Estimating the Fair Value of Investments in Entities That Calculate Net Value per Share

By Matthew Crane and Robert A. Dyson

In September 2006, FASB issued Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements* (now Accounting Standards Codification [ASC] section 820-10, *Fair Value Measurements and Disclosures*), with the stated objective of simplifying the measurement and disclosure of fair value information. The application of this guidance to investments in certain nonpublic entities, such as alternative investments, proved more difficult than originally envisioned. In the authors' opinion, this was due to diverging views on fair value and the difficulty in obtaining information on alternative investments.

Individuals and institutions purchase alternative investments to achieve a specific investment objective while diminishing risk. Typically, alternative investments sell ownership interests; invest the proceeds, mostly in securities, to achieve specific investment objectives; and distribute to their owners the net income earned on investments and net gains realized on the sale of investments. Alternative investments diminish risk by holding many different securities and receiving professional investment management services. In addition, individuals and institutions may diminish their risk by investing in ownership interests not directly exposed to the volatility of the public market, while realizing greater risk-adjusted returns.

Alternative investments include ownership interests in hedge funds, private equity funds, real estate funds, venture capital funds, off-shore fund vehicles, and fund of funds. These investments are often not listed on national exchanges or over-the-counter markets or traded in active markets and, thus, do not have a quoted market price. Investors typically redeem their ownership interest from the alternative investment rather than sell it in a secondary market. This redemption is not always readily available, in that many alternative investments require a minimum period of time between a redemption request and the actual transfer of cash, such as lockups and redemption gates. The investees often provide their investors with net asset value (NAV) per share, such as member units or an ownership interest in partners' capital proportional to their share of net assets. Redemptions are measured at NAV. *Exhibit 1* presents an example of calculating NAV.

As discussed in the following section, fair value is defined as the price that would be received to sell an asset in an orderly transaction. Because the ownership interests of most alternative investments are not traded in an active market and do not have a quoted market price, investors would estimate the fair value of those interests based on other observable inputs. Certain alternative investments provide an NAV based on the fair values of their underlying assets and liabilities. The question arose whether, in these cases, the NAV can be considered an input based on observable market information in order to estimate the fair value of ownership interests in alternative investments.

As a consequence, FASB, in September 2009, issued Accounting Standards Update (ASU) 2009-12, *Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, to permit, as a practical expedient, the measurement of fair value of certain alternative investments based on net asset value. The practical expedient is available to those alternative investments whose underlying assets and liabilities are measured at fair value because, for such entities, the NAV reflects fair value. ASU 2009-12 is effective for interim and annual periods ending after December 15, 2009, with earlier application permitted.

GLOSSARY

Exit price is the price that would be received to sell an asset or paid to transfer a liability.

An **investment company** is a separate legal entity whose business purpose and activity comprise all of the following:

- Investing in multiple substantive investments;
- Investing for current income, capital appreciation, or both;
- Investing with investment plans that include exit strategies.

Accordingly, investment companies do not either—

- acquire or hold investments for strategic operating purposes; or
- obtain benefits (other than current income, capital appreciation, or both) from investees that are unavailable to noninvestor entities that are not related parties to the investee.

A **lockup** is a minimum period of time during which an investor agrees that the money invested in a hedge fund is committed and cannot be withdrawn until the expiry of that minimum period.

Net asset value per share is the amount of net assets attributable to each share of capital stock—other than senior equity securities, such as preferred stock—outstanding at the close of the period. It excludes the effects of assuming conversion of outstanding convertible securities.

An equity security has a **readily determinable fair value** if it meets any of the following conditions:

- The sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations (Nasdaq) systems or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
- An equity security is traded only in a foreign market that is of a breadth and scope comparable to one of the U.S. markets referred to above.
- The fair value per share (unit) of an investment in a mutual fund is determined and published and is the basis for current transactions.

Redemption gates limit the percentage of fund capital that can be withdrawn on a hedge fund's scheduled redemption date, or delay or suspend withdrawals altogether where there is a possibility of a "run" on the fund's capital. Redemption gates can generally be applied at the discretion of the investment manager.

