

**AICPA Investment Companies Expert Panel
January 13, 2011 Expert Panel call highlights**

I. Administrative items/AICPA matters:

1. The Investment Companies Expert Panel (EP) members discussed the status of the December 2010 Expert Panel meeting highlights draft. The AICPA expects to post the final meeting highlights to its website shortly.
2. The AICPA staff provided an update on publications. The Audit Risk Alert *Investment Companies Industry Developments —2010/11* was recently published and is available for purchase online at the following link: (http://www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/IndustryspecificGuidance/InvestmentCompanies/PRDOVR~PC-022363/PC-022363.jsp). The panel members also discussed the timing of review of 2011 conforming changes to the Audit and Accounting Guide *Investment Companies*. As part of 2011 conforming changes, the EP members will consider updating the tax chapter due to the recent RIC Modernization Act.

II. Accounting/Reporting Issues

1. At the December 2010 Expert Panel meeting, the EP members discussed the Exposure Draft of proposed Accounting Standards Update (ASU) *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*. The Exposure Draft proposes to eliminate the collateral maintenance provision that a company may use to determine whether a transfer of financial assets in a repo transaction is accounted for as a sale or secured borrowing. This proposed ASU may cause certain transactions that currently might be accounted for as a sale of securities with an agreement to repurchase (such as certain dollar roll transactions) to instead be accounted for as a secured borrowing transaction. The proposal would be effective for new transfers and existing transactions that are modified as of the beginning of the first interim or annual period after the final ASU is issued (currently scheduled for the first quarter of 2011.) The EP members continued discussing the operational challenges for advisers and service providers that this proposed ASU would cause. The EP members also discussed the definition of “substantially the same” in the existing framework of Topic 860 and whether any further guidance clarification would be needed, as different interpretations may lead to variance in industry practice. Lastly, the EP members provided an update on individual informal discussions with the FASB staff regarding issues identified above.
2. Fair value disclosures
 - a. An EP member discussed the required fair value disclosures under ASU 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. The ASU provides an example disclosure of significant inputs for Level 3 securities; in its example FASB lists, in detail, significant inputs for the residential mortgage-backed securities. The EP noted that providing this level of detail on security-by-security level would be challenging for a number of types of investments, including venture capital

noted that the adviser likely would register with the SEC as the adviser would typically have the intent to eventually invest the committed capital amount, putting them over the asset threshold. In addition, towards the end of the life of PE fund, when the capital goes below \$150m as distributions occur, the EP notes that the adviser should probably stay registered so as to avoid having to register, then deregister as the capital goes below \$150m. The EP will seek clarification of this point with the SEC staff on a future EP call.

2. The EP members discussed considerations related to the SEC Custody Rule and trusts, including qualified custodian statement delivery and surprise count procedures. An EP member discussed an instance where a beneficiary of a trust in a managed account may not be aware of assets held in their account nor receive statements (for example, generational trusts or blind trusts). In performing a surprise examination, while it would be preferable to confirm with both the trustee and the beneficiary, it would be practical to confirm solely with an unaffiliated trustee, as long as the trustee has legal authority over the trust assets. The EP members discussed that for a pooled investment vehicle, if the investment adviser also serves as trustee, the accounting firm would need to confirm with individuals in pool, and not the trustee. An EP member also discussed that for collateralized debt obligations (CDOs), there is a need to determine whether the confirmation would go to debt holders, or equity holders, or an independent bond trustee. Different facts and circumstances may warrant different procedures performed by auditors.
3. The EP members discussed that accounting firms have begun to file a small number of material non-compliance letters with the SEC, as a result of performing surprise examinations to comply with the Custody Rule. The EP will ask the SEC for a general update on this process and any observations on the next EP call.

IV. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or their staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute a statement of the views of the Commission or the staff of the Commission.

A) Custody Rule:

- a. At the December 2010 meeting, the SEC staff (staff) and EP members discussed the application of Question XII.1 of the SEC's FAQ's (http://www.sec.gov/divisions/investment/custody_faq_030510.htm) and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQ's). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as

- both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). The staff indicated that there was no update on this matter since the December 2010 meeting. An EP member indicated that recently a request for a no-action letter has been submitted to the SEC regarding this matter.
- b.** During the December 2010 EP meeting, the staff and the EP members discussed how auditor independence rules will apply to newly registered advisers, particularly those advisers who will utilize calendar-year financial statement audits of PIVs to comply with the Custody Rules. The concern was at what point the auditor needs to be SEC-independent: when they register, which must be completed by July 21, 2011, or January 1, 2011, the first day of the fund's calendar year. An EP member inquired whether the staff would consider issuing a no-action letter similar to the one issued in 2006 relating to compliance with the Custody Rule by newly registered investment advisers. The EP and staff will continue discussing this matter in the future.

B) Other

- a.** During the November EP call and December EP meeting, the EP members continued to share observations about the confirmation process for investment companies in light of the recently issued AICPA clarity redraft of the External Confirmation standard (http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/DownloadableDocuments/Clarified_SASs/Clarified_SA_S_External_Confirmations.pdf) and the similar PCAOB proposal. An EP member asked the staff about its position related to concerning caveats/disclaimers received in responses from the brokers. The staff indicated it is still evaluating the observations and that there is no update at this time.
- b.** The EP members and staff discussed the RIC Modernization Act which was recently signed into law. The staff encouraged registrants to consider disclosing the Act's impact, if material to the entity.
- c.** The SEC staff shared financial statement comments from recent reviews, including the following:
 - i.** Certain business development companies (BDCs) did not disclose maturity dates of portfolio loans on their Schedule of Investments (SOIs).
 - ii.** In some cases, securities pay interest partially in cash and partially in kind. Some BDCs have reported the interest rate on the securities as the total of the cash and in-kind rate (for example, 6% cash and 8% in-kind reported as 14%) and did not disclose that a portion of the interest is payable in kind. The staff believes that, for these securities, registrants should disclose that a portion of the interest is payable in kind. Registrants may also consider disclosing both the cash and PIK rates in the SOI or in a footnote to the SOI.
 - iii.** Certain BDCs have included U. S. treasury securities within the Cash and Cash Equivalents caption on the balance sheet. The staff noted that treasury

securities should rather be categorized as investments and as such reflected on the Schedule of Investments.

- iv. The staff noted that in one instance where a registrant was required to include the financial statements of a significant subsidiary within the parent filing, it included unaudited financial statements as of a different year-end than the parent financial statements. The staff indicated that Rule 3-09 of Regulation S-X requires audited financial statements of significant subsidiaries to be included in the filing and such audited financial statements should be as of the same dates and periods of the parent, if practicable. The staff will evaluate alternative presentations on a case by case basis.
- d. The staff reminded the EP that certain XBRL requirements became effective on January 1, 2011. The staff noted that an open-ended fund that files a registration statement (or an amendment to an existing registration statement) needs to submit certain XBRL information to the SEC within 15 days of filing. Such XBRL information must also be posted to the fund's website.

Investment Companies Expert Panel

Highlights of the February 10, 2011, 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 company issues.

I. Administrative items/AICPA matters:

1. The AICPA staff informed the Expert Panel members that
 - a. Investment Companies Expert Panel December 2010 meeting highlights are available at http://www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INVESTMENTCOMPANIES/ICEPMEETINGS/Pages/INVMeeting_Materials.aspx.
 - b. December 2009 Expert Panel meeting highlights available under the above link now reflect a technical correction related to issue 4 (C) in the SEC Update section -Section 2(a)(41) should have been referenced, and not rule 2a-41.
 - c. Notes from January 2011 Expert Panel call will be available online later this month.
2. AICPA publications staff informed the panel members on the timing of review of 2011 proposed conforming changes to the Audit and Accounting Guide *Investment Companies*.

II. Accounting/Reporting Issues

1. The panel members shared their views whether private equity funds should continue to account for management fee waiver programs in a manner consistent with the fee waivers guidance set forth in the AICPA Accounting and Audit Guide *Investment Companies* (ASC 946) or in accordance with ASC 718 and related guidance on stock-based compensation. The EP members will discuss the issue with the private equity industry representatives in their firms and will share their perspectives at future EP calls. The EP will consider discussing the issue with representatives of the AICPA Financial Reporting Executive Committee (FinREC) in the future.
2. On January 28, 2011, FASB and IASB issued a proposal to eliminate differences between IFRS and US GAAP with respect to the offsetting of financial assets, including derivative assets, and financial liabilities, including derivative liabilities, on the balance sheet. Currently, US GAAP permits offsetting (net presentation) if certain criteria are met. The proposal will require offsetting if there is an unconditional right of setoff, such right is legally enforceable in all circumstances, and the company

intends to settle the asset and the liability on a net basis or realize the asset and the liability simultaneously. The Boards believe the proposal will result in greater comparability between similar companies accounting for similar types of transactions. Comments on this proposal are due April 28, 2011. The AICPA formed a task force that will provide comments on this Exposure Draft.

Representatives of the Investment Companies Expert Panel will participate in this effort. For more information about this project, please visit

http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156683893

3. The SEC and CFTC issued a proposed SEC rule that would require investment advisers registered with the SEC that advise one or more private funds to file Form PF with the SEC. This proposal would apply to advisers to hedge funds, private equity funds, and liquidity funds, but not to advisers to SEC-registered funds. The Form PF would include information about assets under management and data about funds that these investment advisers advise. The proposal distinguishes between large and small private fund advisers and there are increased reporting requirements for large private fund advisers that have \$1 billion or more in hedge fund, liquidity fund, or private equity fund assets under management. For more information, visit <http://www.sec.gov/rules/proposed/2011/ia-3145.pdf>
4. The Exposure Draft of proposed Accounting Standards Update (ASU) *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements* proposes to eliminate the collateral maintenance provision that a company may use to determine whether a transfer of financial assets in a repo transaction is accounted for as a sale or secured borrowing. This proposed ASU may cause certain transactions that currently might be accounted for as a sale of securities with an agreement to repurchase (such as certain dollar roll transactions) to instead be accounted for as a secured borrowing transaction. The proposal would be effective for new transfers and existing transactions that are modified as of the beginning of the first interim or annual period after the final ASU is issued (currently scheduled for the first quarter of 2011.) The EP members continued discussing the operational challenges for advisers and service providers that this proposed ASU would cause.

III. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute a statement of the views of the Commission or the staff of the Commission.

Richard F. Sennett, Chief Accountant of the Office of the Chief Accountant, Division of Investment Management of the SEC, will be leaving the Commission in March 2011.

1. Custody Rule:
 - a. The EP asked the SEC staff (staff) whether the following fact pattern is a material non-compliance with Rule 206(4)-2: the accountant is first engaged to perform a surprise examination in 2011 and during the course of that examination, the accountant realizes that the adviser should have, but didn't engage an accountant to perform a surprise examination in 2010. The staff stated that this fact pattern could be indicative of a material non-compliance with the provisions of Rule 206(4)-2. If the accountant concludes this fact pattern is a material non-compliance with Rule 206(4)2, it would be considered a material discrepancy that must be reported by the accountant to the Commission within one business day of the finding. Based on facts and circumstances, the auditor may consider performing additional testing for the prior year (not for the purposes of compliance with the custody rule) even though he/she was not engaged for that period.

- b. The staff and EP members discussed the following fact pattern: a hedge fund started in December 2010 and did not have an audit performed for the year 2010. An adviser managing this hedge fund was not registered with the SEC in 2010 but registered with the SEC in July 2011. At the end of 2011, the fund has a 13-month audit performed. The staff indicated that this 13-month audit (as opposed to the annual 12-month audit) of the hedge fund would satisfy the annual audit provision exception under the Custody Rule as long as balance sheet is presented for every year that the adviser is subject to the Custody Rule. In this case, a balance sheet as of December 31, 2011, and 13-month income statement and statement of changes would be sufficient. Presenting two sets of financials (one for the year and another for stub period) may also be acceptable.

If the fund started in December 2010, and the adviser was registered in 2010, the audit for the period ended December 31, 2010 would be required.

If the fund liquidates on February 29, 2012, then two balance sheets (as of December 31, 2011, and as of February 29, 2012) and an income statement and statement of changes in equity for the 12 months ended December 31, 2011, and for the two months ended February 29, 2012, would be required, as in this case, the adviser is subject to Custody Rule for both 2011 and 2012.

- c. In response to a question about a fact pattern where three (3) funds invest in a special purpose vehicle (SPV) and the SPV liquidates before the funds' fiscal year end, the SEC staff stated that the funds can use the SPV provision and include the SPV's assets or final distributions within the scope of the fund audits in lieu of having to do a liquidation audit of the SPV. Because of the related party-nature of this relationship, and even if these distributions may be immaterial to each fund, the auditor may consider performing additional testing on the SPV.
- d. The staff and the EP members discussed that an auditor could file a material discrepancy letter without qualifying its opinion when reporting on the results of a surprise examination. For example, the rule requires the auditor to notify the SEC of any material discrepancy, which, as per the Guidance for Accountants includes any material non-compliance with rule 206(4)-2. However, the Guidance for Accountants requires the auditor to opine only on compliance with paragraph (a)(1) of rule 206(4)2. So, if an auditor finds out the qualified custodian (QC) did not send quarterly account statements (paragraph (a)(3)), the auditor may report a material noncompliance to the SEC, but could issue a clean attestation opinion.
- e. The SEC received a number of notification letters from accounting firms about material noncompliance as a result of surprise examinations performed. The SEC staff shared the following observations about these notifications:
- i. Certain registered investment advisers (RIAs) did not comply with quarterly account statements requirements of paragraph (a)(3) of Rule 206(4)-2.
 - ii. One RIA received third-party issued checks on behalf of clients and forwarded them to the qualified custodian (QC) instead of returning those checks to the sender within three business days as required by the rule. The EP members noted that related questions arise for dual registrants (RIAs that are also registered broker-dealers), as certain introducing broker-dealers under SEC Rule 15c3-3 under the 1934 Act may be required to send the check promptly to the clearing broker. It was also noted that if, for example, an adviser is dually registered as an introducing broker, and the introducing broker receives client checks and acts as a qualified custodian (e.g., checks are made out to introducing broker and introducing broker cashes the checks and sends the proceeds promptly to the clearing broker), the introducing broker would need an internal control report even if the introducing broker sends the checks promptly to the clearing broker in accordance with the SEC's rules.
 - iii. A RIA sponsored a pooled investment vehicle (PIV) for which audited financial statements were not prepared in accordance with GAAP. Since the RIA could not rely on the audit provision under rule 206(4)-2(b)(4), a QC was required to send quarterly

account statements to pool investors and hold privately offered securities. The accountant reported that quarterly account statements were not sent to investors by the QC and that privately offered securities held by the PIV were not placed with a QC.

- iv. One letter referred to the fact where a QC held securities on an omnibus basis for an unrelated law firm and sent the quarterly accounts statements to the law firm, who then sent individual account statements to the investors, as opposed to QC sending them directly to investors, as required by the Custody Rule.
 - v. A RIA to a PIV that was investing in public and private securities was not able to engage a QC for its private securities until October 2010 and, therefore, the QC did not start sending the quarterly statements for its private securities to clients until after that date.
- f. The staff offered the following comments compiled during its review of certain surprise examination reports:
- i. Some examination reports stated that the RIA was in compliance with paragraph (a)(1) of Rule 206(4)-2 and Rule 204-2(b) as of the examination date. The accountant's examination report should include an opinion on compliance with paragraph (a)(1) of Rule 206(4)-2 as of the examination date and with Rule 204-2(b) during the period since the prior examination date (or for a first year examination, compliance with Rule 204-2(b) since the date the adviser became subject to the rule – see FAQ IV.5).
 - ii. Some reports only covered compliance with paragraph (a)(1) of Rule 206(4)-2 but omitted compliance with Rule 204-2(b) regarding books and records that the RIA needs to maintain.
 - iii. Certain auditors performed alternative procedures for confirmations not received from QCs. The interpretive release states that alternative procedures may be performed for confirmations not received from clients and confirmations not received from issuers of privately offered securities. Therefore, auditors should generally receive all confirmations from QCs included in their samples (the objective of the surprise examination is to determine that client funds and securities are held by a QC in a separate account for each client under that client's name, or in accounts that contain only clients' funds and securities, under the adviser's name as agent or trustee for the clients).
 - iv. One auditor issued an agreed-upon procedures report instead of a compliance examination conducted in accordance with AT Section 601, *Compliance Attestation*, as required by the Rule.
 - v. Certain surprise examination reports were missing key procedures, such as confirmation of funds or securities with clients.
 - vi. Certain surprise examination reports were missing key reporting components prescribed in AT Section 601, *Compliance Attestation*, such as a) a statement that compliance with the specified requirements is the responsibility of the entity's management, b) a statement that the examination was conducted in accordance with attestation standards established by the AICPA, and accordingly, included examining, on a test basis, evidence about the entity's compliance with those requirements and performing such other procedures as the practitioner considered necessary in the circumstances, and c) a statement that the auditor believes the examination provides a reasonable basis for his or her opinion, among others.

- vii. Certain auditors reported on management’s statement regarding compliance with certain provisions of rule 206(4)-2 (management assertion) but did not include management’s assertion in the filing.
- g. During the past few meeting and calls, the SEC staff and EP members discussed the application of Question XII.1 of the SEC’s FAQ’s and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund are clients of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC additionally reminded the EP members that the defined contribution plan’s interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). At the January and February 2011 conference calls, the staff informed the expert panel members that there were no updates on this matter.

2. Other

- a. The staff made comments with respect to funds that have expense recapture plans in place. Due to improved market conditions, these funds may have to pay back expenses that have been waived previously. In these situations where expenses are being paid back, within its registration statement or other applicable filing, the funds should use a separate line item in the fee table, similar to the presentation treatment for a contractual fee waiver, rather than including this in the “Other Expense” line item.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the April 14, 2011, 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 company issues.

I. Administrative items/AICPA matters:

1. The AICPA staff informed the Expert Panel (EP) members that the February 2011 EP call highlights are available at http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/IC/EPMeetings/Documents/Feb_10_2011_IC_EP.pdf
2. AICPA publications update:
 - a. The AICPA staff thanked the panel members for participating in the review of 2011 proposed conforming changes the Guide. The Guide is scheduled to be in inventory and online in the AICPA Online Professional Library by mid-July 2011.
 - b. At the next EP meeting (May 2011) the AICPA staff and the EP members will discuss certain items brought up by the reviewers during the 2011 conforming changes process and consider those items for inclusion in the 2012 Guide.

II. Accounting/Reporting Issues

1. The International Private Equity and Venture Capital Valuation Guidelines Board (IPEV Board) has developed international guidelines for fair valuing private companies. Some funds of funds invest into private equity funds that utilize local GAAP and then refer to valuation guidelines adopted by the IPEV Board. The reporting entity needs to assess any differences in accounting standards utilized by the investees and perform a reconciliation, if necessary. The panel member inquired whether there are any significant differences between US GAAP (or IFRS) and the IPEV guidelines regarding investment valuation that may require adjustment to the net asset value (NAV) provided by the investee fund under ASU 2009-12. The EP member shared that in developing valuation guidelines, the IPEV Board intended them to be in compliance with GAAP. The Board did not try to write accounting standards, but rather identify guidelines and procedures for valuation that would be in compliance with GAAP. The EP member volunteered to bring specific items of concern to the attention of the Board, if needed. An EP member noted when audit opinions solely refer to the basis

of accounting used (for example, US GAAP or IFRS), this mitigates confusion. The panel members further discussed that in UK and EU, there are requirements included in certain LLP agreements that the management needs to be IPEV-compliant by adopting best practice IPEV guidelines.

