

Investment Companies Entities Expert Panel

March 12, 2019 Conference Call



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 call:

AICPA Investment Companies Expert Panel

Conference Call Highlights

March 12, 2019

I. AICPA/Administrative:

1. The Expert Panel (EP) January 2019 conference call highlights have been finalized.
2. The AICPA staff described progress made on initial review of proposed conforming changes to the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

- The EP considered how funds that have adopted a liquidation basis of accounting should account for the accrual of estimated disposal costs for investments (e.g., commissions) still held as of the balance sheet date (i.e., what account is debited). FASB ASC 205-30-25-6 and 25-7 states that “An entity shall accrue estimated costs to dispose of assets or other items that it expects to sell in liquidation and present those costs in the aggregate separately from those assets or items. An entity shall accrue costs and income that it expects to incur or earn (for example, payroll costs or income from preexisting orders that the entity expects to fulfill during liquidation) through the end of its liquidation if and when it has a reasonable basis for estimation.”

The EP generally agreed that estimated disposal costs on investments should be accrued and recorded separately on the balance sheet, in accordance with paragraphs 6-7 of FASB ASC 205-30-25. The EP members also discussed whether estimated disposal costs should be recorded as a debit to cost or expenses or be recorded as a reduction in the net realizable value of the related investment through a debit to change in unrealized loss (income statement), with disclosure in the notes to the financial statements about the estimated disposal costs. The EP members generally believe that consistent with the concepts in FASB ASC 946, the estimated disposal costs should be accounted for in change in unrealized gain/loss (and ultimately realized gain/loss) on the statement of operations, and not as an expense.

1. An investment adviser of a private equity (PE) fund may set up a separate co-investment vehicle for investing in a specific portfolio company. Due to the limitations of the size of the capital commitments of the PE fund, investors in the PE fund are often given the opportunity to separately invest in the portfolio company (either directly into the portfolio company or through the co-investment vehicle). The portfolio company is held by both the PE fund and the co-investment vehicle. The co-investment vehicle may meet the definition of an investment company based upon FASB ASC 946-10-55-15, which states “An investment company with a single investment also may be formed (for legal, regulatory, tax, or other business reasons) in conjunction with another investment company that holds multiple investments (for example, a master-feeder structure or blocker fund). Investment companies formed in conjunction with each other are not required to be formed at the same time. Holding a single investment for that reason does not necessarily preclude an entity from being an investment company.” While the PE fund has audited financial statements, the co-investment vehicle may not have separate audited financial statements.

The EP discussed whether a fund investing in both the unaffiliated PE fund and the unaffiliated co-investment vehicle can use the practical expedient for valuation of the co-investment vehicle, and if so, to what extent can the audited financial statements of the PE fund be used for the valuation of the co-investment vehicle if the co-investment vehicle does not have separate audited financial statements.

The EP members agreed that a fund investing in an unaffiliated co-investment vehicle that does not have separate audited financial statements can use the practical expedient to value its investment in the co-investment vehicle if the co-investment vehicle meets both of the criteria in FASB ASC 820-10-15-4 (i.e., (a) the co-investment vehicle does not have a readily determinable fair value and (b) the co-investment vehicle is an investment company within the scope of Topic 946 or the co-investment vehicle is a real estate fund for which it is industry practice to measure investment assets at fair value on a recurring basis and to issue financial statements that are consistent with the measurement principles in Topic 946).

Generally, the EP members believe that the audited financial statements of the unaffiliated PE Fund, which include a valuation of the co-investment vehicle, cannot be used as a sole source to validate the valuation of the unaffiliated co-investment vehicle, as there are various factors to be considered. For example, the materiality level for the co-investment vehicle may be different from the PE fund's materiality levels or it may hold different investments or securities in the portfolio company. The auditor of the investor fund would consider the materiality, as well as the process and controls, in evaluating whether the net asset value of the co-investment vehicle has been calculated consistent with FASB ASC 946.

2. The FASB issued [ASU 2017-01, Business Combinations \(Topic 805\): Clarifying the Definition of a Business](#), which changes the definition of a business to assist entities with evaluating when a set of transferred assets and activities is a business. The guidance requires an entity to evaluate if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets; if so, the set of transferred assets and activities is not a business.

Given the amendments to FASB ASC 805, *Business Combinations*, the EP is currently exploring potential revisions to Chapter 8 of the Guide, paragraphs 8.37 to 8.48 and Appendix E, "Illustrative Financial Statement Presentation for Tax-Free Business Combinations of Investment Companies," and TQA 6910.33, "Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination".