A **secondary market** is a private, illiquid market where market participants buy and sell securities directly from each other. This market is distinguished from a public secondary market where securities have liquidity and trade through an organized exchange, or a primary market where investors acquire securities from the issuers.

Source: Adapted from FASB's ASC Master Glossary.

This article provides guidance in identifying investments for which the fair value may be determined in conformity with ASU 2009-12, measuring the fair value of those investments, classifying the investments in the fair value hierarchy, and providing disclosures.

Objectives of Fair Value Measurement

ASC section 820-10 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction consummated at the measurement date. This is a hypothetical transaction, considered from the perspective of a market participant that holds the asset or owes the liability. An orderly transaction is not a forced transaction, such as an involuntary liquidation or distressed sale. It assumes exposure to the market for a period prior to the measurement date sufficient to allow for usual and customary marketing activities.

The objective of a fair value measurement is to determine the price that would be received to sell the asset or paid to transfer the liability at the measurement date (an exit price), rather than a purchase or entry price. The fair value of the asset or liability is based on the assumptions that market participants would use in pricing the asset or liability, such as the condition or location of the asset or liability and any restrictions on the sale or use of the asset at the measurement date. Market participants are, by definition, independent, fully informed of all facts known or knowable, and have the willingness and ability to complete the transaction. Related parties, as defined by FASB's ASC Master Glossary, cannot be market participants for purposes of estimating fair value.

EXHIBIT 1
Sample NAV Calculation

Alpha Partners LLP, a hedge fund, presented its statement of assets and liabilities as of December 31, 2010, as demonstrated below. Alpha invests in domestic and foreign marketable securities, private investment in public equity securities (PIPES), private equity, and derivatives, all of which are measured at fair value. Its remaining assets and liabilities, such as receivables, due to partners, contributions received in advance, and accrued expenses and other liabilities are expected to be settled within a year and are presumed to have a fair value approximating the carrying value. The amounts due from brokers represent positions with and amounts due from Alpha's clearing brokers.

($000)

Assets:	
Investments in securities, at fair value	$348,913
Due from brokers	302
Collateral on forward currency contracts	1,114
Cash	502
Forward currency contracts	322
Interest and dividends receivable	826
Total assets	$351,979
Liabilities:	
Due to partners	837
Contributions received in advance	306
Accrued expenses and other liabilities	106
Total liabilities	1,249
Partners' capital	$350,730

The partnership agreement does not provide Alpha's general partner with a special allocation. Thus, all net income and net losses are allocated to the different partners based solely on their ownership interests. Bravo Company, with a 10% limited partnership interest, measures its NAV at $35,073,000 (10% of net partners' capital of $350,730,000) at December 31, 2010. The contributions received in advance would not affect the NAV because the partners' interest is not outstanding at December 31, 2010.

Criteria for Applying NAV

ASU 2009-12 only applies to investments in ownership interests that do not have a readily determinable fair value and either are in an investee that has all the attributes applicable to an investment company or an investee for which it is industry practice to issue financial statements using guidance consistent with ASC 946, *Financial Services–Investment Companies*. In other words, the NAV practical expedient is only available to investments that are not traded in a market and whose values are based on the fair values of the investee's underlying assets and liabilities.

Readily determinable fair value. Most alternative investments are not publicly traded and, by definition, have no readily determinable fair value. Alternative investments that are ordinarily publicly traded may contain temporary sale restrictions. Restrictions are generally noted in the ownership agreements and may prohibit investment holders from redeeming or selling their interests for a set period of time or in anticipation of a significant transaction, such as an initial public offering. ASU 2009-12 deems alternative investments whose restriction to trade in a secondary market expires within one year as having a readily determinable fair value and, hence, would not be measured at NAV.

Absent contractual restrictions, a secondary market might exist for certain alternative investments. Many of these secondary markets do not meet the criteria of an exchange presented in the definition of readily determinable fair value. In addition, the existence of such markets does not necessarily cause an investment to have a readily determinable fair value. Selling an ownership interest at a discount is not a customary transaction when investments can be redeemed at NAV. Investors enter these markets when they do not wish to wait for the lockup or redemption gate to expire normally, which implies a forced or distressed sale. Thus, in these situations, it may be appropriate to apply the practical expedient and use NAV as fair value.