2. The panel members discussed the proposed Accounting Standards Update *Topic 210 – Balance Sheet Netting*, and applicability of paragraph 15 (as stated below) to a mutual fund that a) invests in derivatives, b) has no right of setoff and c) has obtained and/or pledged cash collateral:

15. An entity need not provide the information required by paragraphs 11–14 if, at the reporting date, the entity has no eligible assets and eligible liabilities that are subject to a right of setoff and the entity has neither obtained nor pledged cash or other financial instruments as collateral in respect of recognized eligible assets and recognized eligible liabilities.

The panel members expressed a view that a mutual fund that invests in derivatives with no right of setoff but obtains and/or pledges cash collateral, may need to present information required by paragraphs 11-14, if the proposed ASU is finalized in its current form. The panel members, however, acknowledged that the disclosure paragraph in the proposed ASU needs clarification.

3. The panel members discussed accounting for dollar rolls that are considered secured borrowings under the proposed Accounting Standards Update (ASU) *Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements*, and, specifically, discussed the amount of interest expense that should be recorded on the secured borrowing. The question was raised as to whether the interest expense is the foregone interest on the mortgage pools delivered, less the drop earned, as discussed in an old AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* that was never codified, or whether the interest expense could be based on a different rate, such as the mortgage repo rate. Some panel members indicated that they had not considered this question and suggested that it may be appropriate for further discussion at a future meeting.
4. The panel members discussed recent views expressed by the SEC staff that it may be appropriate for business development companies (BDCs) to consolidate special purpose vehicles (SPVs) that are considered non-investment companies in certain circumstances. The members have been analyzing the consolidation scenarios on a case by case basis for new registration filings and acknowledge both that diversity in practice exists and that guidance received by BDCs from the SEC staff represents a change from historical views and practices. Questions arise as to whether SPVs are considered investment companies and, if so, whether consolidation of a non-investment company SPV by a BDC is appropriate. If the SPV is not considered an investment company, the BDC would generally not consolidate the SPV. The panel members also discussed whether a change in accounting by a BDC with respect to consolidation in the absence of a change in facts (for example, additional or reduced investment) would represent a change in accounting principle or the correction of an error and, if the latter, whether the change would be indicative of a material weakness in internal control over financial reporting. The panel members agreed to revisit this topic at the next expert panel meeting.

III. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or their staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute a statement of the views of the Commission or the staff of the Commission.

1. Custody Rule:

- a.* The SEC staff (staff) informed the panel about a letter issued by the SEC staff, which indicates that the Commission may consider extending the registration deadline imposed by the Private Fund Investment Advisers Registration Act of 2010, which was initially July 21, 2011, to the 1st quarter of 2012. The letter is available at <http://www.sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf>

The EP members, however, expressed a concern, that even with potentially extending the registration requirements deadline until the first quarter of 2012, the extension would not provide a complete relief for advisers and their accounting firms regarding the transition from AICPA independence rules to SEC independence rules.

The EP members noted that for pooled investment vehicles that intend to use the Audit Provision to satisfy the Custody Rule for the fiscal year 2012, if the accounting firm is not SEC-independent on January 1, 2012, the auditor would not be considered SEC-independent for the entire 2012 year.

The EP members will continue discussing this matter with the staff in the future and consider scheduling a separate conference call with the SEC staff. The EP members indicated that certain accounting firms have submitted a request for no-action relief to the SEC staff regarding the transition period to move from AICPA independence rules to SEC independence rules, for newly registered advisers.

- b. The EP members inquired whether, if an adviser uses the surprise examination with respect to a pooled investment vehicle in one year and then in the following year determines that it will be able to rely on the audit provision with respect to that pooled investment vehicle and engages the same accountant to perform that audit, the adviser should initiate a filing of Form ADV-E since the accounting firm will not be reappointed for the surprise examination for year 2. The staff indicated that a Form ADV-E should be filed in the IARD system within four business days of determining that the adviser would be relying on the audit provision. Attached is a link to instructions on filing Form ADV-E in such cases: <http://www.iard.com/PDF/formADV-E.PDF>
- c. The interpretive release from the SEC regarding surprise examinations states that alternative procedures should be performed for confirmations not received from clients or from issuers of privately offered securities. Therefore, the auditor would generally need to receive all confirmations from qualified custodians (QCs) included in the sample, as the main objective of the surprise examination is to determine that all funds and securities are held by a QC in a separate account for each client in the client's name, or in accounts that contain only clients' funds and securities, under the investment adviser's name as agent or trustee for the clients. There may be cases when there are multiple QCs that hold securities and derivatives and the auditor might not be able to receive all confirmations within 120 days of the examination date. The EP members sought the staff's views on issuing the surprise examination late (if it takes longer than 120 days to receive all confirmations from QCs) versus modifying the attestation opinion and issuing the report within 120 days, if such confirmations are delinquent. The staff stated that this would depend on facts and circumstances, and is subject to the judgment of the registrant and its auditor. The decision as to which approach is reasonable may vary based on different examples. If a report is filed late, the auditor may consider whether a material discrepancy (noncompliance with the 120 days requirement) exists that should be communicated to the Commission. The staff also encourages contacting them to discuss specific cases. The EP members expressed concerns that, in situations where the adviser is determined to have "custody" through access, but the client, not the adviser, engaged the QC, certain QCs are not responding to the confirmation requests; some EP members are aware of situations where the QC had a policy not to respond to the auditor's confirmation requests altogether (due to client privacy issues). The EP members discussed the difficulties for the adviser to plan ahead to obtain authorizations from client-engaged QCs to provide confirmations, as the accounting firm needs to make selections of QCs on a sample basis as of a surprise date and thus cannot request the adviser in advance to make arrangements with its client to allow the confirmation. It was suggested that prospectively, when an adviser enters into an advisory agreement with a new client, the adviser should obtain the client's consent providing the adviser with authority to request the QC to respond to auditor confirmation requests of the client's funds and securities.
- d. For many surprise examinations, the accounting firms are not receiving a high percentage of responses for confirmations with clients (customers), which creates the need for an increased

amount of alternative procedures. The EP members inquired whether the SEC has a view on an acceptable percentage that the accounting firms should be receiving. As a principle, the SEC will not identify a bright line (fixed percentage) of confirmation that would need to be received.

- e. Regarding the electronic filing of surprise examination reports (Form ADV-E) using the IARD, certain accounting firms noted that audit teams have had practical difficulties uploading a single, text-searchable document that contained both the accountant's examination report and management's assertion statement.
 - i. The instructions on form ADV-E that are available on the SEC FAQ (Question IV.6.B) (<http://www.iard.com/pdf/formADV-E.pdf>) do not specifically mention the uploading of the management assertion statement. The EP members sought the SEC's views on accountants uploading the management assertion statement along with the surprise examination report, and whether it could be enhanced in the instructions. The staff commented that if the auditor opines on management's assertion, the management assertion would need to be included in the filing, which is consistent with the Commission's guidance in the 1999 Dear CFO letter. However, if the auditor is directly reporting on subject matter, there is no need to include the management assertion, as the auditor is not reporting on management's assertion.
 - ii. The EP members and the staff discussed examples of how users can upload a single, text-searchable document onto the IARD website. For instance, the accountant can produce its surprise examination report, and obtain management's assertion statement, in Word format and merge the two documents into one Word document; type in the signature (//Accounting Firm X LLP//, and //Adviser XX Name//), as applicable, within the surprise examination report and management's assertion statement, respectively. The Word document can then be converted into a PDF document, and then be uploaded to IARD. Accountants may retain a physically signed copy of management's assertion statement for their records. The staff indicated that this method of uploading the documents would be acceptable. An EP member suggested that the IARD site could be modified to allow for the uploading of two separate attachments (a signed examination report and a signed management's assertion statement), and the staff indicated they would follow up to determine if this could be implemented.
 - iii. The EP members observed that the IARD instructions indicate that users should reach out to FINRA for assistance with uploading the documents. The staff confirmed that FINRA is the correct resource for the IARD technical assistance; however, for questions that FINRA is not able to answer or questions such as what or when to file, the SEC staff in the Office of Investment Adviser Regulation should be contacted at (202) 551-6999.
 - iv. In a situation where a registrant or an independent public accountant determines that an incorrect Form ADV-E was filed by the independent public accountant or if an independent public accountant wants to revise the form filed, the independent public accountant must file a new Form ADV-E and provide an explanation as to why the original form is being amended. This is because revisions cannot be made to previously submitted documents.
- f. During several meetings and calls in 2010, the SEC staff and EP members discussed the application of Question XII.1 of the SEC's FAQ's and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan

using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). At the April 2011 conference call, the staff informed the expert panel members that there were no updates on this matter. An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter.

- g. The EP members sought the staff's views on the obligations of the accounting firm to report a material noncompliance (material discrepancy) discovered during a mock (trial) compliance examination of an SEC-registered adviser, when the firm has not been engaged to perform an actual annual surprise examination.¹ The SEC staff indicated that there may be no legal requirement to inform the SEC of such findings; however, auditor's obligations under current auditing and attestation standards need to be considered. The accounting firm should also consider whether such finding occurred during a period covered by an actual surprise examination that they have been engaged to perform. The EP members further observed that the accounting firm would be reporting such noncompliance to the client (i.e., the adviser) who retained them for this mock examination, and when management signs the representation letter for the actual surprise examination, management represents that management has disclosed to the accounting firm (i) all known noncompliance and (ii) any communications from regulatory agencies, internal auditors, and other practitioners concerning possible noncompliance with the specified requirements. The firm performing the actual surprise examination is required to notify the Commission of a material discrepancy, regardless of whether it identified such discrepancy or whether the discrepancy was identified by the firm which performed the mock examination.

