU also amends the guidance in ASC 820 regarding specific disclosures about investments that are eligible for the practical expedient. The new disclosure requirements included in ASC 820, as amended by ASU 2009-12, are **required** even if an entity does not choose to apply the practical expedient. The intent of the disclosures is to provide information to help financial statement users understand the nature and risks of those investments and to assess the probability that investments will be sold at an amount different than NAV per share or its equivalent.

ASC 820-10-55-64A provides an illustrative example of the disclosure requirements.

Specifically, reporting entities must disclose for each interim and annual period, the following information separately for each major category of investment:

- The fair value of the investments using the practical expedient and a description of the significant investment strategies of the investee(s).
- For each major category that includes investments that can never be redeemed with the investee, but for which the reporting entity receives distributions through liquidation of the underlying assets by the investee, the reporting entity's estimate of the length of time over which the underlying assets are expected to be liquidated by the investees.
- The amount of the reporting entity's unfunded commitments related to investments in the major category.
- A general description of the terms and conditions upon which the reporting entity may redeem its investments in the major category.
- The circumstances in which an otherwise redeemable investment might not be redeemable (for example, when a fund is gated or when there is a lock-in period for initial investments) and, for otherwise redeemable investments for which redemption is restricted at the measurement date, the reporting entity's estimate of when that restriction might lapse. If such an estimate cannot be made, that fact must be disclosed, as well as how long the restriction has been in effect.

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The FASB's "practical" solution for measuring fair value of alternative investments (continued)

- Any other significant restriction on the reporting entity's ability to sell investments at the measurement date.
- If it is probable that the reporting entity will sell an investment for an amount different from NAV per share or its equivalent, the entity shall disclose the total fair value of all investments that meet the criteria for a probable sale and any remaining actions required to complete the sales.
- If a group of investments that qualify for the practical expedient would meet the criteria for a probable sale except that the individual investments have not been identified, so the investments continue to qualify for the practical expedient, the reporting entity shall disclose its plans to sell the investments, and any remaining actions needed to complete the sale(s).

Effective date

The amendments to the Codification included in ASU 2009-12 are effective for interim and annual periods ending after Dec. 15, 2009. Early application is permitted for interim and annual financial statements that have not been issued. If a reporting entity early adopts the amendments in ASU 2009-12, it is not required to provide the new disclosures until the first reporting period ending after Dec. 15, 2009.

Helpful guidance

The (American Institute of certified Public Accountants) AICPA recently issued a nonauthoritative Technical Practice Aid to assist reporting entities implementing ASU 2009-12. The guidance can be found in Technical Inquiry Service Section 2220, "Long-Term Investments." •

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