Investment Companies Expert Panel

Highlights of the January 17, 2017 Meeting

The Investment Companies Expert Panel serves the needs of AICPA members on financial and business reporting and audit and attest matters. The expert panel protects the public interest by bringing together knowledgeable parties in the investment companies industry to deliberate and come to agreement on key investment companies issues.

The following are brief highlights of the meeting:

I. AICPA/Administrative:

1. The Expert Panel (EP) September and November 2016 meetings highlights are being finalized.
2. The AICPA staff updated the EP on recent developments regarding the AICPA Asset Management Revenue Recognition Task force.
3. The AICPA Publications staff informed the EP about status of interim review of conforming changes to the 2017 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. The EP members and staff discussed status of the following topics:
   a. Accounting for Convertible Bonds.
   b. RDFV.
2. FASB Accounting Standards Update 2016-19—*Technical Corrections and Improvements*, amended Topic 820, *Fair Value Measurement*, to clarify the difference between a valuation approach and a valuation technique when applying the guidance in that Topic and require an entity to disclose when there has been a change in either a valuation approach and/or a valuation technique. For the March 2017 conference call, the EP agreed to identify factors to consider in applying the amended guidance and document them in future meeting highlights.
3. At the November EP meeting, one EP member discussed that questions have arisen regarding how the accounting for convertible debt with “cash conversion features” impacts the net asset value (NAV) per share of a business development company (BDC). Certain BDCs have considered issuing bonds with an investor option to convert the bonds into a fixed number of the issuer’s common equity shares. If the investor elects to convert, the BDC has the option to settle the instrument in cash, shares, or a combination of cash and shares. These instruments are commonly known as “Instrument X” convertible securities. FASB ASC 470-20 provides guidance for convertible instruments, which is applicable to all entities. For these types of instruments (such as Instrument X) the guidance requires that the issuance proceeds be bifurcated into liability and equity components and provides specific guidance on how issuance proceeds are allocated to the debt instrument and to the

equity feature. Unlike the accounting for convertible bonds that do not have cash settlement features, a portion of the issuance proceeds are allocated to equity. As a result, the net assets of the BDC (assets – liabilities) increase day one.

The EP discussed several questions relating to the computation and financial statement presentation of NAV per share (1) upon issuance, (2) upon settlement, and (3) between issuance and settlement.

At the January 2017 conference call, the EP revisited this topic and several EP members expressed a view that the NAV per share of a BDC should not reflect an increase in the net assets upon issuance of an Instrument X even though an allocation to equity is required. However, due to the unique nature of these instruments, registrants are strongly encouraged to discuss these arrangements with the SEC staff.

4. The EP discussed a situation where a fund participates in a private investment in public equity (PIPE) offering and receives warrants that are only exercisable to the extent the Company that issued the PIPE loses a law suit and has to pay a claimant an amount above its insurance coverage. The EP member inquired whether the entity would treat this as a gain contingency (and hence not record any value for the warrant) or as a financial instrument recorded at fair value.

During the January 2017 conference call, the EP noted that in this particular case involving a PIPE offering, the fund received a financial instrument, specifically a warrant, as part of its participation in the PIPE offering. The recipient of the warrant paid the purchase price of the PIPE, knowing that a financial instrument would be received that may have value in the future if a company loses a law suit and pays amounts in excess of insurance coverage. Therefore, the EP members believed the entity would account for the warrant as a financial instrument and the contingency would be considered when estimating its fair value.

5. The EP was made aware that on September 17, 2015, the Internal Revenue Service (IRS) released regulations under Section 871(m) of the Internal Revenue Code (Code) that may create new taxes for foreign investors in investment companies. The regulations prescribe rules for treating "dividend equivalent payments" with respect to US equities as US source dividend income subject to US tax information reporting and withholding for foreign investors. These regulations will have a significant impact on investment companies whose portfolios contain instruments linked to US equities, including a broad range of equity derivatives as well as equity-linked notes and convertible debt instruments. Both the long and the short party to the transactions in scope of new regulations are jointly and severally liable for the tax. An investment company may be a withholding agent that will be making a payment to the IRS in some circumstances. Some provisions of the new rules are effective for certain transactions beginning January 1, 2017.