2. Other

- a. The panel members sought the SEC staff's views on the following matters relating to BDCs:

 - i. BDCs consolidating SPVs - at the April conference call, the SEC staff referred to the SEC Comments and Observations section on Consolidation and Investees from the 2010/11 AICPA Investment Companies Industry Developments Audit Risk Alert that indicated:

Rule 6-03(c) of Regulation S-X states that "[financial] statements of an investment company may be consolidated only with [financial] statements of subsidiaries which are investment companies." However, the SEC staff has not objected to consolidation of noninvestment company subsidiaries in certain cases (see letters to Fidelity Select Portfolio, April 29, 2008, and NGP Capital Resources Company, December 28, 2007). The staff has recently become aware of certain special purpose vehicles (SPVs) that typically would be consolidated under FASB ASC 810, *Consolidation*, but have not been consolidated based on Rule 6-03(c). The staff encourages registrants to consider the substance as well as the form of the relationship between the investment company and the SPV, and whether consolidation more appropriately reflects the overall financial position and results of operations.

¹ Note that this discussion presumes that the adviser was registered with the SEC at the time of the mock examination. Some advisers engage compliance professionals to perform "diagnostic" mock examinations to identify potential compliance issues prior to SEC registration; if the adviser was not registered with the SEC at the time of the mock examination, there would be no noncompliance to report as the adviser was not obliged to comply with the rule until registration.

During the April 2011 EP conference call, the SEC staff indicated that their views on the topic have not changed. For questions relating to consolidation by BDCs and other matters, including if there was a previous determination that the SPV was not an investment company, the staff encouraged the registrant and its auditor to consult with them regarding transition, if needed.

- ii. Item 4 of Form N-2 requires the registration statement of closed-end funds, including BDCs, to disclose debt coverage information in a senior securities table. This information is required to be audited. The expert panel members are aware of diversity in practice regarding compliance with the audit requirement for the senior securities table. In meeting the form's requirements to include financial statements, financial highlights and an audit opinion covering the financial statements and financial highlights, registrants typically incorporate by reference the annual report.

The staff reminded the expert panel members that, as explained in the 2001 Dear CFO letter, to meet the audit requirement, the independent accountant must express an opinion on the senior securities table itself or on a financial statement or financial highlights that include the senior securities table. Registrants must include, or incorporate by reference, this opinion in the registration statement. One way to meet the senior securities table audit requirement is for the registrants to include the senior securities table information with the per share and ratio information in the financial highlights. Since the financial highlights are specifically covered by the audit opinion, the senior securities table information also would be covered. If registrants, however, include the senior securities table information elsewhere in the annual report (e.g., in an unaudited section, such as the MDFP), the audit opinion must expressly cover the senior securities table. Alternatively, if a registrant includes the senior securities table only in the registration statement (as opposed to be included in the financial statements), the registrant should file a separate opinion in the registration statement covering the senior securities table information. An EP member indicated some funds may include the senior securities table in the financial highlights that are included in a note to the financial statements.

- b. The SEC staff provided the following comments related to their recent financial statement reviews:
 - i. Certain BDCs structure the advisers' incentive fees based on achieving a specific cumulative total return hurdle. The adviser may not be entitled to the incentive fees if the cumulative total return does not exceed a certain percentage (i.e., the hurdle rate). Section 205(b)(3) of the Advisers Act precludes an adviser from receiving payment of the portion of the incentive fee calculated on unrealized gains. However, the staff noted that for purposes of accrual of the incentive fee, similar to the AICPA TPA (TIS 6910.29), the BDC would need to consider the hypothetical liquidation basis, and calculate the incentive fee accrual as if all the assets and liabilities have been liquidated at fair value at the reporting date. Therefore, if a BDC's cumulative performance (including performance attributable to unrealized gains), exceeded the hurdle rate, the BDC would accrue an incentive fee. Conversely, if a BDC's performance (including performance attributable to unrealized gains) did not exceed the hurdle rate, the BDC would not accrue an incentive fee. For example, if 8% is the hurdle rate, and the BDC achieved a 10% return, the incentive fee should be accrued even on unrealized gains, whereas if a 7% return was achieved and 8% was the hurdle rate, the incentive fee would not need to be accrued. If the registrant's cumulative total return on a hypothetical liquidation basis is less than the total return hurdle rate, and the registrant, therefore, does not accrue incentive fees as of the balance sheet date, the staff expects registrants to provide the following additional disclosures: (1)

Amount of cumulative net investment income, cumulative net realized and cumulative net unrealized gains that would be subject to the incentive fee accrual if the BDC had achieved the hurdle rate at the balance sheet date, (2) Amount of the incentive fee that would be accrued as of the balance sheet date if the BDC had achieved the hurdle rate, or, if not practical, based on the calculation methodology (e.g., due to catch up clauses, etc.), the maximum incentive fee that could be accrued (e.g., 20% * cumulative net income less prior incentive fee accruals) and (3) Cumulative total return (or whatever metric the hurdle rate is based on) as of the balance sheet date in order to inform the shareholder how close the BDC is to achieving the hurdle rate (e.g., 8% stated hurdle and the return is currently at 7.7%).

- ii. One registration statement indicated that the RIA paid offering costs, but the BDC would reimburse the RIA for these costs if certain conditions were met or upon liquidation. The staff noted no indication of those costs reflected in the seed balance sheet or in the notes disclosure of the BDC. Under the terms described in the reimbursement agreement, it appeared that the fund would be virtually unable to escape repayment (that is, regardless whether the BDC was successful or unsuccessful, it would pay the costs since the BDC would ultimately liquidate). The staff advised the registrant that, because in their view recovery was probable, the BDC would need to accrue those costs. The staff analogized to its position on expense recapture plans which enable the adviser to recoup previously waived fees if the fund operates below its expense cap in future years. If an adviser is waiving fees, but recoupment is probable (e.g., recoupment period exceeds 3 years), the fund would need to accrue the recoupment which would offset the benefit of a current year's waiver).
 - iii. The staff noted a BDC had borne certain organization costs which were included in the accumulated net investment loss on the seed balance sheet and reflected in the notes to financial statements. However, the BDC did not include a statement of operations reflecting the organization costs as an expense. In this case, the staff asked for the statement of operations to be provided.
- c. The 2008 IFRS roadmap indicated that in 2011, the SEC would determine whether to require the IFRS financials. In his speech at December 2010 AICPA SEC/PCAOB conference, Paul Beswick suggested a "condorsement" approach under which both FASB and US GAAP would continue. While this is one view and not the official view of the Commission, representatives of the SEC will be meeting with various constituents, including the Investment Company Institute, to make sure that the industry views are heard.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the May 12, 2011, 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 company issues.

I. Administrative items/AICPA matters:

1. AICPA staff communicated the status of the April Expert Panel (EP) call highlights. When available, they will be posted on the AICPA website at the link below:
http://www.aicpa.org/interestareas/frc/industryinsights/pages/expert_panel_investment_companies.aspx
2. The AICPA staff discussed with the Expert Panel members various comments made during the conforming changes review of the Audit and Accounting Guide *Investment Companies* (the “Guide”). These comments included how to best incorporate AICPA and PCAOB auditing and attestation guidance into the Guide going forward and potentially removing or editing Appendix C “Internal Revenue Code Worksheets” in future editions of the Guide as some financial instruments (especially derivatives) have more complex tax diversification issues than is apparent from the worksheet.

Further, the “Illustrative Report of Independent Registered Public Accounting Firm on Management’s Assertion Regarding Controls at a Custodian Pursuant to Rule 206(4)-2 and Release No. IA-2969 Under the Investment Advisers Act of 1940” contained in chapter 11 (and posted on www.aicpa.org) is titled “Report of Independent Registered Public Accounting Firm”. EP members noted that the custody rules require a PCAOB registered and inspected accounting firm for this engagement; however, the report is in accordance with the AICPA attestation standards, not PCAOB attestation standards. The EP member expressed a view that the reports are explicit that they are done under AICPA attestation standards, and not under PCAOB standards, and the intent of the title was to demonstrate that the firm was registered, because users are required to report to the SEC that the examination was performed by a registered firm; therefore, the report title in the Guide should be retained.

The EP members also discussed the illustrative Statement of Cash Flows in paragraph 7.183 of the Guide and that the line items “Decrease in receivables for securities sold” and “Decrease in

payable for securities purchased” generally would not be necessary as the true cash impact would already be reflected in the purchases and sales of investments. The EP considered updating the illustrative Statement of Cash Flows in the future edition of the Guide by removing “Decrease in receivables for securities sold” and “Decrease in payable for securities purchased” from the cash flow statement and those amounts would be reflected in the purchase and sales of investments balances.

3. The EP members and AICPA staff discussed the timing of upcoming meetings and conference calls.

II. Accounting/Reporting Issues

1. EP members discussed derivative disclosures in financial statements, particularly the application of Rules 6-04 and 12-13 under Regulation S-X which require disclosures of investments other than securities.
2. EP members discussed whether there would be a benefit to adding clarifying language in Chapter 3 of the Guide around whether certain financial instruments are derivatives. For example, there have been questions about whether purchased options were derivatives; the EP members expressed a view that purchased options would generally be considered a derivative. The EP members also discussed some considerations as to when rights and warrants would qualify as derivatives. The EP members will form a separate task force to consider expanding derivatives guidance in the Guide.
3. EP members discussed how registered investment companies (RICs) fair value their international securities while considering the closure of a foreign market. For example, if a foreign market is closed and a registered investment company hits its fair value trigger, would one add the factor to the last closing price of the security on the closed foreign market or continue to price using the last traded price and look for significant events to determine if an adjustment is needed. EP members believed that registered investment companies would benefit from having a policy on this that they apply consistently.
4. The EP members discussed new fees associated with certain provisions of the Dodd-Frank Act, specifically the Transaction and Clearing fees associated with swaps that are paid monthly (and accrued based on activity). These charges will generally be associated with individual swap transactions, but there are some complications as they may have volume discounts. The EP members discussed considerations to evaluate if these are expensed or allocated to the cost of the trade. The EP members indicated they will continue discussing this topic at future meetings. In addition, the EP members discussed the Purchased Adjustment Interest (PAI) charges. EP members noted these are currently being discussed in the industry as to whether they are part of the cost basis. Some EP members analogized this to broker commissions and rebates for achieving certain volume discounts and how funds have historically accounted for them.
5. The EP members continued discussing the proposed Accounting Standards Update *Topic 210 – Balance Sheet Offsetting* and IASB Exposure Draft *Offsetting Financial Assets and Liabilities* and the comments the Expert Panel members, their firms and others in the industry submitted. An EP member also shared observations from informal discussions with the FASB staff. The AICPA comment letter on this proposal is available at http://www.aicpa.org/advocacy/financialreporting/downloadabledocuments/aicpa_offsetting_comment_letter.pdf
6. EP members discussed situations where an investment company holds investments in multiple classes of an investee fund. For instance, a fund of funds holds \$3,000,000 in Class A of the investee, and \$500,000 in Class S (a side pocket class) of the investee. For the purposes of leveling in the ASC 820 hierarchy, a question arises whether the investment should be bifurcated if the investment into Class A meets the criteria for Level 2, but the investment into

Class S is illiquid, and, therefore, a Level 3 investment. The EP discussed industry practice in leveling such investments and noted that the EP members generally believe that in the situation of a unitized fund as described above, there could be multiple units of account for an interest in an investee fund, and that a similar analogy would apply to investments in partnerships where a portion of the investment is locked up or has other varying liquidity characteristics.

