

MEMO# 19298

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FASB ISSUES WORKING DRAFT OF FORTHCOMING STANDARD ON FAIR VALUE MEASUREMENTS

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ACCOUNTING/TREASURERS COMMITTEE No. 18-05 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 39-05 SEC RULES COMMITTEE No. 58-05 RE: FASB ISSUES WORKING DRAFT OF FORTHCOMING STANDARD ON FAIR VALUE MEASUREMENTS The Financial Accounting Standards Board recently issued a working draft of its forthcoming accounting standard on fair value measurements.¹ The forthcoming accounting standard would amend generally accepted accounting principles and would apply to all entities that prepare GAAP-based financial statements, including investment companies. The standard would apply broadly to financial and non-financial assets and liabilities that are required to be measured at fair value under existing accounting standards. We are pleased to report that the Working Draft reflects many of the Institute's recommendations in its comment letter on the Board's original proposal.² In particular:

- The Working Draft clarifies that securities traded on multiple exchanges should be valued by reference to the principal market (i.e., the market where the preponderance of transactions take place).
- The Working Draft clarifies that securities traded in over-the-counter dealer markets may be valued at the bid price or a price within the bid-ask spread that provides an estimate of the price at which market participants would currently transact, consistently applied.

¹ Statement of Financial Accounting Standards, Fair Value Measurements, (October 21, 2005) (the "Working Draft"). The Working Draft is posted on the FASB website

http://www.fasb.org/project/fvm_working_draft_standard.pdf. ² See Institute Memorandum to Accounting/Treasurers Members No. 32-04, Closed-end Investment Company Members No. 60-04, SEC Rules Members No. 128-04 [No. 17960], dated September 8, 2004. ² • The Working Draft precludes application of block discount factors to readily available market prices for unrestricted securities. The Working Draft notes that adjusting market prices for the size of the position introduces management intent (to trade in block size) into the valuation process, reducing comparability. • The Working Draft precludes adjusting the current market price for expected transaction costs (e.g., brokerage commissions to be incurred on disposal). Fair Value The Working Draft defines fair value as the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability. A current transaction is not a forced or distress sale. Rather, a current transaction is an orderly transaction that assumes adequate exposure to the market. Marketplace participants are entities that are independent, knowledgeable, and have legal and financial

ability to transact. The reference market is the most advantageous market in which the entity would transact. Valuation Techniques The Working Draft retains the original proposal's three valuation techniques. In particular, the "market approach" uses observable prices and other relevant information generated by market transactions. The "income approach" converts future amounts (e.g., cash flows or earnings) to a single discounted present value amount. The "cost approach" is based on the amount that would be required to replace an asset in service (i.e., replacement cost). Valuation techniques used to estimate fair value should maximize the use of market inputs and minimize the use of entity inputs. Fair Value Hierarchy The fair value hierarchy distinguishes between the inputs to valuation techniques used to estimate fair value, considering the relative reliability of the inputs. While the original proposal contained three levels within the proposed fair value hierarchy, the Working Draft contains five levels. • Level 1 inputs are market inputs that reflect quoted prices for identical assets or liabilities in active markets. The Working Draft clarifies that matrix pricing is a pricing method within Level 1. • Level 2 inputs are market inputs that reflect quoted prices not encompassed within Level 1, that is, (a) quoted prices for identical assets or liabilities in markets that are not active and (b) quoted prices for similar assets or liabilities in all markets, regardless of the level of activity. • Level 3 inputs are market inputs other than quoted prices (e.g., interest rates, yield curves, volatilities, default rates, etc.). • Level 4 inputs are market inputs that are not directly observable for the asset or liability but that are corroborated by other market data through correlation. Examples include inputs that are derived through extrapolation. 3 • Level 5 inputs are entity inputs. Examples include inputs derived through extrapolation but that are not corroborated by other market data. Disclosure Requirements Similar to the original proposal, the Working Draft requires disclosure of the amount of assets remeasured at fair value on a recurring basis as of the reporting date, in total and as a percentage of total assets. In addition, the Working Draft requires disclosure of where within the fair value hierarchy the fair value estimates fall, segregating those estimates that fall within Level 1, Levels 2-4, and Level 5. Fair value estimates for restricted securities would typically fall within Levels 2-4. Effective Date The Fair Value Measurements standard will be effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. However, the disclosure requirements will be effective for financial statements issued for fiscal years ending after December 15, 2006. Final Standard to be Issued During Fourth Quarter The Working Draft will be available on the FASB website through November 21, 2005. While the Board is not formally seeking comments at this time, they will consider any comments provided by interested parties. If you have any comments on the Working Draft, please contact the undersigned at 202/326-5851 or smith@ici.org. Gregory M. Smith Director - Operations/Compliance & Fund Accounting