3. The EP members considered if a fund that is organized as a partnership with defined classes within the partnership agreement should follow the guidance in FASB ASC 946-235-50-2(d), which requires investment companies to disclose for each class capital share transactions in the notes to the financial statements (if not disclosed separately in the statement of changes in net assets), even though the fund is not a unitized fund with shares. The EP members generally noted that if a fund is organized as a partnership and the partnership agreement clearly defines classes with different terms/economics (such as, liquidity, minimum subscription amount, management fees, among others), the fund should follow the guidance in FASB ASC 946-235-50-2(d) and disclose capital share transactions separately for each class.

III. 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. Financial Statement Comments In accordance with Section 408(c) of the Sarbanes-Oxley Act, the SEC staff reviews the financial statements of issuers, including registered investment companies, at least once every three years. During the recent government shutdown, certain designated SEC staff performed only "excepted" functions in accordance with their [Operations Plan Under a Lapse in Appropriations and Government Shutdown](#); normal operations resumed in February and the SEC staff shared the following recent financial statement review comments:
 - a. "Return of capital" policy disclosure – FASB ASC 235-10-50-1 states, in part, that "a description of all significant accounting policies of the entity shall be included as an integral part of the financial statements". When a registrant has a significant investment in a Master Limited Partnership or a REIT and receives distributions from those investments, an investment company may estimate the portion of the distribution that could be characterized as a return of capital. The SEC staff would expect to see disclosures about the investment company's accounting policy for return of capital distributions.
 - b. "Fund of fund" disclosures – registrants should include disclosures about the underlying fund structure when there is a significant investment in an underlying fund. Additionally, registrants should include information about where investors can obtain the financial statements for an underlying fund that represents a significant portion of the registrant's portfolio. The SEC staff referred to the November 1997 Dear CFO letter which indicates that when a fund of funds has a significant amount of its portfolio invested in a single underlying fund or owns a controlling interest in an underlying fund, the fund of funds should consider providing additional financial information to shareholders. The SEC staff also reminded that pursuant to FASB ASC 946-210-45-7, if an investment in a single underlying fund is so significant to the fund of funds, the fund's management shall consider whether the presentation of financial statements in a manner similar to a master-feeder fund is more appropriate.
 - c. Consistency of information presented to investors –the SEC staff may review registrants' websites for consistency with a registrant's filings with the Commission. Recent reviews noted fund websites which presented expense ratios that appeared inconsistent with expense ratios included in financial statements and registration statements. SEC staff further noted fund websites that provided no explanation for the difference. The SEC staff reminded registrants to consider the consistency and presentation of information provided to investors.
2. Other Comments The SEC staff also shared other relevant points of outreach:
 - a. Internet optionality for certain reports of registered investment companies – the recently adopted [rule 30e-3](#) under the Investment Company Act of 1940 will allow certain registered investment companies to transmit shareholder reports by making such reports accessible at a website address specified in a notice to investors. The SEC has also adopted amendments to rule 498 under the

Securities Act of 1933 and fund registration forms to require that during a certain transition period funds that choose to implement the new delivery method for shareholder reports provide prominent disclosures in prospectuses and certain other shareholder documents that will notify investors of the upcoming change in transmission format for a period of two years. As part of SOX reviews, the staff may inquire as a form of outreach if they do not see such disclosures being made.

- b. Form N-CEN data review – The SEC staff review Form N-CEN filings and evaluate answers to variety of questions. These reviews may result in registrants hearing directly from the Division of Investment Management’s Analytics Office to ensure data validity and data consistency.

The SEC staff is also monitoring and evaluating the consistency of certain disclosures made in Form N-CEN with disclosures made in the financial statements and related filings to inform their reviews of either financial statements or reviewable filings – e.g., 1) legal proceedings; 2) NAV errors and material weaknesses; 3) errors and omission insurance policy; 4) changes in accounting principles and practices.

- 3. **Form N-PORT** The SEC staff discussed the [Amendments to the Timing Requirements for Filing Reports on Form N-PORT](#). These amendments do not affect the amount or timing of the information that will be made available to the public and the current compliance dates for N-PORT did not change.

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|--------------------------|---|
| Form N-PORT ¹ | Compliance Date for Filing Reports on EDGAR |
| Large Fund Groups | April 1, 2019 |
| Smaller Fund Groups | April 1, 2020 |

The Commission amended rule 30b1-9 to require reports on Form N-PORT for each month in a fiscal quarter to be filed with the Commission not later than 60 days after the end of that fiscal quarter (as opposed to filing each monthly report no later than 30 days after the end of each month). The amended rule 30b1-9 requires that funds, no later than 30 days after the end of each month, maintain in their records the information that is required to be included in Form N-PORT. The following chart shows the filing dates for larger funds groups’ first reports on Form N-PORT:

| Fiscal Quarter End | First Report on Form N-PORT must be filed on EDGAR by: | Required Monthly Data |
|--------------------|--|------------------------|
| March 31, 2019 | May 30, 2019 | March 2019 |
| April 30, 2019 | July 1, 2019 ² | March, April 2019 |
| May 31, 2019 | July 30, 2019 | March, April, May 2019 |