The EP considered whether the withholding tax under 871(m) is an income tax of the fund and therefore should be accounted for in accordance with ASC 740 or a tax assessed on individual foreign investors of the fund, whereby the fund is acting as a withholding agent on behalf of such investors. The EP generally agreed that the determination would depend on whether the foreign investors have the ability to utilize the withholding tax payment made by the fund on their behalf as a payment against their personal income tax, if they were to file a tax return. If the investors are able to claim taxes paid on their tax returns, then the withholding is likely not an income tax of the fund. Regardless of whether or not the withholding tax under 871(m) is considered an income tax of the fund, the EP generally agreed that it would be appropriate to recognize a liability when the fund is the withholding agent.

EP members also generally agreed that the reporting entity should account for other cash flows that arise under a derivative transaction as a result of the 871(m) withholding tax separately from the fair value of the derivative contact itself because these other cash flows are investor, rather than instrument, specific. However, a reporting entity would need to determine whether a market participant would consider these cash flows when determining fair value.

Finally, EP members discussed whether the withholding tax under 871(m) should be accounted for as a deduction from the relevant income item in accordance with ASC 946-225-45-3 (g) and (h) or as a distribution to investors. The EP agreed that the presentation depends on whether the withholding taxes are considered income taxes of the fund or taxes assessed on foreign investors of the fund.

EP members agreed to revisit the topic at the March 2017 conference call.

6. In the venture capital or private equity industries, a fund may sell an investment in a portfolio company, and, as part of the sales agreement, may be entitled to consideration contingent on how the portfolio company performs in the future. The question of how to record earn-outs had been raised at the April 2010, March 2012, and November 2015 EP meetings. The EP agreed that measurement of earn-outs was an accounting policy election. Specifically, the EP believes that it is a policy election which may allow for:

- measuring at fair value (and subsequent remeasurement at fair value with changes reflected in the income statement) as the consideration meets the definition of a financial instrument (and may be considered an investment/continuing investment in the portfolio company) and investment companies are required to fair value their investments; or
- accounted for as a gain contingency and therefore recorded only when realized.

Certain venture capital funds have been selling their investments in portfolio companies in which a substantial portion of the proceeds are received from earn-outs. At the January 2017 conference call, the EP considered how the fund should relieve the cost basis of the original investment in recognizing realized gains or losses in situations in which the fund has an accounting policy of measuring the earn-out at fair value. The following examples illustrate two possible alternatives:

Fact pattern:

- Fund owns an investment in a portfolio company which has a fair value of $10,000,000 and a cost basis of $4,000,000.
- In year 1, the fund sells its investment in the portfolio company for cash proceeds of $2,000,000 (20% of fair value) and an earn-out which is valued at $8,000,000 (80% of fair value).
- In year 2, the fund receives $12,000,000 in final payments from the earn out.

Possible alternatives:

1. Account for the initial proceeds as a <u>complete</u> sale of the investment. In year 1, the fund would recognize a realized <u>loss</u> of $2,000,000 (proceeds of $2,000,000 less cost basis of $4,000,000). The fund would also recognize a financial instrument/investment of $8,000,000 with zero cost basis. In year 2, the fund would recognize a realized <u>gain</u> of $12,000,000 (proceeds of $12,000,000 less cost basis of $0).
2. Account for the initial proceeds as a <u>partial</u> sale of the investment. In year 1, the fund would recognize a realized <u>gain</u> of $1,200,000 (proceeds of $2,000,000 less $800,000 which is 20% of the original cost basis). The fund would also recognize a financial instrument/investment of $8,000,000 with a cost basis of $3,200,000 which is 80% of the original cost basis. In year 2, the fund would recognize a realized <u>gain</u> of $8,800,000 (proceeds of $12,000,000 less cost basis of $3,200,000).