7. The EP members discussed views whether private equity funds should continue to account for management fee waiver programs in a manner consistent with the fee waivers guidance set forth in the Guide (ASC 946) or in accordance with ASC 718 and related guidance on stock-based compensation. The EP considered whether the development of a Technical Practice Aid (TPA) may help to provide guidance to financial statement preparers and auditors. The EP will not develop a TPA on this matter at this time.
8. The EP members discussed recognition of loan origination fees received on deals that certain investment companies, including business development companies (BDCs), invest in. Many BDCs have historically amortized loan origination fees amounts over the life of the loan. EP members indicated that the fair value guidance in ASC 825-10-25-3 (previously paragraph 3 of FASB Statement No. 159) would potentially indicate that immediate recognition of the loan origination fees is the more appropriate accounting under a full fair value model. EP members also acknowledged that the guidance in ASC 825-10-25-3 pertains to the recognition of expense by the borrower and not the recognition of income by a lender/investor. [Note: Subsequent to the meeting it was confirmed that FASB Statement No. 159 did not change the guidance for income recognition from that already provided by FASB Statement No. 91.]
9. The EP members shared their views regarding the accounting treatment for distribution of securities in-kind rather than cash to an investor. EP members agreed that generally in-kind redemptions to an investor would trigger a realized gain or loss at the fund level. Therefore, the sale would be reflected based on the fair value of the investments and the associated realized gain or loss would be recorded.
10. The Financial Accounting Standards Board (FASB) directed its staff to draft a proposed Accounting Standards Update (ASU) on Investment Properties. Currently, international accounting standards allow entities to value its investment in real estate at fair value, while US GAAP does not provide such an option. It is anticipated that the proposed ASU would be issued in the second quarter of 2011. The AICPA staff learned that the FASB anticipates issuing this proposed ASU together with the proposed ASU on Consolidations of Investment Companies. The AICPA staff and the EP members held a discussion on whether and how the Expert Panel should comment on these proposals, once issued.
11. The EP members discussed matters relating to recent views expressed by the SEC staff that it may be appropriate for BDCs to consolidate special-purpose vehicles (SPVs) that are considered non-investment companies in certain circumstances. The EP members shared that accounting firms and advisers have been analyzing the consolidation scenarios on a case by case basis for new registration filings and acknowledged that diversity in practice exists and that guidance received by BDCs from the SEC staff represents a change from historical views and practices. EP members noted that questions arise as to whether SPVs are considered investment companies and, if so, whether consolidation of a non-investment company SPV by a BDC is appropriate. If the SPV is not considered an investment company, the BDC would generally not consolidate the SPV. The EP members also discussed whether a change in consolidation accounting by a BDC without a change in facts (e.g., change in level of control) would represent a change in accounting principle or the correction of an error, and, if an error, whether it would be indicative of a material weakness in internal control over financial reporting. The EP members agreed to continue discussion on BDCs and consolidation of non-registered investment companies with the SEC and the EP members in the future.

12. The EP members discussed the potential impact of the FASB Revenue Recognition project to investment advisers/distributors. Specifically, the EP discussed deferred commission assets and whether these will need to be charged to expense or continue to be capitalized.
13. The EP members discussed commodity funds registered with the SEC Division of Corporation Finance (Corp Fin) and the EP members' views with respect to the recent update to the SEC Financial Reporting Manual (FRM) requiring that financial statements be prepared at both the trust and series level. An EP member, who had recently been involved with this issue with Corp Fin staff, noted that their position is based on the requirement in Article 3 of Regulation S-X to provide financial statements of "the registrant" (which legally is the full trust), and that Article 6 of Regulation S-X specifically exempts registered investment companies from this rule and allows presentation of only individual series. EP members discussed potential concerns with the presentation required by Corp Fin as it may imply cross-liability where none legally exists.
14. The EP members discussed foreign jurisdictions that have short-term capital gains tax (that is, a tax on securities held less than one year). The EP members discussed divergence in practice on the accounting treatment. EP members noted that some funds record the entire tax liability as a tax accrual and then, when the short term holding period expires, reverse the accrual, where others make a probability assessment to estimate a tax liability on a blended rate.
15. The EP members discussed accounting considerations for TBA forward purchases/TBA dollar rolls and whether these are regarded as derivatives. The EP will continue discussing this matter in future meetings.
16. The EP reviewed a Dollar Roll example to determine if the transaction was a dollar roll subject to secured borrowing accounting treatment or was a purchase and sale and considered certain aspects of the technical guidance, especially ASC 860-10-55-17 (TBA transactions) and 860-10-55-59 (effective control Guidance). The EP will schedule a follow-up conference call to review proposed scenarios and analysis.

III. Audit and Attestation Issues

1. The EP members discussed some procedures accounting firms used to comply with Rule 204-2(b) of the Investment Advisers Act of 1940 for the surprise examination in relation to the books and records provision. The EP members discussed how the reconciliation of confirmation responses against the adviser's books and records may assist the accounting firms in complying with this provision.
2. The Expert Panel discussed disclosure requirements and control weaknesses regarding a situation where there were NAV errors for a period of several months. The Expert Panel discussed that since the error was identified and corrected in connection with the preparation of the interim financial statements, it would appear that the controls over financial reporting were effective, and that, because year-end auditor control reports issued for Form N-SAR purposes are "as of" year-end, no material weakness would have existed at the year-end date. The Expert Panel also discussed the general control framework that would allow for NAV errors to exist for some period of time and what impact that could have on both the auditor's assessment of controls and management's certification as to whether significant changes in the control structure had occurred during the period.

IV. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute a statement of the views of the Commission or the staff of the Commission.

The SEC Assistant Chief Accountants for the Office of the Chief Accountant, Division of Investment Management (the “staff”), joined the EP Meeting. The staff provided a summary to the EP members about projects they are currently working on, questions they are receiving and their involvement on regulatory matters and in assisting other Divisions and Offices within the SEC as questions arise. The staff also shared that they recently observed the Pricing Sources Task Force Meeting among the PCAOB, issuers, pricing services and public accounting firms to discuss pricing procedures.

The staff also highlighted that they are currently reviewing new registration statements for BDCs. An issue that they continue to focus on related to BDCs is consolidation of nonregistered investment company subsidiaries. The staff also indicated that the project to amend SEC Regulation S-X is currently on hold. The staff also summarized the notice of the order raising the asset and income thresholds for “qualified investors” that was recently released. They encouraged interested parties to submit comments on the proposal, which are due in July 2011.

1. The staff shared the general themes of the content of material discrepancy [with Rule 206(4)-2] communications the SEC has received to date from auditors:
 - a. Failure of the qualified custodian (QC) to send quarterly statements to investors when the adviser is not relying on the Audit Provision.
 - b. Adviser used the privately offered securities exception related to safe-keeping of assets requirements when the audit provision is utilized, but the securities did not meet the definition of privately offered securities.
 - c. There were client funds and securities held by an entity that is not a qualified custodian.
2. The Expert Panel members and the staff discussed areas of focus or findings during Office of Compliance Inspections and Examinations (OCIE)’s inspections of investment advisers:
 - a. Valuation of investments, including the documented policies and procedures for valuing client assets and calculating NAV;
 - b. Conflicts of interest, particularly related to fees expensed and compensation paid to the advisers;
 - c. Custody, noting that during inspections OCIE is continuing to use some level of confirmation of client assets, and for private funds, OCIE may request access to review the auditor’s work papers to avoid sending confirmations, although this is less common.
 - d. Specific recent Custody Rule violations found in inspections include the following:
 - i. Advisers are not permitted to maintain client funds or securities in accounts in their names or an adviser employee’s name, as the Custody Rule requires client funds and securities to be maintained by a qualified custodian in a separate account for each client under that client’s name or in accounts that contain only the adviser’s clients’ funds and securities, under the adviser’s name as agent or trustee for the clients.
 - (1) For example, there was a situation where the adviser held client funds in an account in the employees’ names.
 - (2) In other cases, an adviser temporarily deposited client assets in commingled accounts, or accounts held by affiliates of the adviser.
 - ii. The adviser, who was not a qualified custodian, received stock certificates from clients and instead of returning them to the clients, forwarded them to the qualified custodian. This violated Rule 206(4)-2(a)(1) because the adviser should have returned the stock certificates to the clients within three business days.
 - iii. For an adviser of a pooled investment vehicle that was planning to use the audit provision, it was noted that the audited financial statements were not distributed in time (120 days after year end, or 180 days for a fund of fund). The reasonable belief position that is included in the SEC’s Responses to Frequently Asked Questions (http://www.sec.gov/divisions/investment/custody_faq_030510.htm) on the custody

rule could not be applied because the audited statements had been significantly delayed for multiple years.

