Section 6910, *Investment Companies*

.42 Presenting Financial Highlights Under the Liquidation Basis of Accounting for an Investment Company[1]

Inquiry—Should an investment company present total return or internal rate of return (IRR) after adopting the liquidation basis of accounting? Should an investment company present net investment income or expense ratios after adopting the liquidation basis of accounting?

Reply—Once an entity adopts the liquidation basis of accounting, the entity is required to present, at a minimum, a statement of net assets in liquidation and a statement of changes in net assets in liquidation. In addition, FASB ASC 205-30-50-1 states that an entity shall make all disclosures required by other topics that are relevant to understanding the entity's statement of net assets in liquidation and statement of changes in net assets in liquidation. The disclosures shall convey information about the amount of cash or other consideration that an entity expects to collect and the amount that the entity is obligated or expects to be obligated (in the case of the accruals described in paragraphs 6–7 of FASB ASC 205-30-25) to pay during the course of liquidation. Upon adoption of the liquidation basis of accounting, an entity accrues estimated costs and income and recognizes assets that it might not have previously. Subsequent to the adoption of the liquidation basis of accounting, an entity shall remeasure its assets and liabilities (if required under the relevant topic for those liabilities) and the accruals of disposal or other costs at period end.

In determining whether financial highlights should be presented for periods subsequent to the initial application of the liquidation basis of accounting, the reporting entity should consider whether and how the accrual of costs and income and recognition of other assets that were recorded as of the adoption of the liquidation basis (for example, the cumulative-effect adjustment) would affect the financial highlights information and whether the result would be meaningful to a user of the entity's financial statements.

The board noted in paragraph BC13 of ASU No. 2013-07 that "…financial statements that are prepared using the liquidation basis of accounting provide users of those financial statements with specialized information because the **emphasis shifts from reporting about the entity's economic performance and position to reporting about the amount of cash or other consideration that an investor might reasonably expect to receive after liquidation**…" [emphasis added]. Accordingly, given the shift in focus (and measurement basis of assets and some liabilities), an entity should consider whether financial highlights continue to be relevant and useful to understanding the entity's statement of net assets in liquidation or statement of changes in net assets in liquidation. Financial highlights information may no longer be relevant and useful in understanding the liquidation basis statements. Additionally, if the financial highlights are deemed necessary, consideration should be given to whether different descriptions or disclosures should be used, rather than those that are used for going concern financial statements of investment companies.

Factors to consider when determining whether total return is relevant to understanding the entity's statement of net assets in liquidation or statement of changes in net assets in liquidation may include the following:

[1] See footnote 1.

- How does the use of liquidation basis of accounting by the investment company affect comparability of the total return, and is the resulting performance information relevant and informative?
- Will the total return be meaningful on a comparative basis given that certain income and costs are accelerated, and other assets may be recorded as of the adoption of the liquidation basis of accounting?
- Would total return for the liquidation period be relevant and meaningful for the users of financial statements in understanding the changes in net assets in liquidation?
- What additional disclosures would be necessary when presenting total return under the liquidation basis of accounting for a user of the financial statements to understand the differences between the going concern basis total return and the liquidation basis amounts?

  IRR is less likely to be the performance measure used by a fund applying the liquidation basis of accounting because many private equity, venture capital, and real estate funds have a plan of liquidation in their governing documents at inception. However, when IRR is the performance measure used by a fund in liquidation because IRR is a cash-based metric, it would generally be more relevant than total return to users of investment company liquidation basis financial statements. IRR is based on the timing of cash inflows and outflows from investments, and the liquidation value of the asset is based on the amount of cash or other consideration that an investor might reasonably expect to receive.

Factors to consider when determining whether net investment income or expense ratios are relevant to understanding the entity's statement of net assets in liquidation or statement of changes in net assets in liquidation may include the following:

- Under the liquidation basis of accounting, income and costs and other assets would be accrued as of the adoption of the liquidation basis. Consider whether and how any cumulative-effect adjustment would be included in ratio information and whether users of the financial statements would find such information meaningful given the change in recognition of income and expense.
- Would the changes in estimated income and costs recorded in the statement of changes in net assets in liquidation after adoption of liquidation basis be relevant and useful in the form of income and expense ratios? Often, users of the financial statements will use such information to compare investment companies or determine whether the investment company is operating consistent with its investment objective. However, such use of financial highlights information may no longer be relevant as a result of the liquidation.
- Are additional disclosures necessary when presenting the net investment income and expense ratios in liquidation basis financial statements for those metrics to be meaningful?

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