The reporting entity cannot apply the practical expedient if it becomes probable that it will sell its investment at an amount different from the net asset value per share. In these circumstances, the reporting entity must measure its investment at fair value using the general requirements outlined in ASC 820. A sale is only deemed probable if its meets all of the following criteria as of the measurement date:

■ Management, having the authority to approve the action, commits to a plan to sell the investment.

■ 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.

■ Actions required to complete the plan indicate that it is unlikely that significant changes in the plan will be made or that the plan will be withdrawn.

Attributes applicable to an investment company. Reporting entities must determine if an investee has all the attributes applicable to an investment company or belongs to an industry where it is the practice to issue financial statements using guidance consistent with ASC 946. This requirement is based on the premise that an investment company's financial statements should reflect each class of its shareholders' or partners' interest in its net assets as of the reporting date. ASC 946 applies to all investment companies that are required to report their investment assets at fair value, are a separate legal entity, and have the following attributes:

■ 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.

■ 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.

■ The funds of the investment company's owners are pooled to avail owners of professional investment management.

■ The investment company is the primary reporting entity.

Measurement of NAV

As illustrated in Exhibit 1, net asset value per share is the amount of net assets attributable to each share of capital stock or ownership interest outstanding at the close of the period. Although this calculation is simple in theory, certain adjustments may be necessary. An NAV may be adjusted if it is not calculated as of the reporting entity's measurement date or is not calculated in a manner consistent with the measurement principles of ASC 946.

Investors often do not receive timely information regarding their investments. For example, reporting entities commonly receive the investee's most recent audited financial statements. As discussed in *Exhibit 2*, Bravo Company has a 10% limited partnership interest in Alpha Partners LLP, a hedge fund that is also a registered investment advisor. Bravo needs Alpha's audited financial statements as of and for the year ended December 31, 2010, in order to prepare its own financial statements for the same year. However, Bravo does not receive those statements in a timely manner to accommodate its own reporting requirements. In these circumstances, Bravo should request that Alpha provide either a supplemental NAV calculation as of December 31, 2010, or sufficient information to perform a roll forward from the last reported NAV.

Exhibit 2 is a summary of Bravo's roll forward of its investment in Alpha. As a result of this roll forward, Bravo estimates the net asset value of Alpha at $35.073 million (10% of the total partners' capital of $350.730 million).

An adjustment is necessary if the NAV was not calculated using the measurement principles of ASC 946. NAV would not reflect fair value when some or all of the underlying investments are not measured at fair value, when NAV is reported on a cash basis, when the investments reflect a blockage discount, or when NAV is not adjusted for the impact of unrealized interest or incentive fees.

ASU 2009-12 specifically declined to provide guidance on calculating NAV in a manner consistent with the measurement principles of ASC 946. To assist reporting entities in their responsibility to conclude whether the manager of the alternative investment calculated the NAV in a manner consistent with ASC 946, the AICPA issued Technical Questions and Answers (TIS) sections 2220.18 to 2220.27 in December 2009. Although not authoritative, TIS section 2220 provides excellent advice on implementing ASU 2009-12. This matter is discussed in the next section.

The reporting entity is responsible for obtaining reliable information to estimate a fair value based NAV, either from the investee manager or from other sources.

The reporting entity is responsible for obtaining reliable information to estimate a fair value based NAV, either from the investee manager or from other sources. For example, if Alpha measured its marketable securities using a blockage discount, Bravo may use a standard pricing service to adjust the investments to fair value. If the calculation of an adjusted NAV is not practical, the reporting entity is precluded from measuring its investment at NAV. For example, if Alpha measured all of its investments in private investments in public equity securities (PIPES) and private equity investments at cost and those amounts are material, Bravo may conclude that Alpha is not preparing its financial statements in conformity with ASC 946. In those instances, Bravo would be precluded from measuring its investment in Alpha using NAV.

