

# Defining Issues<sup>®</sup>

KPMG LLP



## Alert

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## Measuring the Fair Value of Investments in Investment Companies

Investors may use net asset value to estimate the fair value of investments in investment companies that do not have a readily determinable fair value if the investees have the attributes of investment companies and the net asset values or their equivalents are calculated consistent with the AICPA Audit and Accounting Guide, Investment Companies, which generally requires investments to be measured at fair value.<sup>1</sup> The approach has been made available through a new FASB Accounting Standards Update as a “practical expedient” for investors in investment vehicles such as hedge funds, private equity funds, venture capital funds, funds of funds, and in foreign and other vehicles, such as real estate funds.<sup>2</sup>

Using the net asset value of the investment without further adjustment is a practical expedient because the GAAP fair-value-measurement framework defines an asset’s fair value as its current exit price (i.e., its estimated selling price at the measurement date) and an investment’s net asset value may differ from its current exit price.<sup>3</sup> The Board concluded that the cost and effort involved in evaluating potential adjustments to net asset value to determine the fair-value estimate would outweigh the financial-reporting benefits for investments within the scope of the Update.

### Measurement

The practical expedient should be applied on an investment-by-investment basis and applied consistently to the investor’s entire position in a particular investment unless it is probable as of the reporting date that all or a portion of the investment will be sold at an amount other than net asset value.

If the investee’s reporting date is different from the investor’s, the investor may use the practical expedient based on the latest net asset value reported by the investee, adjusted for significant market events that have occurred since the date the investee calculated the net asset

<sup>1</sup> FASB ASC Topic 946, Financial Services-Investment Companies, available at [www.fasb.org](http://www.fasb.org), and AICPA Audit and Accounting Guide, Investment Companies, May 2009.

<sup>2</sup> Accounting Standards Update No. 2009-12, Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent), available at [www.fasb.org](http://www.fasb.org).

<sup>3</sup> FASB ASC Topic 820, Fair Value Measurements and Disclosures (FASB Statement No. 157, Fair Value Measurements), available at [www.fasb.org](http://www.fasb.org).

value. Investors are also permitted to use the practical expedient for investments that report net asset values that are not prepared in accordance with the Investment Companies Guide. However, investors should make all necessary adjustments to the reported net asset value necessary to arrive at an adjusted net asset value that is calculated consistent with the Investment Companies Guide as of the investor's measurement date.

#### **Limitations on Using the Practical Expedient**

The Update prohibits the use of the practical expedient if it is probable as of the reporting date that an investment, or a portion of an investment, will be sold for an amount other than net asset value, for example, in a secondary market transaction. The investor would instead be required to estimate the fair value of the investment considering all of the rights and obligations inherent in the investment and other market data applicable to the investment interest. A sale is probable if the following conditions are present as of the reporting entity's measurement date:

- Management commits to a plan to sell the investment and has the authority to approve the action.
- An active program to locate a buyer and other actions required to complete the plan to sell 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 the investee's approval of the sale).
- 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.

For a group of investments that meet the above criteria, except that the individual investments in the group have not been identified (for example, if an entity decides to sell 20 percent of its entire private equity portfolio and the probable-of-being sold conditions would be met if the individual investments were identified), the practical expedient may nevertheless be applied.

#### **Disclosures**

The following disclosures about the nature and terms of the investments in the scope of the Update must be presented separately in each interim and annual period for each major category of investment, whether or not the practical expedient was used.

- The fair value of the investments (net asset value if the practical expedient was used) and a description of the significant investment strategies of the investee(s).
- For major categories that include investments that can never be redeemed with the investees, but receive distributions on liquidation of the investees' underlying assets, disclose the estimated time period over which the underlying assets are expected to be liquidated.
- The amount of the reporting entity's unfunded commitments related to the investments.
- A general description of the terms and conditions under which the investor may redeem the investments (for example, quarterly redemption with 60 days' notice).



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- The circumstances in which an otherwise redeemable investment or a portion of it might not be redeemable (for example, due to a lockup or the imposition of a gate), and the reporting entity's best estimate of when a restriction against redemption of an otherwise redeemable investment that is in place as of the reporting entity's measurement date might lapse. If an estimate cannot be made, the reporting entity must disclose that fact and how long the restriction has been in effect.
- Any other significant restriction on the ability to redeem or sell investments at the measurement date.
- Total fair value of all investments that are probable-of-being-sold as of the reporting date for an amount other than net asset value calculated consistent with the Investment Companies Guide, and any remaining actions required to complete the sale or sales.
- Plans to sell, and any remaining actions required to complete the sale or sales for a group of investments that would otherwise meet the probable-of-being-sold criteria described above, but the individual investments to be sold have not been identified.

The Update provides an example of the above disclosures.

The Update provides guidance on classifying within the fair value hierarchy the investments to which the practical expedient has been applied. The guidance generally requires reporting entities to consider all attributes of the investment. If the investor can redeem the investment with the investee on the measurement date at net asset value, the investment should likely be classified as Level 2. Investments that cannot be redeemed with the investee at net asset value would generally be classified as Level 3. If the investment is not redeemable with the investee on the measurement date, but will be at a future date, the length of time until the investment is redeemable should be considered in determining classification as Level 2 or 3.

The Update's disclosure requirements do not apply to employers' postretirement-benefit-plan assets for which disclosures are required by other GAAP.<sup>4</sup>

**Effective Date and Transition**

The Update is effective for periods ending after December 15, 2009. Early adoption is permitted. Reporting entities that adopt the guidance early are not required to provide the new disclosures until the effective date. We believe it would be appropriate for entities that adopt the guidance early to disclose the carrying value of investments valued using the practical expedient in addition to the disclosures otherwise required by GAAP. Early adopters may also want to provide other disclosures described in the Update to present a full picture of their financial position and the assumptions made to value these types of assets.

The descriptive and summary statements in this newsletter are not intended to be a substitute for the FASB Accounting Standards Update or any other cited or potential accounting literature or SEC regulations. Companies applying GAAP or filing with the SEC should apply the texts of the relevant laws, regulations, and accounting requirements, consider their particular circumstances, and consult their accounting and legal advisors.

<sup>4</sup> FASB ASC Topic 715, Compensation-Retirement Benefits, available at [www.fasb.org](http://www.fasb.org).