3. The staff and EP members continued to discuss the process of uploading surprise examination reports into IARD. The staff investigated if the IARD system could be modified to accept the upload of multiple documents. This would mitigate challenges that accountants are having in uploading a single, text-searchable document that contains both the signed accountant's report and signed management's assertion statement. The staff indicated that one submission is preferred, and indicated two options to accomplish this:
 - a. The accountant can produce its surprise examination report, and obtain management's assertion statement, in Word format and merge the two documents into one Word document; type in the signature (//Accounting Firm X LLP//, and //Adviser XX Name//) as applicable, within the surprise examination report and management's assertion statement, respectively. The Word document can then be converted into a PDF document, and then be uploaded to IARD. The staff suggested that accountants retain a physically signed copy of management's assertion statement for their records.
 - b. Prepare the signed accountant's report in a text-searchable pdf document, and include the signed management assertion statement within the attachment as a picture image.
4. On Form ADV Schedule D, SEC registered investment advisers (RIAs) must identify, among other things, the name and address of the public accountant who audited a private fund and whether the accountant issued an unqualified opinion. For entities that have audit opinions issued on their financial statements out of the US for purposes of the Custody Rule and out of the Cayman Islands due to local auditor requirements, the staff indicated that both the US and Cayman Islands accounting firms should be listed in Form ADV Schedule D.
5. During the April 2011 conference call, the staff informed the EP about a letter issued by the SEC, which indicates that the Commission may consider extending the registration deadline imposed by the Private Fund Investment Advisers Registration Act of 2010, which was initially July 21, 2011, to the 1st quarter of 2012. The letter is available at <http://www.sec.gov/rules/proposed/2010/ia-3110-letter-to-nasaa.pdf>. The EP members, however, expressed a concern that even an extension of registration requirements until the first quarter of 2012 would not necessarily provide complete relief for advisers and their accounting firms regarding the transition from AICPA independence rules to SEC independence rules. For example, the EP members noted that, for pooled investment vehicles that intend to use the Audit Provision to satisfy the Custody Rule for fiscal year 2012, if the accounting firm is not SEC-independent on January 1, 2012, the auditor would not be considered SEC-independent for the entire 2012 year. The EP members and the staff will continue discussions regarding auditor independence with respect to newly registered advisers, and revisit the issue once the final rule is issued with regards to the registration deadline.
6. The staff noted that OCIE is looking into the methodology that advisers use to report "SEC yields" on Treasury Inflation Protection Securities (TIPS) funds based on recent news articles.
7. The staff noted a fund that recently launched which had a form of principal protection. In those situations, the fund should consider whether the related contract providing the protection is a derivative that also needs to be fair valued. An EP member noted that the inclusion of the contract's fair value in a net asset value determination for redemption purposes may (at least theoretically) cause the contract itself to be violated, as some contracts do not allow payment of any contract value to a redeeming shareholder before the completion of a defined holding period. However, an EP member also noted that, when a contract is "out of the money", the fair value of the contract (net of future fees payable) is usually negligible, if not zero.
8. The staff noted that when an auditor performs a 206(4)-2 surprise examination or an examination pursuant to either Rule 17f-1 or 17f-2 and attests directly on the entity's compliance, and not on

management's assertion about the compliance, that management's assertion would not need to be filed with the SEC.

9. The staff shared a summary of the comment letters related to the President's Working Group on Financial Markets and Money Market Fund Reform. There was a recent roundtable meeting for the Commission to gather more information on money market funds which was recorded and is available on the SEC's website. There is no set time table right now, but this is an area the Commission continues to be focused on and is considering multiple options and factors.
10. The staff shared the following comments related to the Form N-MFP:
 - a. The staff noted that Item 27 requires the title or description of the security to include the interest rate, coupon, and maturity.
 - b. The staff noted that Item 44 requires the adviser to identify illiquid securities, which would include term repurchase agreements that extend beyond 5 business days.
 - c. The staff noted that Items 17 and 24 require that the yield needs to be entered as a decimal point and not as a percentage (that is, if the yield is 13 percent, ".13" should be entered rather than "13"). The system assumes the registrant puts in the actual amount and will automatically adjust it to a percentage.
11. The staff provided an XBRL Update. Provisions for filing certain prospectus data became effective January 1, 2011 and to date, over 800 filings have been received using XBRL. The SEC has received numerous questions, which were summarized into three themes:
 - a. Filing process - related to which form and how the filing should be made. As advice on the filing process for XBRL, the staff reminded the panel that registrants have an opportunity to perform a test filing before each actual filing within EDGAR, which will allow the adviser to (1) put the XBRL submission through EDGAR's validation process and (2) preview the submission to ensure data integrity and completeness.
 - b. The viewer – the staff noted this should be used as a tool and should not be looked at as the end goal for XBRL. In utilizing the viewer, the adviser should ensure that all data contained in the HTML version of the Risk/Return Summary is in the XBRL filing. Advisers should also note that there are certain limitations to the viewer, most of which relate to formatting, (such as, indentation, bolding, underlines). Thus, in certain instances, the XBRL data viewed in the viewer will not exactly match how it has been disclosed in its HTML version.
 - c. Website postings - A fund is required to post what has been submitted to the Commission as an XBRL filing to its website. If the fund does not have a website, the SEC expects that it would be posted on the website from which an investor obtains financial information or fund literature. Typically that would be a website of the fund's sponsor, distribution agent or another appropriate third party.

The staff noted there is no time table currently as to when it will be mandatory to include the Schedule of Investments as an XBRL submission. The staff encouraged users to submit any XBRL-related questions via email to Ask-oid@sec.gov.

12. The EP members and staff continued to discuss consolidation of nonregistered investment companies (including special-purpose vehicles) by BDCs. The staff has requested advisers and accounting firms to consult with the SEC, as necessary, with specific fact patterns.
13. The EP members and the staff discussed BDCs which are being formed through contribution of an existing private fund portfolio, or portions of multiple portfolios, upon launch. The issue has arisen regarding what information should be included in the registration statement and what pro-forma information should be provided. The staff indicated that the appropriate disclosures may vary depending on facts and circumstances and advisers should consult with the SEC, as necessary.
14. The staff described how the SEC and CFTC are meeting to discuss proposed CFTC rules (for example, Rule 4.5 proposal that impacts RICs, including proposal to rescind sections 4.13(a)(3) and (a)(4)

exemptions from registration as a commodity pool operator (CPO)). Currently, the CFTC exempts RICs from registration with the CFTC, but under the proposed rules, certain funds and advisers may also be required to register with the CFTC as CPOs. The SEC acknowledged there were some disclosure and reporting requirements in the proposed rules that would be duplicative and conflicting, thus the SEC is working with the CFTC to mitigate these conflicting or duplicative requirements.

15. The staff discussed the article “SEC Looks for Ways to Improve Fund Shareholder Reports” published on Ignites.com on April 28, 2011. The article describes testimony of Lori Schock, Director of the SEC Office of Investor Education and Advocacy, on gathering feedback from investors on what types of information is useful, whether disclosure in fund shareholder reports is adequate, and how it can be improved.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the September 8, 2011, 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 company issues.

I. Administrative items/AICPA matters:

1. The Expert Panel (EP) chair thanked Tim Jinks, Mike Maher, and Richard Grueter for their contributions to the Expert Panel and announced EP composition for 2011-2012 volunteer year.
2. The AICPA staff informed the EP members that this year, the Investment Companies Audit Risk Alert will cover only investment company-specific topics and provided the timing of industry experts' review of the Alert's draft.
3. The next Expert Panel conference call is scheduled for Thursday, October 13, 2011.

II. Accounting/Reporting Issues

1. The Expert Panel members considered how investment companies recognize fee income on a debt investment that is marked-to-market under the AICPA Audit and Accounting Guide *Investment Companies*. There is a view that a literal read of the Guide would suggest deferring and amortizing upfront fees, which may be inconsistent with the treatment a commercial company would get for the same fees if the fair value option was elected for the debt instrument. In that case, the fees would be recognized on Day 1. The Expert Panel members observed that the issue was first raised with AICPA Financial Reporting Executive Committee (FinREC, then AcSEC) during clearing of the current edition of the Guide (in 1999-2000) and is similar to business development company (BDC) issue previously discussed during May 2011 EP meeting. EP members acknowledged that diversity in practice exists, with some following the Guide and amortizing deferred fee income on debt instruments and others choosing fair value option accounting, yet, in practice, majority of investment companies follow the Guide. The EP members noted that the method of accounting for these fees does not affect net asset value (NAV) calculation.
2. Certain EP members observed that audit opinions issued by firms for Business Development Companies (BDC) have not been consistent. The confusion and inconsistencies mainly surround whether a BDC should be treated like a Registered Investment Company (RIC) under the Investment Company Act of 1940 (40 Act) and follow the guidance for RICs, even though BDC's are required to

follow the reporting requirements under the Securities Exchange Act of 1934 (34 Act), including filing 10-K's, 10-Q's, 8-K's and proxy statements. The EP discussed the following:

a. Should the audit opinion mention that the independent accountant verified securities owned?

Section 64 of the 40 Act requires a BDC to apply Section 31 as if the BDC were a registered closed-end investment company, except that the reference to the financial statements required to be filed pursuant to Section 30 shall be construed to refer to the financial statements required to be filed by such BDC pursuant to Section 13 of the Securities Exchange Act of 1934. We note that Section 30(g) of the 40 Act contains the section that requires a certificate of the independent public accountant to be filed together with the annual report, and that the certificate by the independent public accountant should state that auditors have verified securities owned, either by actual examination, or by receipt of a certificate from the custodian. Since BDCs should be referring to Section 13 of the 34 Act instead of Section 30 of the 40 Act, the EP members questioned whether the audit opinion should reference verifying securities owned as required by Section 30.

During September 2011 meeting, the EP members shared preliminary views that BDCs are treated in practice no different from other RICs. While confirmation of securities by BDCs is not explicitly required by the 40 Act, diversity in practice exists, and one member shared that in some cases, the SEC contacted the registrant to include language about confirming securities in their report.

b. Should the audit opinion reference a separate statement of financial highlights similar to a RIC opinion?