The NAV may also be adjusted to reflect carried interest and clawbacks. Although many variations exist, the carried interest is often an allocation of proceeds from the sale of individual investments to the investment manager. The allocation is based on a specific methodology defined in the governing documents.

A clawback frequently involves an obligation on the part of the investment manager to return previously received incentive allocations to the investment fund due to subsequent losses. Clawbacks are calculated as of each reporting date under the methodology specified in the fund's governing documents and are typically recognized as a deduction from the general partner's capital account in the entity's financial statements. Clawbacks, when paid, are typically distributed to other investors.

In presenting each class of shareholders' or partners' interest in the net assets as of the reporting date, the financial statements would consider the carried interest and clawbacks as if the investment company had realized all assets and settled all liabilities at their reported fair value, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date. Thus, a reporting entity should adjust NAVs that omit carried interests and clawbacks.

Unlike many calculations of fair value, the NAV does not acknowledge that the lack of ready liquidity/marketability tends to reduce the value of a security. This is not consistent with conclusions reached by appraisal practitioners, courts, capital market participants, and the IRS. ASU 2009-12 recognizes restrictions such as lockups and redemption gates only by requiring a disclosure of the restrictions.

EXHIBIT 2
Roll Forward—Alpha Partners LLP

Bravo Company has a 10% limited partnership interest in Alpha Partners LLP, a hedge fund, which is also a registered investment advisor. Bravo has a loan covenant requiring audited financial statements no later than March 31, 2011. Typically, Alpha files its financial statements toward the end of April to meet regulatory requirements to file no later than April 30 or 120 days after its fiscal year ending December 31. Thus, Alpha's filing deadline of April 30, 2011, is not timely for Bravo's own reporting requirements. As a consequence, Bravo uses Alpha's September 30, 2010, unaudited investor report and rolls forward information into December 31, 2010, using information obtained from Alpha.

		Unaudited ($000)
I	Last reported NAV 9/30/2010	$461,130
II	Add capital contributions/subscriptions	2,896
III	Subtract distributions/redemptions/withdrawals	(37,328)
IV	Adjustment for changes in valuation	(75,968) (a)
	Roll forward NAV 12/31/2010	$350,730

(a) Market changes included revised portfolio values and unrealized gains/losses:

Unrealized losses in marketable securities	($55,344)
Changes in value of PIPES (private investment in public equity securities)	287
Realized losses in private equities	(3,296)
Changes in portfolio companies:	
Pacific Exploration LLC (revaluation based upon recent financing)	22,530
Manatee Exploration LLC (revaluation due to revised projection)	12,855
Solid Entergy LP (revaluation due to poor financial results)	(53,000)
	($75,968)

Unit of Account

The ASC Master Glossary defines unit of account as "that which is being measured by reference to the level at which an asset or liability is aggregated (or disaggregated)." The unit of account in an alternative investment is the interest in the investee and not the underlying investments. The investor owns an undivided interest in the entire investee portfolio and does not have the ability to dispose of the individual assets and liabilities in the investee portfolio.

For purposes of applying NAV, the unit of account only reflects the outstanding ownership at the reporting date. As illustrated in Exhibit 1, the unit of account does not include the effects of contributions received in advance or the assumed conversion of any outstanding convertible securities.

Internal Controls and NAV

All reporting entities are responsible for measuring their investments in conformity with generally accepted accounting principles in their financial statements. In measuring alternative investments at NAV, the reporting entity fulfills this responsibility by determining whether the investee reports its assets and liabilities in a manner consistent with ASC 946, which includes the measurement of the underlying investments at fair value. Thus, reporting entities must have procedures to independently evaluate whether the investee fund manager has an effective process and related internal controls to estimate the fair value of its investments that are included in the calculation of NAV. TIS section 2220 provides guidance on internal controls relative to NAV.

