AICPA Investment Companies Expert Panel

Conference Call Highlights

April 17, 2020

I. Accounting/Reporting Issues:

1. On March 31, 2020, the Bank of England Prudential Regulation Authority requested that large UK banks cancel payments of all outstanding 2019 dividends and suspend payments of dividends through the end of 2020. As a result, on March 31, 2020, several UK banks canceled dividends with ex-dividend dates prior to March 31, 2020 and payment dates subsequent to March 31.

The EP discussed how a fund that has a significant investment in a company that has canceled dividends with an ex-date prior to year-end would account for dividends that were cancelled either on the year-end date (e.g. March 31) or post-year-end (e.g. February 29) in its annual financial statements. According to FASB ASC 946-320-25-4, investment companies record dividend income on the ex-dividend date, not on the declaration, record, or payable date, because on the ex-dividend date the quoted market price of listed securities and other market-traded securities tends to be affected by the exclusion of the dividend declared.

For funds with a February year-end, the EP members believed this announcement would be treated as a non-recognized (Type II) subsequent event that would warrant disclosure in the notes to the financial statements. However, for funds with a March year-end, a fund would have to consider whether the information was known or knowable as of the year-end date, and whether the financial statements should be updated to recognize this event. The EP members considered guidance in FASB ASC 820-10-35-41C(b), which discusses how a quoted market price in an active market does not represent fair value at the measurement date if significant events, such as an announcement, take place after the close of the market but before the end of the measurement date. Certain EP members expressed a view that funds would most likely need to reverse the dividend income and related receivable. Funds would also need to consider whether any adjustments will be needed to the valuation of investments in these banks.

2. An EP member shared that the FASB staff recently received a technical inquiry regarding situations in which a lender had provided a loan payment holiday to assist borrowers impacted by COVID-19. The inquiry did not relate to troubled debt restructurings. The staff discussed the following two alternative accounting treatments and determined that both were acceptable:

    i. Adjust the effective interest rate and continue to record interest income during the payment holiday;

    ii. Cease recording interest income during the holiday and resume afterward.

The Expert Panel observed that a fund should perform an analysis to assess the underlying investment and that the accounting treatment would depend on the particular facts and circumstances for the investment. For example, a fund would consider if the payment holiday represents a change in effective interest rate because there is an expectation that the company will be able to make payments in the future or if the payment holiday is indicative of a collectability issue and it's doubtful that the company will be able to make interest payments going forward.

3. In light of the current market conditions, certain funds have been repurchasing their public debt at values below their redemption amounts. At the September 2017 meeting, the EP discussed the classification of any gains/losses that arise from a fund's extinguishment of debt and generally agreed that such amount should be accounted for as a separate line item on the income statement outside of net investment income. At the April 2020 meeting, an EP member inquired what would be considered the appropriate timing of recognition of that gain/loss.

Paragraph 1(a) of FASB ASC 405-20-40 notes that a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished when the debtor pays the creditor and is relieved of its obligation for the liability. Per FASB ASC 405-20-40-1(a)(4), one way a liability can be extinguished is through the reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds. The EP expressed a view that it is a legal determination. If a fund repurchases its outstanding public debt, it would record the extinguishment of that debt at the point in time when the obligor is legally relieved of its obligation (i.e., the settlement date).

4. The Federal Reserve has established the Money Market Mutual Fund Liquidity Facility (MMLF), whereby the Federal Reserve Bank of Boston will make loans available to eligible financial institutions to purchase securities from money market funds. An EP member inquired what disclosures, if any, a money market mutual fund would need to consider if it decides to participate in the MMLF to address liquidity issues (to meet demands for redemptions) or to avoid "breaking the buck".

Certain EP members expressed a view that there may be nothing specific to disclose as the sale of the securities would be similar to any other sale, but acknowledged that each fund participating in the MMLF would need to undergo legal analysis to determine whether a sale under the program can be categorized as an "arm's-length" transaction. Another EP member observed that as the sale of the securities under the MMLF program is contemplated at the amortized cost, one may question whether an amortized cost is representative of fair value and whether additional disclosures may be warranted.

5. The EP continued sharing other observations seen in practice regarding the implications of the COVID-19 outbreak:

    a. Fair Value:

    - Estimating fair value requires significant judgment in normal circumstances. However, in the current environment characterized by market volatility and uncertain outlook, applying judgement in determining fair value will be even more challenging. Both the AICPA and the International Private Equity and Venture Capital Valuation ("IPEV") recently issued valuation related articles on COVID-19. The AICPA article and IPEV article provide reminders of FASB ASC 820 principles and are intended to serve as reminder and assist practitioners and others with applying FASB ASC 820 guidance during COVID-19 crisis.