The SEC staff also discussed the following implementation question related to the interim final rule:

- 1. For larger fund groups, the compliance date is 4/1/19. For funds with a fiscal quarter ending on 1/31/19 where the 60th day after the end of the fiscal quarter is on 4/1/19 or funds with a fiscal quarter ending on 2/28/19 where the 60th day after the end of the fiscal quarter is on 4/29/19, would these funds need to file their first Form N-PORT filings with the SEC on 4/1/19 or 4/29/19, as applicable?

The SEC staff noted that while funds with these quarter ends would be required to maintain their monthly N-PORT filings in their internal records, the funds will not have to file their Form N-PORTs with the SEC for these quarters and referenced the chart shown above for compliance dates. The first N-PORT filing date is for funds with a fiscal quarter-end of 3/31/19 where N-PORT filings must be made for quarters ending March 2019 by 5/30/19.

- 4. **PCAOB Standards** The SEC staff explained the process for the Commission’s upcoming vote on the adoption of two new PCAOB standards:
 - a. [Auditing Accounting Estimates, Including Fair Value Measurements and amendments to PCAOB auditing standards.](#)
 - b. [Amendments to Auditing Standards for Auditor’s Use of the Work of Specialists.](#)
- 5. **Madison No-Action Letter** The SEC staff discussed the recent [Madison Capital Funding LLC](#), December 20, 2018, no-action letter, specifically items 6 and 7 regarding developing and implementing controls and control attestation (written internal control report). In response to an EP question, the SEC staff noted that the asset verification requirement in item 7 relates to the Control Attestation (internal control report), not a separate requirement to perform asset verification. The SEC staff separately noted that the determination of whether a surprise examination must also be performed is not within the scope of this letter. The SEC staff is encouraging registrants to reach out with specific questions about

¹ Large Fund Groups - funds that together with other investment companies in the same “group of related investment companies” have net assets of \$1 billion or more as of the end of the most recent fiscal year of the fund. Smaller Fund Groups - funds that together with other investment companies in the same “group of related investment companies” have net assets of less than \$1 billion as of the end of the most recent fiscal year of the fund,

² [footnote 52] Because 60 days after the fund’s April 30, 2019 fiscal quarter end falls on a Saturday (June 29, 2019), the report on Form N-PORT must be filed with the Commission no later than July 1, 2019 (the next business day). See General Instruction A to Form N-PORT (“If the due date falls on a weekend or holiday, the filing deadline will be the next business day.”). In order to make General Instruction A clearer for registrants, we are moving the due date instruction to the end of the paragraph. See amended General Instruction A to Form N-PORT.

application of the letter's conditions, including those in items 6 and 7, as necessary, and as specific facts and circumstances, including those concerning the nature of the registered investment company, differ from those described in the letter.

6. IDC No-Action Letter On February 28, 2019, the Division of Investment Management issued a [letter](#) to the Independent Directors Council that provides assurance that the staff would not recommend enforcement action to the Commission for certain violations of Sections 12(b), 15(c) or 32(a) of the Investment Company Act of 1940 (the "Act") or Rules 12b-1 or 15a-4(b)(2) under the Act, which require a registered fund's board to approve certain items while physically in person. The letter addresses situations where directors cannot meet in person due to unforeseen or emergency circumstances, or where directors previously fully discussed and considered all material aspects of the proposed matters at an in-person meeting but did not vote on the matter during that meeting.
7. OCIE Priorities The SEC Office of Compliance Inspections and Examinations announced its [2019 examination priorities](#). Perennial risk areas and products and services include matters of importance to retail investors, including seniors and those saving for retirement; compliance and risk in registrants responsible for critical market infrastructure; select areas and programs of FINRA and MSRB; digital assets; cybersecurity; and Anti-Money Laundering.
8. Share Class Initiative The SEC's [Share Class Selection Disclosure Initiative](#), initially announced in February 2018, resulted in [settling charges](#) against 79 investment advisers who will return more than \$125 million to clients, mostly retail investors.
9. Staff Changes [Brent J. Fields has been named Associate Director of Disclosure Review and Accounting in the SEC's Division of Investment Management, replacing Barry Miller.](#)

IV. **Audit and Attest Issues:**

1. The EP was updated on the current status of proposed modifications to "Reports on Processing of Transactions by a Transfer Agent" subsection of chapter 12 of the Guide.
2. The EP members considered whether the Guide should include illustrative audit report for business development companies (BDCs) and separate report issued on senior securities table for BDCs and closed-end funds.

