



Financial Accounting Standards Board

Board Meeting Handout

Financial Instruments with Characteristics of Equity

May 6, 2009

INTRODUCTION

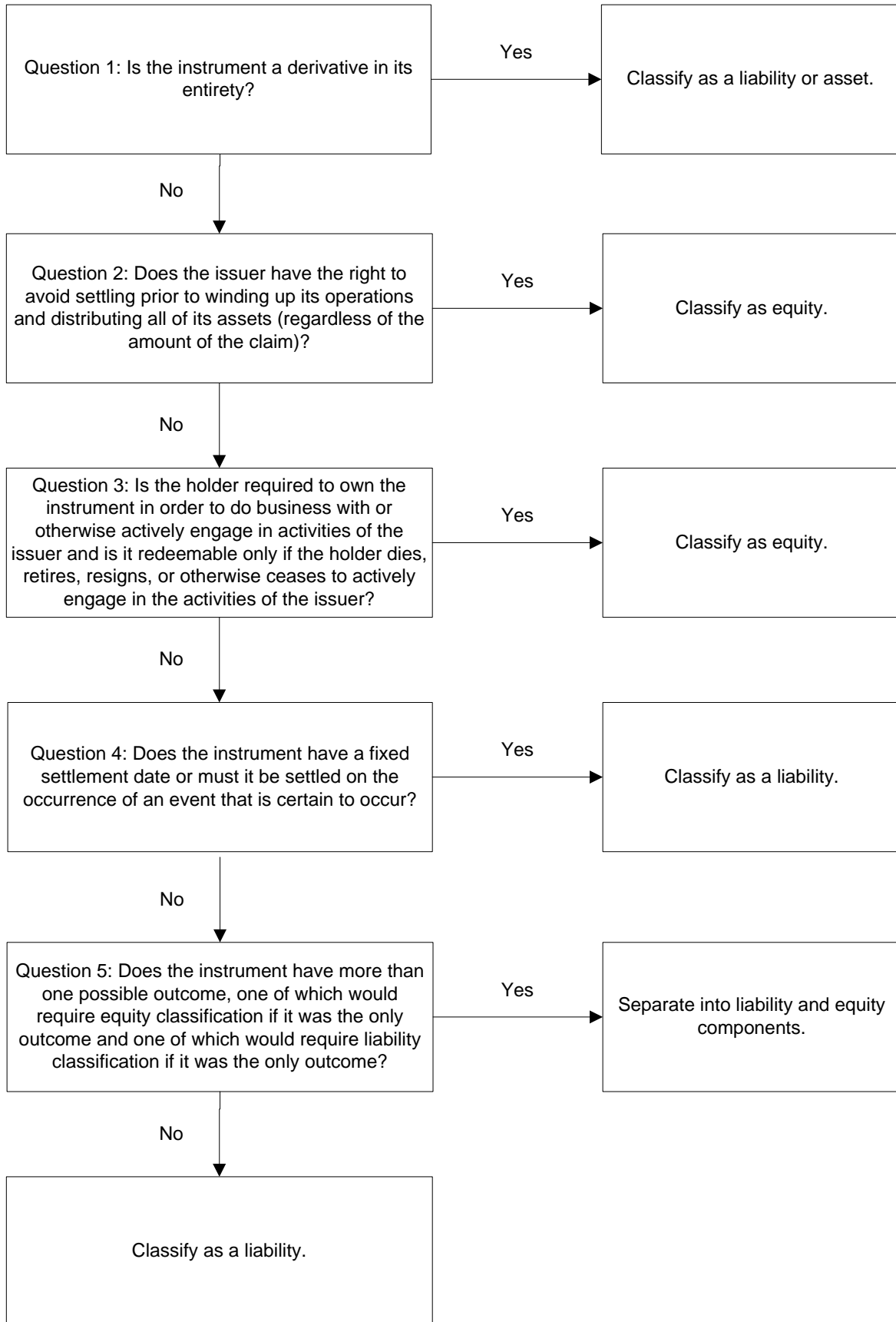
1. The purpose of this meeting is to discuss a proposed approach to distinguishing equity instruments from liabilities that uses the following three characteristics:
 - a. Subordination or priority of the holders' rights to distributions of assets or other valuable consideration (In other words, if there were a shortage of assets to satisfy claims against the entity, are the holders' rights superior or inferior relative to other claimants?)
 - b. The existence or lack of requirements to settle the instrument before the entity winds up its operations and distributes all remaining assets.
 - c. A claim to a percentage of the assets remaining after settling all higher priority (senior) claims of the entity.