The EP members discussed that historically, most fund complexes record the initial sale of the investment as the full realization event, regardless of the existence of the contingent consideration. While this viewpoint may generally be acceptable, in light of circumstances where the contingent consideration makes up a majority of the sales proceeds, the EP members noted that removal of the entire cost balance with the initial sale should be evaluated based on facts and circumstances. If the reporting entity were to assign value to the contingent consideration upon the sale of the asset, a pro rata amount of the cost may be allocated to the contingent consideration and relieved at such time that the contingent consideration is received.

7. The EP held a separate conference call in January 2017 on accounting for variation margin for certain centrally cleared swaps. The EP was made aware that in 2016, the Chicago Mercantile Exchange (CME) and LCH.Clearnet Limited (LCH) have amended their rulebooks to legally characterize variation margin payments for over-the-counter derivatives they clear as settlements rather than collateral. The CME rule changes were effective January 3, 2017, and, therefore, would not affect 2016 financial statements of entities with calendar year ends. LCH changed its rules in 2016, but counterparties can elect whether and when to apply the change. The EP members discussed financial reporting implications of this change, as well as the historical accounting for futures, and will revisit this topic at the March EP conference call.

III. Audit and Attest Issues

1. The AICPA staff updated the EP on recent developments regarding potential dual reporting for certain attestation reports included in the Guide.

IV. SEC Staff Update

Disclaimer

The following comments and observations were compiled by the AICPA Investment Companies Expert Panel and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The comments and observations were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff.

The SEC Chief Accountant and Assistant Chief Accountants for the Division of Investment Management (the "SEC staff") joined the EP conference call to discuss the following questions presented by the EP members and share additional observations:

1. The EP sought the SEC staff's views regarding presentation of beginning NAV per share in the per share rollforward. Prior to adoption of the floating NAV, the NAV/share was presented to 2 decimal places. For example, if a fund's ending NAV/share in the prior year was $0.9992, it would have been presented at $1.00 in prior year financial statements. The EP inquired, whether, subsequent to adoption of floating NAV, beginning NAV should be presented in the per share rollforward at $0.9992 or $1.0000. The EP also inquired about presentation if the adviser made a top off contribution to the money market fund prior to adopting floating NAV/share.

The SEC staff noted the fund could present its beginning NAV/share at $1.0000 or at its actual beginning NAV/share extended to four decimal places, if different from $1.0000, if the difference between the two is deemed immaterial. To the extent an adviser makes a top off contribution, the impact of such contribution on the per share rollforward should be shown separately. Further, if the actual beginning NAV/share is used, and it is different from $1.0000, the SEC staff suggested that a registrant include a footnote or a tickmark to the rollforward explaining the nature of the difference between the beginning NAV/share and the prior year ending NAV/share, as reported in prior year financial statements.

2. The EP discussed the following scenario. A closed end fund that continually offers securities is increasing the amount of securities available and has incurred offering costs related to the securities filings. The fund has been in existence for over five years. How should these costs be accounted for: should they be expensed as incurred or deferred and amortized to expense on a straight-line basis over twelve months?

At the November EP meeting, the EP discussed that in accordance with FASB ASC 946-20-25-6, offering costs of closed-end funds with continuous offering periods "should be recognized as deferred charge", and in accordance with FASB ASC 946-20-35-5, then "amortized to expense over 12 months on a straight-line basis **when operations begin *(emphasis added)***." In the fact pattern discussed above, operations have already commenced, while the specific guidance in Topic 946 relates to costs incurred prior to the commencement of operations.

During the January 2017 EP call, the SEC staff stated that they generally would not object if a closed-end fund with a continuous offering period defers offering costs incurred after the fund commences its operations, in connection with subsequent continuous offerings of shares, and amortizes them over the 12 months period. The SEC staff recommended that registrants consult with them regarding specific fact patterns, as facts and circumstances may differ.

