

Section 6910, *Investment Companies*



.43 **Accrued Income When Using the Liquidation Basis of Accounting¹**

Inquiry—FASB ASC 205-30-25-7 states that an entity should accrue costs and income that it expects to incur or earn through the end of its liquidation if and when it has a reasonable basis for estimation. Would an investment company accrue income related to estimated earnings on the investments held by the investment company?

Reply—Income for investment companies is generally derived from investments that are measured at fair value under the going concern basis of accounting. Fair value may be determined based on the discounted value of cash payments expected to be received. Under the liquidation basis of accounting, FASB ASC 205-30-30-3 requires that the income be accrued on an undiscounted basis.

FASB ASC 205-30-30-1 requires an entity to measure assets to reflect the estimated amount of cash or other consideration that it expects to collect in settling or disposing of those assets (liquidation value) in carrying out its plan for liquidation. In some cases, fair value may approximate the amount that an entity expects to collect. However, an entity shall not presume this to be true for all assets.

Due to the inherent uncertainty in determining the cash to be received upon selling an investment, an entity's best estimate of the liquidation value of an investment may be equal to (or derived from) its current fair value. An entity is not precluded from using fair value to measure its assets in liquidation as long as it represents the best estimate of liquidation value. However, if, for example, a less liquid investment is expected to be disposed of in a short time at a discount to its fair value, that estimated liquidation value should be recorded upon adopting the liquidation basis. Regardless of the valuation method used, management should be careful to accrue the costs to dispose of its investments, such as commissions, as required by FASB ASC 205-30-25-6.

FASB ASC 205-30-25-7 requires an entity to accrue income that it expects to earn through the end of liquidation, if and when it has a reasonable basis for estimation. Evaluating whether an entity has a reasonable basis for estimating investment income is specific to an entity's particular circumstances and the nature of the investment. Factors that could be considered when making this evaluation include investment-specific characteristics (for example, credit quality, leverage rate, operating expectations, dividend history and expectations), general market conditions (for example, market interest rates, investor sentiment), and the estimated disposal date for the investment. Although it is generally more likely that an entity may have a reasonable basis to estimate income from a fixed income security rather than from an equity security, an investment company should consider whether it has a reasonable basis to estimate income from all types of investments.

For example, an entity may determine that fair value is the best estimate of liquidation value. In addition, an entity may conclude it has a reasonable basis to estimate interest income on a fixed income security based on the contractual nature of the income stream, its analysis of the credit quality of the issuer, general market conditions, and its expected disposal date. Although the fair value of the fixed income security generally

¹ See footnote 1.

includes the discounted future interest payments, FASB ASC 205-30-30-3 requires that the income be accrued on an undiscounted basis. If the entity expects to liquidate the investment in a short period of time, it may determine that the accrual of income on an undiscounted basis is not material. In considering whether and for what period to accrue income upon adoption of the liquidation basis of accounting, an entity may not be able to reasonably estimate the precise date of disposal for each of its investments. However, the entity may be able to reasonably estimate the minimum time it plans to hold these investments until it begins to dispose of them. These estimates should be reevaluated at each reporting date. If upon entering liquidation, an entity expects to dispose of an investment at a future date and uses fair value as its best estimate of liquidation value because, for example, it does not have a reasonable basis to determine the proceeds from investment disposal, management should carefully consider the net effect of 1) the income accrual already reflected in the fair value measurement and 2) the effect of discounting all other future cash flows from the expected disposal date to the date the entity entered liquidation, because such amounts should be removed from the fair value.

If the entity determines that fair value is its best estimate of liquidation value, that fair value and liquidation value would represent only the amount the entity expects to collect on the future disposal date, and the entity may still need to accrue the income from the date that liquidation became imminent until that future disposal date.

It may be possible for an entity to perform an analysis of the overall portfolio based on the premiums or discounts on securities, expected time to disposition, and estimated changes in yield to determine whether the difference between liquidation value and fair value could be material and whether to perform a more detailed calculation. Liquidity, credit quality, and other factors may also need to be considered.

Paragraphs 1–2 of FASB ASC 205-30-50 require certain disclosures to be made. In particular, the investment company would be required to disclose the type and amount of income accrued in the statement of net assets in liquidation and the period over which that income is expected to be collected or earned.

Example

Assume that an investment company with a December 31 year-end has one fixed income investment. The investment company determines that liquidation is imminent on January 1, 2015, and the entity, after consideration of factors specific to its security and general market conditions, will likely dispose of its investment on December 31, 2015. The fixed income instrument matures in 15 years on December 31, 2029, has a par value of \$100, and a coupon of 10 percent per annum paid annually on December 31. The current market rate of interest (yield) for the fixed income investment is 9 percent. On January 1, 2015, when liquidation is determined to be imminent, the fair value of the fixed income investment is determined to be \$108.06. The fair value was determined by discounting the future cash flows at the market rate of interest as follows:

Present value of cash flows discounted at 9% on January 1, 2015	Cash Flows	
	December 31, 2015 to 2028	December 31, 2029
\$108.06	\$10/year	\$110

On January 1, 2015, the investment company estimates the expected sales proceeds on the date it expects to dispose of the fixed income investment (December 31, 2015) as the discounted value of the cash flows of the security expected to be received subsequent to December 31, 2015. The investment company concludes that 9 percent (the current market rate) is the best estimate of the market rate for this investment as of December 31, 2015. Based on this determination, the estimated sales proceeds (or liquidation value) are \$107.79, calculated as follows on January 1, 2015, for expected disposition on December 31, 2015:

Present value of future cash flows discounted at 9% as of December 31, 2015	Estimated Cash Flows as of January 1, 2015	
	December 31, 2016 to 2028	December 31, 2029
\$107.79	\$10/year	\$110

In this example, the fair value (as of January 1, 2015) and the liquidation value (estimated sales proceeds at December 31, 2015) are different due to the cash flows incorporated into each calculation, the difference between the coupon rate and the current market rate, and fact that the cash flows are being discounted over different periods. As the expected disposition date is December 31, 2015, the cash flow occurring on this date is not incorporated into the liquidation value.

After arriving at liquidation value, the investment company also concludes, for this security, that it has a reasonable basis to estimate the interest income through liquidation and accrues, as of January 1, 2015, the undiscounted interest coupon payment of \$10, expected to be received during the period from January 1, 2015, to expected disposition on December 31, 2015. As a result, on January 1, 2015, the investment company would measure its total position (investment and accrued interest income) at the amount of cash it expects to receive

during the period through liquidation on December 31, 2015 of \$117.79. (The \$10 coupon payment is recorded as accrued income, and the \$107.79 of expected sales proceeds from disposition of the fixed income investment would be recorded as the liquidation value of the security). Other approaches for estimating the liquidation value of the security (or a portfolio of similar securities) at the expected disposition date may be acceptable, but an entity should ensure that its liquidation basis financial statements reflect (a) the entity's best estimate of the cash expected to be collected at the disposition of the security, and (b) the expected future income from the date liquidation became imminent through the expected disposition date, when the entity has a reasonable basis to estimate that amount.

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