SUMMARY OF THE GENERAL PRINCIPLES AND DEVELOPMENT OF DECISION RULES

2. The following is a summary of the general principles that underlie the proposed approach:
 - a. Equity instruments are always subordinated to all liability instruments but may be senior to other classes of equity.
 - b. An instrument is equity if the issuer cannot be required to settle it, unless the issuer winds up its operations and distributes all of its remaining assets. (A sufficient but unnecessary condition for equity classification.)
 - c. A settlement requirement that becomes effective when the holder has died, retired, resigned, or otherwise ceased to take an interest in the activities of the entity does not cause an instrument to be classified as a liability if the holder was required to hold the instrument in order to transact with the entity or otherwise engage in the activities of the entity.

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- d. Settlement requirements other than those described in item (c) indicate that an instrument is a liability or a liability-equity hybrid instrument (part equity and part liability).
 - e. An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome.
 - f. Claims to percentages of remaining assets are neither necessary nor sufficient to identify an equity instrument. However, they may help to classify otherwise borderline instruments.
3. Those general principles cannot be distilled into a single rule, but they can form the basis for a set of decision rules to implement the principles as follows:
- a. An entity must classify as equity retained earnings and capital contributed without the contributor receiving a claim against the entity in exchange even if that entity has issued no equity instruments.
 - b. An issuer must classify an instrument as a liability if the instrument has a fixed settlement date or must be settled on the occurrence of an event that is certain to occur, excluding those described in items (c)(1) and (c)(2) below.
 - c. An issuer would classify the following other instruments as equity:
 - (1) Instruments that the issuer cannot be required to settle prior to winding up its operations and distributing all of its assets (regardless of the amount of the claim)
 - (2) Instruments that the holder is required to own in order to do business with or otherwise actively engage in activities of the issuer and that are redeemable only if the holder dies, retires, resigns, or otherwise ceases to actively engage in the activities of the issuer. (This would include holdings, the amounts of which vary based on volume of business transacted by the holder.)
 - d. An instrument shall be separated into liability and equity components if the instrument has two separate or alternative outcomes, one of which would require equity classification if it were the only outcome and one of which would require liability classification if it were the only outcome.
4. The flowchart on the following page illustrates the decision rules described in paragraphs 3(a)–3(d):



QUESTIONS FOR THE BOARD

1. Does the Board agree with the general principles described in paragraphs 2(a)–2(f)?
2. Does the Board agree with the decision rules described in paragraphs 3(a)–3(d)?



Financial Accounting Standards Board

Board Meeting Handout¹

Determining the Fair Value of Interests in Alternative Investments Using Net Asset Value

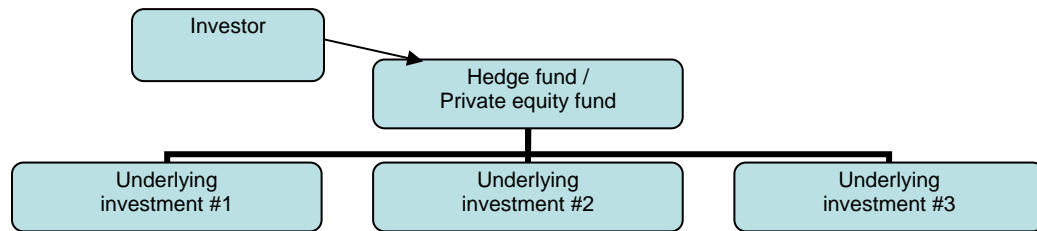
May 6, 2009

MEETING PURPOSE

1. The purpose of this meeting is to discuss practice issues that have arisen since the issuance of FASB Statement No. 157, *Fair Value Measurements* related to determining the fair value of certain alternative investments in entities that apply the AICPA Audit and Accounting Guide, *Investment Companies* (the Guide). The staff will ask the Board if it would like to issue a proposed FSP to address those issues.
2. Examples of alternative investments within the scope of today's discussion include investments in hedge funds (referred to as redeemable funds) and private equity funds (referred to as nonredeemable funds).
3. Funds that apply the Guide are required to apply Statement 157 to their underlying investments to arrive at the net asset value (NAV) of the fund. For the investor in a fund, GAAP permits or requires a fair value measurement of an investor's investment in a fund. Investors in funds have typically relied on a current NAV to estimate the fair value of their investments in funds. The focus of this issue is on

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the investor's determination of the fair value of its investment in a fund (see the following diagram):