These procedures include those performed before the initial investment ("initial due diligence") and those performed after the initial investment ("ongoing monitoring"). During both initial due diligence and ongoing monitoring, investees often provide information on the fair value of the immediate investee and the underlying investments, such as recent audited financial statements and reports detailing the reasons for the changes in fair value. Investors could confirm these valuations by obtaining the investee's recent audited financial statements or reliable information available from business information sources or on the Internet. Investors might also consider the following:

- The investees' fair value estimation processes and control environment, and any changes to those processes or the control environment;
- The investees' policies and procedures for estimating fair value of underlying investments, and any changes to those policies or procedures;
- The use of independent third-party valuation experts to augment and validate the investees' procedures for estimating fair value;
- The portion of the underlying securities held by the investees that are traded on active markets.

Investors also need to consider risk factors when evaluating the integrity of the data obtained from the investees by—

- obtaining the investees' recent audited financial statements;
- checking the professional reputation and standing of the investee's auditor;
- determining the reasons for qualifications, if any, of the auditor's report on the investees' financial statements;
- determining whether there is a history of significant adjustments to the NAV reported by the investees as a result of the annual financial statement audit or otherwise;
- determining whether the NAV has been appropriately adjusted for items such as carried interest and clawbacks;
- comparing historical realizations to last reported fair value; and
- obtaining a SAS 70 (*Service Organizations*) report on the entity providing management services to the investee.

While performing its due diligence, an investor may conclude that it cannot get comfortable with the NAV reported by the investee. For example, the investee's auditor may issue a qualified audit report pertaining to the valuation of the underlying investments. As illustrated in *Exhibit 3*, Alpha's auditor issued a qualified audit report on Alpha's financial statements, based on the inability to verify the fair value of a material investment. This situation is becoming more common given current uncertain economic conditions and the growth of investments in other countries, where fair values may not be readily available.

In the above example, Bravo would first have had to conclude whether Alpha is applying ASC 946 in preparing its financial statements. In this case, Alpha's auditor could not verify the fair value of a significant investment in Alpha's financial statements. In the author's opinion, Bravo should give greater credence to the professional opinion of Alpha's auditor and conclude that Alpha has not provided sufficient evidence that it is preparing its financial statements in conformity with ASC 946. Bravo could attempt to determine the fair value of that investment on its own and adjust Alpha's reported NAV accordingly. Bravo's access to such information would not be a common occurrence. The failure to measure the fair value of that investment or to conclude that Alpha is preparing its financial statements in conformity with ASC 946 would preclude Bravo from measuring its investment in Alpha at NAV.

This example has implications beyond the application of ASU 2009-12. One such implication is how Bravo should measure its investment in Alpha if it cannot use the NAV practical expedient. Such measurement issues are beyond the scope of this article, but could result in Bravo's own auditors issuing an opinion with a scope limitation reflecting uncertainty with the measurement of a material investment.

Classification in the Fair Value Hierarchy

The classification of the equity ownership interests measured at NAV in the fair value hierarchy must be disclosed in conformity with ASC 820-10. The fair value measurement is dependent on the ability to observe the information available, often called "inputs." FASB classifies inputs in the following fair value hierarchy:

EXHIBIT 3
Consideration of Auditor's Qualified Report on NAV

Alpha Partners LLP estimated the fair value of its investee, Manatee Exploration LLC, at $98,555,000, based on an updated projection. Alpha's auditor was not able to verify the valuation of Manatee, which represented 28.1% of Alpha's total partners' capital. Accordingly, the auditor issued a qualified audit report based on a scope limitation due to the lack of sufficient evidential matter.

At the same time, Alpha asserts its redemption gate, expressed in its partnership agreement, to withhold all redemption requests for six months because of liquidity issues. It appears the liquidity issues stem, at least in part, from the inability to sell any of the ownership interests in Manatee.

Questions about the value of Alpha arose for the first time in 2010. Alpha has no prior history of significant adjustments to the NAV as a result of the annual financial statement audit or otherwise. Previously, Bravo measured its investment in Alpha at NAV and classified that investment as a Level 2.