    - The EP discussed a situation where an investment company that uses net asset value as a practical expedient to value its investment in an underlying fund may not have current information from the underlying fund available at the balance sheet date due to COVID-19 related business interruptions. The EP noted that an investment company would use the most recent underlying fund information available and estimate the change in the net asset value of the underlying fund through the balance sheet date in accordance with FASB ASC 820-10-35-60. An investment company would need to use judgement in determining adjustments needed to arrive at the net asset value of the underlying fund as of the balance sheet date.

b. Subsequent events disclosures:

- At the March 2020 Expert Panel conference call, the EP discussed how subsequent events arising after the balance sheet date that materially impact a fund's financial condition would be disclosed. As the COVID-19 outbreak continues, the EP members acknowledged there may be more information available now [in April 2020] that may assist an investment company in expanding qualitative and quantitative subsequent events disclosures.

c. An EP member shared that COVID-19-related staffing issues at printing facilities may cause potential delays in printing financial statements and prospectuses.

6. An EP member received a question regarding how to account for securities with negative interest either because the security is issued with a negative interest rate or the security is a variable rate security whose interest rated flipped to a negative interest rate due to the current economic crisis. The requestor referred the EP to its discussion on this topic from the March 2016 meetings and inquired if negative interest from securities could be accounted for as (1) a reduction of interest income previously generated by the security [prior to the current situation causing negative interest], (2) an expense other than interest expense or (3) interest expense.

The EP will continue discussing this topic at the May 2020 meeting.

7. The EP considered a situation where a private equity fund is set up only for insurance companies that prefer to invest largely in debt rather than equity for statutory reasons (for example, 90 percent of the investment will be in debt and 10 percent in equity). All investors would invest pro-rata and have the same 90/10 debt to equity split for their investment for the life of their investment in the fund. The debt will pay contractual interest rate of 5 percent to investors and the investors would receive their P&L allocation on the equity portion of their investment based on a standard waterfall agreement. The EP discussed how this fund should calculate its internal rate of return (IRR), when the investors are invested mostly in the fund's debt vs. equity. The EP expressed a view that for this fact pattern, for the purposes of the IRR calculation, debt and equity may be considered as a single investor class in applying FASB ASC 946-205-50-23. The EP members noted that IRR may be more meaningful for users of financial statements in these circumstances, when debt and equity are treated as a single investor class because they are investing in both the debt and equity on an equal, pro-rata basis.

II. Audit and Attest Issues

1. The EP resumed its discussion of feedback received from regulators on the illustrative draft audit opinion for business development companies.

III. AICPA/Administrative:

1. AICPA IC EP March meeting highlights are available here.

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.

1. The staff of the Division of Investment Management (SEC IM staff) stated that the Commission remains fully operational during the Coronavirus (COVID-19) pandemic and, beyond health and safety, is focused on maintaining continuity of Commission operations, monitoring market functions and system risks, providing prompt, targeted regulatory relief and guidance to stakeholders, and working with other financial regulators, as needed, to coordinate efforts. The SEC IM staff has received many questions from registrants and continues both financial statement reviews and rulemaking efforts, though the Commission has stated on the public webpage discussing the SEC's COVID-19 Response under section titled "Effect on Comment Periods for Certain Pending Actions" that they understand challenges associated with COVID-19 may impair stakeholder's ability to meet current comment periods and will not take final action on several proposals before May 1, 2020 including:
    a. Amendments to Rule 2-01, Qualifications of Accountants;
    b. Amending the "Accredited Investor" Definition;
    c. Use of Derivatives by Registered Investment Companies and Business Development Companies.
2. The SEC IM staff created an IM COVID-19 Response FAQ, where they have organized responses to questions about funds and advisers affected by COVID-19 for ease of reference. These responses represent the views of the staff of the Division, however they reference both staff actions and Commission actions, as well as contact information for both specific and general questions.

    a. Investment Adviser-related highlights:
        - New and updated Custody Rule FAQs regarding:
            1. inadvertent receipt of client securities when an adviser's personnel may be unable to access mail or deliveries (new Question II.1);
            2. inability to complete surprise examination (new Question IV.7); and
            3. custody of certain privately issued securities that are evidenced by physical certificates (new Question VII.4).
        - Existing Custody Rule FAQs regarding:
            1. inability of a pooled investment vehicle to distribute its audited financial statements within 120 days after its fiscal year – the IM staff referenced existing Question VI.9 from the Custody Rule FAQs (for more detail, refer to the SEC Staff Update from the March 2020 EP meeting highlights) on the COVID-19 landing page.
        - The EP inquired whether (i) Fund of Funds and (ii) Funds that invest in Fund of Funds would be afforded similar relief to that given in existing Question VI.9 with respect to meeting the 180 day and 260 deadline, respectively, given for stand-alone funds in FAQ VI.9, i.e. "The Division would not recommend enforcement action for a violation of rule 206(4)-2 against an adviser that is relying on rule 206(4)-2(b)(4) and that reasonably believed that the pool's audited financial statements would be distributed within the 120-day deadline, but failed to have them distributed in time under certain unforeseeable circumstances." Subsequent to the meeting, the SEC IM staff directed the EP to Custody Rule FAQ Question VI.9 which was modified on April 27, 2020 to address this question.
        - The SEC IM staff also noted that, as stated in March 20, 2020 OCIE Statement on Operations and Exams – Health, Safety, Investor Protection and Continued Operations are our Priorities, "reliance on regulatory relief will not be a risk factor utilized in determining whether OCIE commences an examination."

b. Investment Company-related highlights:

- The IM staff noted there are several Commission and Staff action items listed on IM's page related to investment companies that have been released over the past month, including actions related to in-person board meetings, inter-fund lending, affiliate transactions, and certain filing requirements.
- The IM staff highlighted an IM staff statement reminding investment company issuers of their obligations under section 10(a)(3) of the Securities Act of 1933 to update the information in their prospectuses, including the required underlying certified financial statements. The statement also reminds investment companies of their information delivery obligations for sales of fund shares to new investors and encourages investment companies to communicate with investors about their delivery preferences. The SEC IM staff highlighted certain specific delivery obligations for existing vs. new investors.
- The Commission announced temporary, conditional relief for BDCs that allows additional flexibility in certain requirements to make additional investments in small and mid-sized businesses, including those impacted by COVID-19, subject to certain protection conditions. The relief focuses on two areas:
  (1) issuance of senior securities and asset coverage, and
  (2) expanded relief for BDCs with existing co-investment orders.
- The relief in both areas is intended to allow for BDCs to continue to facilitate providing capital to small and mid-sized businesses in light of the current market environment. Absent these exemptions, they may be unable to do so, either because the BDC cannot satisfy their asset coverage requirements due to temporary mark-downs in the value of their investments or from the prohibition of certain affiliated funds from participating in additional follow-on investments.

(1) The first area of relief for BDCs relates to the issuance of senior securities and calculation of an *Adjusted Asset Coverage Ratio*, as described in the Order. During the exemption period, a BDC may issue or sell a senior security that represents an indebtedness or that is a stock (together, the "covered senior securities"), if certain provisions are met.

- The EP and the SEC IM staff further discussed the adjusted asset coverage calculation included in the relief, noting it included an example where the BDC had a statutorily determined limitation of 150% and its asset coverage calculation did not fall below that limitation, but still determined to utilize the relief. The EP and SEC IM staff discussed an additional scenario where a BDCs asset coverage calculation at the calculation date fell below the limitation:

Example *Adjusted Asset Coverage Ratio* Calculation:

For example, a BDC has a 190% asset coverage ratio on December 31, 2019. Its asset coverage ratio declines to 130% in April on the date of calculation due to a 25% decline in asset values, not using the Adjusted Portfolio Value, and 190% if it calculated the ratio using the Adjusted Portfolio Value (without the 25% decline in asset values). This BDC, if electing the relief and complying with the Order, would have an Adjusted Asset Coverage Ratio of 175% (190% minus 15% (25% of the difference between 190% and 130%)). As a result, the BDC would comply with the statutory asset coverage limit of 150% and be able to issue an additional 25% in leverage before reaching its statutory limit.
NOTE: The above example demonstrates a scenario where a BDCs asset coverage has fallen below its statutory limit of 150% and holds all other variables, such as investment purchases and sales, consistent since December 31, 2019. Other facts and circumstances could exist. Like the example in the Order, this example assumes the BDC has met the other conditions necessary to utilize the relief.

(2) The second focus area of the relief provided to BDCs expands on current BDC co-investment orders and allows for BDCs to co-invest with certain affiliated private funds that did not participate in the original investment, to participate in the follow-on investments.

(3) Lastly, the EP inquired whether an accounting firm may serve as an "independent evaluator" as described in the provision for the Board approval for each issuance of senior securities. The SEC IM staff noted that service providers like accounting firms might be hired by a BDC to provide such a service, and the staff would expect an accounting firm to perform an analysis of their independence for that BDC, including if they had an audit relationship with the BDC or affiliate. The staff are as always available for consultation on specific fact patterns.

3. The Commission also voted to adopt final rules related to offering reform for BDCs and CEFs, substantially as was originally proposed in May 2019. Expansion of offering reform to BDCs and CEFs was mandated by Congress in the Small Business Credit Availability Act and the Economic Growth, Regulatory Relief, and Consumer Protection Act to allow for a more streamlined registration, offering, and investor communications process.

Some key highlights of the final rule are as follows:

- *Shelf Offering Process and New Short-Form Registration Statement*
- *Ability to Qualify for Well-Known Seasoned Issuer (WKSI) Status*
- *Immediate or Automatic Effectiveness of Certain Filings*
- *Communications and Prospectus Delivery Reforms*
- *New Method for Interval Funds and Certain Exchange-Traded Products to Pay Registration Fees*
- *Periodic Reporting Requirements*
- *Incorporation by Reference Changes*
- *Structured Data Requirements*

At a high-level, the reforms essentially allow for certain eligible funds to engage in the same registration processes that have been available to operating companies since 2005 and also included changes to supplement the specific amendments mandated by Congress to align the immediately effective or automatically effective offering process long available to other types of investment funds with the eligible funds. Lastly, the reforms also include certain disclosure requirements and new structured data requirements that will make it easier for investors and others to analyze BDC and fund data.

The rule and form amendments will become effective on August 1, 2020, with the exception of the amendments related to registration fee payments by interval funds and certain exchange-traded products, which will become effective on August 1, 2021.

In addition, the Commission is adopting compliance dates for specific requirements under the amendments to provide a transition period after the effective date of the final rule, which are described in detail here.