BACKGROUND

4. Fund investments have various terms and conditions (that is, features). For a nonredeemable fund, the investor does not usually have the ability to redeem its interest with the fund. Typically, the investor receives its investment and any return on its investment as the fund sells its underlying investments. A nonredeemable fund may also have a capital commitment. A capital commitment is a requirement that the investor provide additional capital to the fund to be used by the fund to make additional investments. For a redeemable fund, the investor typically does have the ability to redeem its investment with the fund at certain specified dates (for example, on a quarterly, semi-annual or annual basis). However, redeemable funds often have an initial lock-up period, which prevents redemption for a specified period (for example, a year). Redeemable funds also often have terms that permit the fund manager to impose a restriction on redemption (such as, gates or side pockets) subsequent to an investment in the fund. Gates may be imposed to manage a large number of redemption requests from investors in order to prevent the manager from having to sell a significant position in the fund in a disorderly manner.
5. In estimating the fair value of an investment in a fund, many constituents have indicated that it is difficult to determine whether market participants would make an adjustment to a properly determined, current NAV for the features inherent in the fund.

6. In January 2009, the AICPA Accounting Standards Executive Committee and the Alternative Investments Task Force issued a draft issues paper entitled, *FASB Statement No. 157 Valuation Considerations for Interests in Alternative Investments* (the draft paper) for comment. The draft paper is available at the [AICPA website](#) and includes nonauthoritative guidance on such questions as what is the appropriate unit of account for an interest in a fund and how should an investor entity determine the principal or most advantageous market for an interest in a fund. The draft paper also discusses features and circumstances of funds that may have an impact on the estimation of fair value.
7. The staff reviewed comments received by the AICPA on the draft paper. Additionally, the staff held discussions regarding the valuation of alternative investments with various constituent groups, including users, auditors, and preparers.
8. The staff noted that many constituents had concerns about several aspects of the draft paper. The staff believes those concerns can be summarized into two main categories. The first category of concerns is that the draft paper is not operational. These constituents highlight that the draft paper lacks sufficient clarity about whether adjustments to NAV are necessary. They believe the draft paper argues both for and against making adjustments to a properly computed, current NAV and, therefore, that the draft paper is not operational. The second category of concerns is that the draft paper places too much emphasis on the reliance on secondary market transaction information as an observable input to a fair value measurement. Many constituents indicated that secondary markets for hedge fund and private equity investments are virtually nonexistent and that when transactions in a secondary market do take place, they are typically distressed transactions.

SCOPE

9. The staff believes it is necessary to limit the scope of a proposed FSP to investments in entities that apply the Guide since the staff does not believe that it

would be appropriate to solely rely on book value per share (the equivalent of net asset value for a noninvestment company) to estimate the fair value of an investment in an entity that does not apply the Guide. Entities that apply the Guide are required to estimate the fair value of their underlying investments, while other noninvestment company entities may or may not carry their assets at fair value.

10. In addition, the staff is proposing a scope exception when there is an active market for the identical investment (that is, a Level 1 measurement). For example, some investment companies may actively trade on an exchange at a price that differs from the NAV. In that circumstance, this guidance would not change the existing requirement in Statement 157 to use the traded price on the exchange.

11. In summary, the staff recommends the following scope:

This FSP shall apply to investments in entities that are within the scope of the AICPA Audit and Accounting Guide, *Investment Companies* (the Guide), except when fair value is required to be determined in accordance with paragraph 24 of Statement 157, which applies to Level 1 measurements. For example, this FSP applies to investments in entities that are within the scope of the Guide for purposes of applying:

a. The Guide, for a subsequent fair value measurement of an investment in another entity applying the Guide;

b. FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, for a subsequent fair value measurement of an investment in an entity applying the Guide when the fair value option has been elected.

c. The AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, for a subsequent fair value measurement of an investment in an entity applying the Guide when the investor elects fair value as the subsequent measurement attribute (also, if the investment is subsequently measured at cost or equity method, when testing for other than temporary impairment).

d. APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, EITF Issue No. D-46, "Accounting for Limited Partnership Investments", or other equity method guidance, for an other than temporary impairment analysis of an equity method investment in an entity applying the Guide;

e. FASB Statement Nos. 35, *Accounting and Reporting by Defined Benefit Pension Plans* and 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* or other benefit plan guidance, for a subsequent fair value measurement of an investment in an entity applying the Guide made by a benefit plan;

f. FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* for a fair value disclosure of an investment in an entity applying the Guide.