Form N-2 shows where a RIC registered under the 40 Act would be required under Item 4 to present detailed financial highlights. However, Instruction 2 to Item 4.1 specifically scopes out BDCs, and directs a BDC to item 4.2. Item 4.2 then refers to items 301/302/303 of Regulation S-K, which did not specifically name financial highlights as a required piece of information, although make generic reference that a registrant should show important information that is relevant not to make the financial statements misleading (in accordance with ASC 946-205-45-1 and the Guide). Because of that, the EP member raised the question of whether the financial highlights should be presented in the footnotes or a separate schedule. The panel members expressed a view that the audit opinion of a BDC should be similar to a RIC's opinion.

c. How many years of financial highlights should a BDC present in the financial statements?

Item 301 of Regulation S-K, which is applicable to a BDC, references 5 years of select financial data. The EP members expressed a view that BDC would also present 5 years of financial highlights in their financial statements.

3. The subgroup of Expert Panel is developing best practice guidance (non-authoritative) that will expand upon certain security types on whether they would be considered a derivative for GAAP investment company practice.
4. The Expert Panel members shared their views on SEC Release No. IC-29776 "Use of Derivatives by Investment Companies under the Investment Company Act of 1940". The EP observed that due to more legal matters, as opposed to accounting, covered in this release, legal counsels within the industry firms will take the lead in commenting on this release.
5. Dollar Roll accounting - the Expert Panel discussed the classification (purchase and sale vs. financing) of a dollar roll, particularly when there are no stipulations between the fund and the counterparty. More specifically, ASC 860-10-55-59 states, in part, that for transfers of existing securities under a dollar-roll repurchase agreement, the transferee must be committed to return substantially-the-same securities to the transferor, which would indicate that the transferor has maintained effective control. Therefore, in trading situations where only SIFMA Uniform Practices are adhered to and there are no stipulations that would specifically satisfy the substantially-the-

same criteria, effective control has been relinquished and purchase and sale accounting would apply.

6. The AICPA staff updated the panel members on the status of FASB projects on Investment Companies and Investments Properties Entities.
7. ASU 2011-4 removed the “in-use and in-exchange” concepts from Topic 820. The panel members discussed how the removal of the “in-use and in-exchange” concepts would impact private equity funds and BDCs who have historically used the enterprise value approach to value debt and equity instruments when they have control; and, when a Private Equity Fund or BDC has control of the capital stock, whether the enterprise value approach would still be acceptable under ASU 2011-4 or the standard now required each of the instruments to be valued on an instrument-by-instrument basis.

The panel members expressed a view that until this removal, using enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP noted that this is a unit of account question and identified the following 3 views emerging:

- a. treat each single instrument (debt or equity) as the unit of account, with all identical securities managed within a single portfolio for valuation purposes. This would result in a change in the enterprise value approach;
- b. treat equity instruments with voting rights (such as controlling interests) as the unit of account and carve out debt. This would also result in a change in the enterprise value approach;
- c. treat both equity instruments that have voting rights and other equity and debt instruments as the controlling interest, and, hence, unit of account. This would not result in a change in the current valuation practice.

The EP members observed that it may be challenging to say that debt and equity represent the same unit of account. The EP also noted that the issue was informally discussed by FASB in October 2010, during which FASB expressed a view that enterprise value could be used. The EP will consider scheduling a separate conference call to discuss this issue.

8. Representatives of AICPA Employee Benefit Plans Expert Panel (the EBP EP) joined the meeting via conference call to discuss the following items of interest:
 - a. Definition of a non-public entity in regards to new fair value measurements ASU 2011-04, that is, in situations where a non-public trust/fund, such as a common collective trust, is administered or advised by a public company (such as a bank), the trust/fund would retain its non-public entity status. The EP members discussed that regardless of who sponsors the vehicle, the vehicle would retain its non-public distinction.
 - b. Given downgrade of U.S. government securities by credit rating agencies, and given that the investment policy of a client, which is a large pension plan, restricts them to investing in U.S. government securities primarily, what should auditors consider disclosing in the notes to our client's financial statements, or how might auditors consider modifying their opinion? The Investment Companies EP members shared that they have observed some companies including disclosures in subsequent events, based on materiality, effect on the entity, MD&A, and risk footnotes. The format would be similar to disclosures for other European issues.

III. Audit and Attestation Issues

1. The Expert Panel members shared their views regarding PCAOB's Concept Release on Auditor Independence and Audit Firm Rotation. The comments to PCAOB are due by December 14, 2011. The EP members discussed the cost, time and effort that may be imposed on the investment management industry, if audit firms are rotated periodically. In addition, due to SEC independence rules, certain “Big Four” accounting firms may not be SEC-independent, which may limit options for global companies that seek to utilize such accounting firms. The EP also discussed potential changes

to the auditor reporting model, and challenges that would arise if the accounting firms would need to provide an auditors discussion and analysis.

IV. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute a statement of the views of the Commission or the staff of the Commission.

1. Custody Rule:

- a. The SEC staff discussed a question on the frequency of the annual surprise examination performed pursuant to the Custody Rule. SEC Release No. IA-2969 "Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940" indicates that "Rule 206(4)-2(a) generally requires that client funds and securities of which an investment adviser has custody under the rule be verified by actual examination at least once during each calendar year by an independent public accountant." Based on SEC FAQ Question I.3, certain advisers engaged accountants to perform the first surprise examination as of early 2011 (e.g., January 31, 2011). The EP and SEC staff discussed a scenario whereby the next surprise examination will be performed as of November 30, 2012 (in the next calendar year), and there would be a 22-month time period between surprise examinations. The SEC staff indicated that as long as the November 30, 2012 examination is conducted on a "surprise" basis, the date would be acceptable as Rule 206(4)-2(a)(4) requires the surprise examination to be performed at least once per calendar year. As per the Guidance in IA-2969, the accountant is also required to opine on the adviser's compliance with Rule 204-2(b) for the period since the prior surprise examination, which in this example, would cover the 22-month period.
- b. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC's FAQ's and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund are clients of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). At the April 2011 conference call, the staff informed the expert panel members that there were no updates on this matter. An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. During September 2011 EP meeting, the SEC staff indicated that there is no update on this matter at this time.

2. Other

- a. The February 2011 EP conference call highlights indicated that for funds with expense recapture plans, "due to improved market conditions, funds may have to pay back expenses that have been waived previously. In these situations where expenses are being paid back, within its registration statement -, the funds should use a separate line item in the fee table, similar to the presentation treatment for a contractual fee waiver". Instruction 3(c)(iii) to Item 3 of Form N-1A (page 13) indicates that within "Other Expenses", the Fund may subdivide this

caption into no more than three sub-captions that identify the largest expense or expenses comprising “Other Expenses.” Frequently, the amount paid is not quantitatively significant, and is not among the three largest components of “Other Expenses”. However, due to the qualitative importance of this item, the SEC staff indicated that in such cases, the fund should separately present these amounts paid. The staff was not prescriptive in where the disclosure should be in the table and would not object if these amounts were presented similar to the presentation of a contractual fee waiver or if they are included in “Other Expenses”, even when they are quantitatively not among the three largest components of “Other Expenses”. The SEC staff indicated that there are no current plans to update the Form N-1A instructions for this matter, and encouraged registrants to discuss presentation considerations with their examiner.

- b. The SEC issued Concept Release No. IC-29776 “Use of Derivatives by Investment Companies under the Investment Company Act of 1940” requesting comments on a number of issues, including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration and valuation, and invites public comment on any other matters that they believe are relevant to the use of derivatives by funds. Upon receiving comments, the Commission will consider whether regulatory initiatives or guidance related to derivatives are needed to improve the current regulatory regime for funds.
- c. Earlier in the meeting, EP discussed the content of BDCs’ audit opinions and noted inconsistency regarding inclusion of a statement regarding confirmation of securities with the custodian. The EP noted that the staff was making comments that certain audit opinions on BDCs’ financial statements did not include that statement. It was also noted that certain BDC auditors were confirming securities owned by the BDC but did not include the statement to that effect in the audit opinion. The staff indicated they are discussing with IM’s Chief Counsel’s Office whether BDC auditors are required to include in their opinions a statement regarding confirmation of securities owned by the BDC.
- d. Financial statement review comments:
 - i. Consolidation – the staff brought to the EP’s attention the following matter on which a registrant and its auditor consulted the staff: An open-end registered investment company (Fund) invests in a wholly-owned, non-SEC registered Cayman Islands tax blocker (Cayman Blocker). The Cayman Blocker invests in a wholly-owned non-SEC registered commodity pool (CP). The Fund’s ultimate exposure to the CP could represent up to 25% of the Fund’s total assets. The arrangement represents a 3-tiered structure. The staff noted that the Fund consolidated the Cayman Blocker in its semi-annual financial statements, but the Cayman Blocker did not consolidate the CP (and therefore the Fund did not consolidate the CP) even though the Cayman Blocker owns 100% of the CP and economically controls it. The Fund’s semi-annual financial statements reflected the investment in the CP within the investments line item on the balance sheet and reflected the name of the CP on the SOI. The Fund’s semi-annual financial statements did not provide any transparency into the holdings or expenses of the wholly-owned CP. In addition, the Fund’s expense ratio did not reflect the expenses of the CP. The registrant initially concluded the Cayman Blocker should not consolidate the CP based on Rule 6-03(c)(1) of Regulation S-X that states that registered investment companies may only consolidate investment companies. The CP is neither an investment company, as defined in the 1940 Act, nor an entity that would be an investment company under the 1940 Act but for the exceptions in Sections 3(c)(1) or 3(c)(7).

The staff informed the registrant that under GAAP, the consolidation analysis needs to be evaluated using a “bottom up” approach. First the registrant should determine whether the Cayman Blocker should consolidate the CP. Since both the Cayman Blocker and the CP are non-SEC registered funds and are both investment companies under GAAP, the registrant determined the Cayman Blocker should consolidate the CP because it has a controlling financial interest in the CP. Next, the registrant should

determine whether the Fund should consolidate the Cayman Blocker. Since the registrant had previously determined the Fund should consolidate the Cayman Blocker, the registrant determined it was appropriate to consolidate the whole 3-tiered structure. Therefore, upon consolidation in its audited annual report, the Fund included all of the CP's investments in its SOI and included the CP's expenses in its statement of operations and expense ratio.