In evaluating the reasons for the audit report qualification, Bravo decides that it is not in a position to conclude that the available information and estimated values are measured consistent with ASC 946. The inability of the auditor to verify the values of Manatee, which reported an increase in fair value, suggests that hidden problems exist which may preclude any reasonable evaluation of the reported values. Unable to perform a reasonable evaluation of the reported values of a material portion of Alpha's portfolio, Bravo cannot use the practical expedient. Accordingly, Bravo could attempt to measure its investment in Alpha using the fair value methods presented in ASC 820. In addition, Bravo reclassifies its investment in Alpha from Level 2 to Level 3 to reflect the change from observable inputs to its own assumptions.

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, and values based on observable market information, such as interest rates and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates.
- Level 3 inputs reflect the reporting entity's own assumptions about those used by market participants in pricing the asset or liability (including assumptions about risk) based on the best information available under the circumstances.

In the authors' experience, reporting entities are placing increasing significance on the classification of the inputs as a result of concern over the liquidity of their investments. Inputs based on observable market data are deemed to be a higher level in the fair value hierarchy and are classified as either Level 1 or Level 2. Of the two, Level 1 inputs are the most reliable because they are based on quoted market prices in active markets for identical assets. Level 2 inputs are deemed less reliable because the actual market of the assets or liabilities in question is not active, requiring valuation by analogy with similar assets or consideration whether an inactive market with potentially wide swings in value reflects true market value or that certain observable data are valid indicators of value. If any significant assumptions used in the determination of value are not observable market data, the assets or liabilities are deemed to be Level 3, the lowest level in the fair value hierarchy.

Redemption restrictions are important in classifying the instrument in the fair value hierarchy. Reporting entities typically redeem their interest at NAV, which is based on the fair value of the underlying assets and liabilities calculated in a manner consistent with ASC 946. Thus, the

EXHIBIT 4
Sample Disclosure—Bravo Company

Note 1: Summary of Significant Accounting Policies (in part)
Investments in investment partnerships are valued at fair value, based on the applicable percentage ownership of the investment partnerships' net assets as of the measurement date, as determined by the board of directors. In determining fair value, the board of directors utilizes valuations provided by the investment partnerships. The investment partnerships value securities and other financial instruments on a fair value basis of accounting. The estimated fair values of certain investments of the investment partnerships, which may include private placements and other securities for which prices are not readily available, are determined by the board of directors or sponsor of the respective investment partnerships and may neither reflect amounts that could be realized upon immediate sale nor amounts that ultimately may be realized. Accordingly, the estimated fair values may differ significantly from the values that would have been used, had a ready market existed for these investments. The fair value of the fund's investments in investment partnerships generally represents the amount the fund would expect to receive if it were to liquidate its investment in the other investment partnerships, excluding any redemption charges that may apply.

Note 2: Fair Value Measurements of Financial Instruments (in part)
The following table sets forth additional disclosures of the company's investments whose fair value is estimated using net asset value per share (or its equivalent) as of December 31, 2010:

Investment	($000) Fair Value	Unfunded Commitment	Redemption Frequency	Redemption Notice Period
Common collective funds*	$ 45,296	$ –	Daily to monthly	None to 30 days
Investment partnerships**	56,238	–	Quarterly	90 days to six months
Total	$ 101,534	$ –		

* The common collective funds include investments in an international value equity fund. The international value equity fund is a private equity fund whose objective is to achieve long-term capital appreciation by investing substantially all of its assets in non-U.S. companies with market capitalization greater than $1 billion.

** The investment in investment partnerships includes restricted and unrestricted investments in hedge funds whose objective is to seek above-average rates of return and long-term capital growth through investments in private equity and private investment in public equity securities (PIPES). In addition, the hedge funds own marketable securities to provide liquidity when needed. Investments representing approximately 62% of the value of the investments in this class are subject to a redemption gate of up to six months at December 31, 2010. Whether an additional redemption gate will be asserted cannot be estimated.

redemption price is analogous to an exit price under ASC 820-10. Investments measured at NAV are classified in the fair value hierarchy using the following guidance:

- Reporting entities with the ability to redeem the investment at NAV per share at the measurement date shall categorize the fair value measurement as a Level 2.
- Reporting entities that never have the ability to redeem the investment at NAV per share at the measurement date shall categorize the fair value measurement as a Level 3.
- Reporting entities that do not have the ability to redeem the investment at NAV per share at the measurement date, but may redeem the investment at a future date, should consider such factors as the length of time before the investment becomes redeemable in determining whether they should categorize the fair value measurement as a Level 2 or Level 3.