12. A range of reporting entities (investors) may have such investments, including: investment companies, corporations, benefit plans, and not-for-profit entities (such as private foundations and universities).

Question 1—Does the Board agree with the staff's recommendation about the scope of the proposed FSP?

ADJUSTMENTS TO NET ASSET VALUE

13. Constituents have indicated that additional guidance is needed on estimating the fair value of redeemable and nonredeemable investments in funds that apply the Guide. They highlight that these investments have unique features and circumstances that warrant further consideration by the Board. Examples of features and circumstances include:

- a. Redeemable funds:
 1. Lock-up periods,
 2. Notice periods for redemptions and a requirement that transfer of a limited partner's interest be approved by the fund sponsor/general partner,
 3. Holdbacks,
 4. Imposition of gates subsequent to initial investment,
 5. Use of side pockets, and
 6. Other significant changes in the redemption terms subsequent to initial investment.
- b. Nonredeemable:

1. The fact that an interest in a nonredeemable fund cannot be redeemed,
 2. Requirement that transfer of a limited partner's interest be approved by the fund sponsor/general partner, and
 3. Unfunded capital commitments.
- c. Nonredeemable and redeemable - secondary market transactions.

14. The staff recommends that the Board indicate that NAV is the fair value of an investment in a fund within the scope of this guidance, provided that the NAV has been determined in accordance with the Guide and is reflective of the fair value of the underlying investments at the investor's measurement date (that is, the NAV is current). The staff does not recommend that the Board provide any additional guidance beyond that contained in the Guide for determining NAV.

15. The staff makes its recommendation after considering the following:

- a. The staff believes NAV is the best estimate of fair value for an interest in a fund that applies the Guide that is available without undue cost and effort.
- b. The Guide requires funds to use Statement 157 to estimate the fair value of the underlying investments. Thus, a properly calculated NAV reflects all the risks (for example, illiquidity) inherent in the underlying investments within the fund that market participants would consider in estimating fair value at the measurement date in an orderly transaction under current market conditions.
- c. It is not clear whether market participants would make adjustments for the features and circumstances of alternative investments described in the draft paper or whether those adjustments are on balance positive or negative adjustments to NAV. Some adjustments may be positive (such as the ability to access investments that are not otherwise available to individual investors and the perceived superior abilities of the fund manager) and

others negative (such as the imposition of a gate). Even gates may have some positive aspects to them (for example, the imposition of a gate prevents the fund manager from having to sell investments in a disorderly transaction).

- d. If the investor were to adjust NAV, the adjustment would likely be highly subjective; thus, the adjustment would be applied inconsistently, reducing comparability across reporting entities. Some users of financial statements have indicated that adjusting NAV would not provide the most decision useful information about investments in entities that apply the Guide and that they prefer the comparability of NAV (supplemented with disclosures about the terms and conditions of the investment).

Question 2—What, if any, guidance does the Board want to provide for estimating the fair value of an investment in a fund that applies the Guide?

DISCLOSURES

16. The staff believes that the Board should require the following disclosures (in addition to those required by Statement 157):

- a. For nonredeemable funds, disclose the net asset value (fair value) of the investment and:
 1. The reporting entity's best estimate of the expected timing of distributions from nonredeemable funds
 2. The reporting entity's best estimate of the amount and expected timing of additional capital commitments, if any.
- b. For redeemable funds, disclose the net asset value (fair value) of the investment and:
 1. The terms and conditions upon which the reporting entity may redeem its investment (for example, quarterly redemption with 30 days notice),

2. If the reporting entity is currently restricted from redeeming its interest in the fund (for example, due to a lock-up or a gate), the nature and terms of the restriction and the reporting entity's best estimate of when the restriction will lapse.

Question 3—Does the Board agree with the staff's recommendation about disclosures?

Question 4—Does the Board want to provide guidance on the Level in the Statement 157 hierarchy for an investment in a fund within the scope of this guidance?

EFFECTIVE DATE AND TRANSITION

17. The staff recommends the following effective date and transition:

This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, *Accounting Changes and Error Corrections*, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application.

Question 5—Does the Board agree with the staff's recommendation about the effective date and transition?

COMMENT PERIOD

18. The staff recommends a 30-day comment period ending on or about June 22, 2009 (the staff currently expects to issue a proposed FSP on or about May 22, 2009).

Question 6—Does the Board agree with the staff's recommended comment period?

Question 7—Does the Board grant the staff permission to proceed to a ballot draft of a proposed FSP?