

# The Treasurers' Report

Q4 2012

## Update on ASU 2011-04

The ASU requires disclosure of the amounts of any transfers between Level 1 and Level 2, and the reasons for the transfers.<sup>1</sup> Before the ASU, Topic 820 required disclosure of significant transfers between Level 1 and Level 2 and the reasons for the transfers.

The June 30, 2012 Annual and Semiannual reports prepared by J.P. Morgan are typically presenting the values of the transfers in footnotes to the fair valuation / leveling table currently included in the shareholder report.

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<sup>1</sup> FASB Accounting Standards Update 2011-04, page 61

The ASU requires disclosure of quantitative information about the significant unobservable inputs used for level 3 securities and states that a reporting entity is not required to create quantitative information to comply with this disclosure requirement if quantitative unobservable inputs are not developed by the reporting entity (for example, when the entity uses third-party pricing information without adjustment). However, when providing this disclosure, a reporting entity cannot ignore quantitative unobservable inputs that are significant to the fair value measurement and are reasonably available to the reporting entity. Entities that receive vendor pricing are not excluded from this requirement if the relevant information is available from the vendor. The guidance suggests a tabular disclosure by class of financial instrument, indicating for each class: the fair value, the valuation technique, a general description of the types of inputs used, and a quantitative range for each type of input.<sup>2</sup>

For Level 3 fair value measurements, the ASU requires a description of the valuation processes used by the reporting entity (including, for example, how an entity decides its valuation policies and procedures and analyzes changes in fair value measurements from period to period).<sup>3</sup>

For Level 3 fair value measurements, the ASU requires a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement. If there are

interrelationships between those inputs and other unobservable inputs used in the fair value measurement, the entity must also provide a description of those interrelationships and of how they might magnify or mitigate the effect of changes in unobservable inputs on the fair value measurements.<sup>4</sup>

The ASU does not require a Level 3 measurement uncertainty analysis. The ASU does, however, require a narrative description of the sensitivity of Level 3 fair value measurements to changes in unobservable inputs.<sup>5</sup>

The June 30, 2012 annual and semiannual reports prepared by J.P. Morgan that are presenting the quantitative information are using a format similar to the example below as presented in the ASU. Many clients are applying a materiality threshold of the market value of level 3 securities to total market value to determine if the quantitative information will be presented. These thresholds are ranging from 1-3% of total market value.

	Fair value at 12/31/2011 (amounts in thousands)	Valuation Technique(s)	Unobservable Input(s)*	Range
<b>Residential mortgage-backed securities</b>	\$10	Discounted cash flow 3.5%	Constant prepayment Probability of default Loss severity	3.5% - 5.5% 5% - 50% 40% - 100%
<b>Common stocks</b>	\$10	Market comparable companies	EBITDA multiple Revenue multiple	6.0% - 12.0% 5.0% - 20.0%
		Negotiated discount	Discount for lack of marketability	5.0% - 20.0%
<b>Credit Contracts</b>	\$10	Option model	Counter-party credit risk	0.5% - 3.5%
	<b>\$30</b>			

## CFTC Regulation 4.5 - Commodity Pool Operator Registration

The Commodity Futures Trading Commission has adopted rules amending the Part 4 regulations. These new rules require that investment advisors of certain registered investment companies register as Commodity Pool Operators ("CPO"). The new rules reinstate trading criteria for registered investments

companies claiming exclusion from the CPO definition previously in force, add an alternative trading threshold based on net notional value of commodity interest positions and reinstate trading criteria for registered investments companies claiming exclusion from CPO registration under the "Deminimis Rule".<sup>6</sup>

## Reporting and Recordkeeping Requirements

Registration as a CPO imposes reporting and recordkeeping requirements under Part 4 of the CFTC's regulations. CPOs and CTAs are required to file reports regarding their direction of commodity pool assets. These reports must include a description of certain information, such as the amount of assets under management, use of leverage, counterparty credit risk exposure, and trading and investment positions for each pool.

Specific financial reporting requirements under §4.22 of the CFTC's regulations would require funds to produce a

certified monthly report to shareholders (an "Account Statement") consisting of a statement of operations and a statement of changes in net assets. If the fund has \$500,000 or less in net assets at the beginning of the fund's fiscal year, reports are required on a quarterly basis. Most of the information required in the Account Statement is included in funds' semi-annual and annual shareholder reports as required by the Securities and Exchange Commission ("SEC").