3. The staff of the SEC Division of Investment Management recently issued IM Guidance Update No. 2016-06 in connection with the Department of Labor's rule and certain exemptions (DOL rule) designed to address conflicts of interest in retirement advice. Since adoption of the DOL rule, certain mutual funds have been considering changes in fund fee structures for fees paid to financial intermediaries for sales of fund shares and streamlining fund expenses for intermediaries. This guidance update describes disclosures and certain procedural requirements for offering variations in fund sales loads and new fund share classes.

4. The SEC staff discussed January 11, 2017, interpretive letter issued by the Division of Investment Management, which states that in certain circumstances "the restrictions of section 22(d) of the Investment Company Act (the "1940 Act") do not apply to a broker, as that term is defined in the 1940 Act, when the broker acts as agent on behalf of its customers and charges its customers commissions for effecting transactions in a class of shares of a registered investment company ("fund") without any front-end load, deferred sales charge, or other asset-based fee for sales or distribution ("Clean Shares"). Additionally, the interpretive letter stated that section 22(d) does not prohibit a principal underwriter of Clean Shares from entering into a selling agreement with a broker in certain circumstances.

5. The SEC staff discussed a recent consultation related to a single class master fund transitioning into a multiclass master fund and the related marketing of past performance and financial statement financial highlights presentation. The SEC staff described a master-feeder structure with a single feeder fund, whereby investors invested in the master fund either through the feeder fund or directly in the master fund. The feeder fund was dissolved and the investors of the feeder fund were issued shares of newly created Class A of the master fund. The direct investors in the master fund continued to hold the same shares (no adjusted terms) they held prior to the reorganization, now named Class I. The SEC staff indicated that in this particular fact pattern, the registrant would continue marketing Class I at its pre-reorganization performance, which was the master fund's performance. The SEC staff indicated it would not be appropriate to use the past performance of the feeder fund for new Class A. With respect to marketing Class A, the registrant had the option to (1) not present any past performance or (2) adjust the past performance of the master fund for different terms, namely the expenses to be charged, of the new Class A shares. If the registrant chose option (2), the SEC staff also noted that (a) the performance would need to be shown on a gross basis to disclose the effect of any waived fees, and (b) it would not be appropriate to adjust the past performance in a manner that would result in presenting returns higher than those actually earned by the master fund. For financial statement purposes, financial highlights of the master fund shares prior to the reorganization would be presented as Class I for the prior periods (as they had been previously) and for the current period, Class I and Class A would be presented. The SEC staff encouraged registrants to consult on their specific fact patterns and noted that certain staff no action letters, such as the *North American Security Trust No-Action Letter* (pub. avail. Aug. 5, 1994), *IDS Financial Corp. No-Action Letter* (pub. avail. Dec. 19, 1994), and *Quest for Value No-Action Letter* (pub. avail. Feb. 28, 1997), may be helpful in evaluating the whether and how past performance may be used for marketing purposes.
6. The SEC staff informed the EP that they are in the process of drafting new language to be included in future interfund lending orders to clarify auditors' responsibilities. In some of the existing orders, the SEC requires each fund's independent public accountant, in connection with its audit of the fund, to review the operation of the Interfund Lending Program for compliance with the conditions of the application, when forming its basis for the N-SAR letter. The SEC staff indicated that there is currently no plan to revise existing orders.
7. The SEC staff is considering issuing frequently asked questions (FAQs) in connection with recently issued rules (investment company reporting modernization, swing pricing and liquidity rules) and would appreciate registrants in the industry and auditors reaching out as any related implementation issues or questions arise.
8. As indicated in the Final Rule "Investment Company Reporting Modernization", compliance, compliance date for Regulation S-X amendments, including the related amendments to the Statement of Additional Information (and Form N-CSR for closed-end funds), is August 1, 2017. The SEC staff has interpreted this to mean financial statements with quarterly, semi-annual, and annual *periods* ending after August 1, 2017 must comply, as opposed to financial statements included in filings made after August 1, 2017.