Restrictions that permit redemptions at some future date include lockups, redemption gates, or unfunded capital commitments. Both lockups and redemption gates restrict the investor from exiting from the investment for a period of time, which creates illiquidity in the investment. Lockups restrict redemptions automatically. For example, many hedge funds routinely pay investors three months after requesting redemptions and only at specified times during the year, such as at the end of each quarter. Redemption gates are applied at the discretion of the investment fund and are designed to act as a brake to any run on the fund. Capital commitments may preclude redemption because they obligate the investors to increase their investment.

Reporting entities that have the contractual and practical ability to redeem their investments at NAV in the near term may classify those investments at Level 2. Near term is defined as a redemption period of 90 days or less. Thus, the mere existence of redemption gates would not affect the classification of those investments as long as the investee does not assert those gates. However, the likelihood or actual imposition of the gates may influence the determination of whether the investment is redeemable in the near term and cause the investment to be classified as Level 3. For example, assume that Alpha receives an unqualified audit report, but decides to impose a six-month gate for the first time in 2010. In that case, Bravo would classify its investment in Alpha as Level 3.

Many alternative investments require a lockup or assert a redemption gate for part of the investment. Applying the example in the previous paragraph, Alpha could require a 90-day notice for 60% of the investment and assert a six-month redemption gate for the remaining 40%. In the absence of specific guidance, an approach that has been taken is to classify the two portions of the investment in different levels within the fair value hierarchy as follows: Bravo would classify \$21.044 million, or 60% of its \$35.073 million investment in Alpha, as Level 2 and the remaining \$14.029 million (40%) as Level 3.

Reporting entities are required to disclose the nature and risks of alternative investments and whether the investments are likely to be sold at amounts different from NAV.

Reporting entities may hold alternative investments whose redemption features would justify a classification of Level 2 when the underlying securities are classified as Level 3. In this situation, a Level 2 classification may be appropriate because the ability to honor a redemption request is not necessarily affected by the observability of the inputs used to measure the underlying investments.

Disclosures

Reporting entities are required to disclose the nature and risks of alternative investments and whether the investments are likely to be sold at amounts different from NAV. Accordingly, the reporting entity should determine each major category of investment based on the nature and risks of the investments and disclose the following during each interim and annual period:

- The fair value of the investments in each major category and a description of the significant investment strategies;
- For each major category of investments, an estimate of the period of time over which the underlying assets are expected to be liquidated for investments that can never be redeemed, but for which the reporting entity is receiving liquidating distributions;
- The amount of the reporting entity's unfunded commitments related to investments in each major category;
- A general description of the terms and conditions upon which the investor may redeem investments in each major category (for example, quarterly redemption with 60 days' notice);
- The circumstances in which all or part of otherwise redeemable investments in a major category might not be redeemable, the expected expiration of any restrictions, and how long the restriction has been in effect. This includes investments subject to a lockup or redemption gate;
- Any other significant restriction on the ability to sell investments in the major category at the measurement date;
- The total fair value of all investments that will probably be sold for an amount different from NAV and any remaining actions required to complete the sale;
- Any plans and remaining actions to sell investments at amounts different from NAV, but where the specific investments have not yet been identified, so the investments continue to be measured at NAV.

Bravo's disclosure is presented in *Exhibit 4*.

Although ASU 2009-12 is presented as a practical expedient, both preparers and auditors of financial statements still need to analyze and evaluate their alternative investments. Changes in circumstances—many out of the reporting entity's control—may cause the practical expedient to no longer be available or cause a change in the reported level in the fair value hierarchy. ❑

Matthew Crane, CPA/ABV, *is a valuation specialist at McGladrey & Pullen, LLP, New York, N.Y.* ***Robert A. Dyson, CPA,*** *is a director, also with McGladrey & Pullen, LLP, and a member of* The CPA Journal *Editorial Board.*