<sup>2</sup> FASB Accounting Standards Update 2011-04, page 62

<sup>3</sup> FASB Accounting Standards Update 2011-04, page 63

<sup>4</sup> FASB Accounting Standards Update 2011-04, page 64

<sup>5</sup> FASB Accounting Standards Update 2011-04, page 184

<sup>6</sup> Federal Register 77 FR 11345

The following are some key differences between the Account Statement that would be required under section 4.22 and SEC-required shareholder reports.

- Account Statement includes brokerage commissions on portfolio trades as an expense in the statement of operations. For SEC-registered funds, brokerage commissions are embedded in the cost basis of the security and captured in the gains and losses of the security. They are not shown as a separate expense in the statement of operations or the expense ratio. The Account Statement also includes the total amount of other fees for commodity interest and other investment transactions during the reporting period.
- Account Statement must be provided to shareholders (proposed relief allows this requirement to be met by posting the Account Statement on the fund's website) not more than 30 days after month end. Funds have 60 days after the end of the reporting period to file their shareholder reports with the SEC and send them to shareholders.
- Account Statements must be prepared twelve times per year versus two times per year for SEC-required shareholder reports.
- Account Statements must be certified using CFTC language as shown in CFTC §4.22(h) or, under the Harmonization Proposal, funds may opt to use the SEC's certification language. The SEC's certification language is more extensive.

The new reporting requirements will become effective on July 2, 2012. The compliance dates for reporting are as follows:

- 60 days after the end of CPOs first calendar quarter ending after July 2, 2012 for CPOs having at least \$5 billion in assets under management;

- 60 days after the end of CPOs first calendar quarter ending after December 14, 2012 for all other Large CPOs with assets of \$1.5 billion; and
- 90 days after calendar year end 2012 for all other CPOs and CTAs.

### Proposed ASU on the Liquidation Basis of Accounting

The FASB is proposing amendments that would require an entity to prepare its financial statements using the liquidation basis of accounting when liquidation is imminent. The proposal defines a liquidation plan as being imminent when a plan for liquidation "as been approved by the person or persons with the authority to make such a plan effective and the likelihood is remote that the execution of the plan will be blocked by other parties" or "a plan for liquidation is imposed by other forces".<sup>7</sup>

The proposal clarifies measurement and accrual requirements. Assets and liabilities are to be presented reflecting the estimated amounts of cash or other consideration expected to be collected or paid to carry out the plan of liquidation. Any estimated costs incurred to dispose of assets or liabilities should be accrued and presented separately from the measurement of the assets and liabilities. All other expenses and income that are expected to be incurred should be accrued through the anticipated date of liquidation. Accruing expected income and expense amounts through liquidation date is currently best practice in fund reporting.

The proposal solidifies disclosure items specific to the liquidation.

- That the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the

adoption of the liquidation basis of accounting.

- A description of the entity's plan for liquidation, including, at a minimum, a description of the manner by which the entity expects to dispose of its assets and liabilities and the expected duration of the liquidation.
- The methods and significant assumptions used to measure assets and liabilities, including subsequent changes to those methods and assumptions. Significant methods and assumptions might include, for example, the nature and source of expected future cash flows and discount rates used.
- The type and amount of costs and income accrued in the statement of changes in net assets in liquidation.

Liquidating funds have typically included the first two of these disclosures. The measurement methods, including subsequent changes to those methods, have been included in funds' ASC 820 disclosures. Specific disclosures relating to specific costs associated with the liquidation may be added to fund notes to financial statements to supplement other required GAAP disclosures.

<sup>7</sup> Proposed Accounting Standards Update "The Liquidation Basis of Accounting" issued July 2, 2012.

## ASC 815 and 820 Client Census Data

J.P. Morgan has surveyed 13 financial reporting clients' fair valuation and derivative volume disclosure elections. Our results are as follows.

	Clients presenting the disclosure in a note to the schedule of investments	Clients presenting the disclosure in the notes to financial statements	
ASC 820 Valuation Summary Location	1	12	
	Beginning Balance Method	Ending Balance Method	
ASC 820 Three Roll Forward Transfer Methodology	12	1	
	Clients stating that current positions are typical of volume throughout the period	Clients presenting an average monthly notional value	Clients presenting an average quarterly value
ASC 815 Volume Metric	4	8	1

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