The staff indicated that IM's Chief Counsel's Office is determining whether the Fund's compliance with the 1940 Act and rules thereunder would be based on the consolidated structure (i.e., whether the Fund would look through to the Cayman Blocker's and CP's assets, liabilities and p&l to determine compliance).

The staff also informed the EP that another registrant created a structure similar to the one described above in order to obtain exposure to commodities. In this fact pattern, an open-end registered fund invests in a wholly-owned non-SEC registered Cayman tax blocker and the Cayman tax blocker invests in 5 wholly-owned non-SEC registered commodity pools. The Fund's exposure to the commodity pools in the aggregate could represent up to 25% of the Fund's total assets. Subsequent to the staff's review of the registrant's financial statements, this registrant concluded it was appropriate for all entities to be consolidated. The analysis performed by the registrant was similar to the one mentioned above.

The staff also reminded the EP that Rule 3A-02 of Regulation S-X presumes that consolidated financial statements are more meaningful than separate statements and that they are usually necessary for a fair presentation when one entity directly or indirectly has a controlling financial interest in another entity.

- ii. The staff provided an update on a topic discussed during previous EP meetings - accrual of incentive fees. To be consistent with AICPA TIS 6910.29 and the Guide and to ensure proper NAV calculation, the staff previously mentioned that BDCs should be accruing incentive fees on an unrealized net gain position even if the adviser is not yet entitled to payment of the incentive fee since the gains have not been realized. The SEC staff noted that they have observed that certain Registered Funds of Hedge Funds with March 31 fiscal year-ends were not properly accruing incentive fees/allocation in their financial statements. Such Registered Funds of Hedge Funds have provisions in their offering documents that provide that incentive fees/allocation crystallize and are payable to the adviser/GP at December 31. The staff has observed that these Registered Funds of Hedge Funds accrue the incentive fees/allocation on the statement of operations/statement of changes through December 31 and disclose the amount of incentive fees/allocation payable from January 1 through March 31 in the footnotes. The staff believes that for a fund with a March 31 fiscal year-end, incentive fees/allocation should be accrued on the statement of operations/statement of changes for the period from April 1 through March 31, even if the incentive fees/allocation are payable to the adviser/GP on December 31. Further, the staff reminded the EP that when making fair value determinations of investee hedge funds, Registered Funds of Hedge Funds should consider whether the investee hedge funds properly accrue incentive fees/allocation.
- iii. Variable rate demand (VRD) notes – During the financial statement review process, the SEC staff observed that there were certain funds holding VRD notes with liquidity enhancements (in addition to credit enhancements). The staff learned that only a few large banks provide these liquidity enhancements and that not all mutual funds were disclosing the liquidity enhancements, the liquidity enhancement providers, and the possible credit concentration provided in these arrangements. The staff reiterated that when funds have investments in securities with liquidity enhancements, funds

should consider the guidance in ASC 946-210 regarding identification of 3rd parties providing credit enhancements. The disclosure would include the name of the liquidity provider in the security's description in the Schedule of Investments and discussion of the liquidity enhancement arrangements within the notes to the financial statements.

- e. The EP members inquired about the staff's reaction to the decision reached by the FASB in connection with the Investment Companies Consolidation Project to issue an Exposure Draft that as expected to be proposed, would require investment companies to consolidate other investment companies that are controlled. The staff indicated they have been monitoring the project.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the October 13, 2011, 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 company issues.

I. Administrative items/AICPA matters:

1. The AICPA staff informed the Expert Panel (EP) about status of the September EP meeting notes.
2. The EP chair discussed EP composition in the upcoming volunteer year.
3. The AICPA Publications staff informed the EP about current status of the Investment Companies Audit Risk Alert. It is anticipated that the Alert will be available in December 2011.
4. The next Expert Panel meeting is scheduled for Wednesday, November 16, 2011, at the AICPA NYC office.

II. Accounting/Reporting Issues

1. The EP members are developing best practice guidance (non-authoritative) on what would be considered a security and what would be considered a derivative under GAAP for investment companies, and anticipate sharing the draft guidance with the EP in advance of the November 2011 EP meeting.
2. EP members represented on the ICI subcommittee continue working on a white paper on accounting for dollar rolls. The white paper is expected to be finalized by the end of October 2011 and will include feedback collected from the EP's previous discussions on dollar rolls.
3. The AICPA staff updated the panel members on the timing of upcoming proposed Accounting Standards Updates on Financial Services - Investment Companies, Real Estate - Investments Property Entities, and Consolidation - Policy and Procedures projects. Former FASB staff will be joining the November EP meeting to discuss these projects.
4. In connection with a question raised by one member, the EP expressed a view that investments in registered investment company (RIC) would generally be classified as a Level 1 security under the ASC 820 fair value hierarchy. An EP member referred to ASC 320, which states that the fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions. The EP noted that the definition

of Level 1 in ASC 820 does not include "readily determinable", however it appears consistent with other types of Level 1 investments.

III. Audit and Attestation Issues

1. The panel members discussed the recently issued PCAOB Staff Audit Practice Alert No. 8 "Audit Risks in Certain Emerging Markets", which focuses on risks of material misstatement due to fraud that auditors might encounter in audits of companies with operations in emerging markets. The EP discussed the potential impact on valuation of investments in emerging markets, particularly in China. In some cases, the trading of securities has been halted, and there have been issues with missing regulatory filings, and resignation of auditors or board members.

For entities that are primarily invested in securities in Asia or China, the EP discussed whether there should be risk disclosures in the notes to financial statements discussing current business environment and risks. The EP members shared that some are considering expanding emerging markets risk disclosure and corporate governance disclosures, and the EP plans to revisit this topic during the November EP meeting.

2. Regarding the SEC Custody Rule, when performing surprise examinations, the EP discussed whether accounting firms are performing procedures to determine if the qualified custodian sends account statements directly to clients at least quarterly, in accordance with Rule 206(4)-2(a)(3). If auditors become aware that the adviser is not sending statements on at least a quarterly basis, that may represent a material discrepancy. The EP members discussed that if the auditor becomes aware of material noncompliance, the auditor may need to report such instance to the SEC, but there is no specific objective to inquire whether a qualified custodian sends quarterly account statements to its clients. The EP members discussed that accounting firms are inquiring with the RIAs whether they have a reasonable belief that such statements are being sent on at least a quarterly basis, but noted that looking for quarterly statements sent to the adviser's clients is generally not part of the design of specific procedures relating to a surprise examination.
3. The PCAOB has recently released a proposed rule that would require disclosure of the name of the engagement partner in the auditors' report and the annual form filed with PCAOB, as well as the name of any other person or accounting firm that took part in the audit. The proposed requirements would assist the user of the financial statements in identifying whether the other person or accounting firm are registered with the PCAOB and whether they have been subject to disciplinary actions. Comments on the proposed rule are due by January 9, 2012.

IV. SEC Update

These highlights are not authoritative positions or interpretations issued by the SEC or its staff. The highlights were not transcribed by the SEC and have not been considered or acted upon by the SEC or its staff. Accordingly, these highlights do not constitute a statement of the views of the Commission or the staff of the Commission.

1. Megan Monroe joined the SEC Investment Management Division staff as a new Assistant Chief Accountant.
2. **Custody Rule:**
 - a. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC's FAQ's and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of

the FAQs). The staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. During the October 2011 EP conference call, the SEC staff did not have any updates on the inquiry at this time.

3. Other

- a. In June 2011, the SEC adopted new rules under the Investment Adviser's Act of 1940 to implement provisions of the Dodd-Frank Act. Beginning on page 18 of the release (<http://www.sec.gov/rules/final/2011/ia-3221.pdf>), there is a discussion of "assets under management" being used to determine an adviser's registration requirements. Beginning on page 22, the release discusses calculating "regulatory assets under management" on a gross basis (i.e., without deduction of any outstanding indebtedness or other accrued but unpaid liabilities). Footnote 83 on page 23 also states the following:

Some commenters asked that we clarify how the calculation on a gross basis would apply with respect to, among others, mutual funds, short positions, and leverage. See IAA General Letter; MFA Letter. We expect that advisers will continue to calculate their gross assets as they do today, even if they currently only calculate gross assets as an intermediate step to compute their net assets. In the case of pooled investment vehicles with a balance sheet, for instance, an adviser could include in the calculation the total assets of the entity as reported on the balance sheet.

The release implies that the gross calculation would not be reduced for securities sold short. During the October 2011 conference call, the SEC staff indicated that the short sales should not be deducted from the regulatory assets under management.

- b. As discussed during prior EP meeting and calls, the SEC staff reiterated that if a fund both waived expenses and recouped or recaptured expenses within the same period, the fund may separately present that netted amount on the fee table in the prospectus and supplement it with disclosure as follows:
- i. footnote attached to that line item explaining the waiver and recapture and whether the fund was in a waiver or recapture state at the end of the period; and
 - ii. disclosure of the potential liability to the adviser that the fund could be liable for in the future (somewhere in the prospectus, for example in the statutory section).

The EP members also raised a question regarding what potential disclosures in the financial statements and the fee table may be required if waived expenses and recaptured expenses that occurred within the same period are presented gross. The staff noted that the required financial statement disclosures would be based on facts and circumstances, and encouraged registrants to consult with the SEC staff regarding presentation in the fee table in such cases.

- c. The staff noted that if a mutual fund invests in a BDC, the mutual fund needs to include the BDC's fees as "Acquired Fund Fees and Expenses" on the fee table in the prospectus. The staff referred to the Question 1 within the "Staff Responses to Questions Regarding Disclosure of Fund of Funds Expenses" on the SEC's website (<http://www.sec.gov/divisions/investment/guidance/fundfundfaq.htm>).
- d. The SEC staff did not share any financial statement review comments at this time.
- e. In a request to follow up on reference to confirmation of investments held with the custodian in the audit opinion on BDCs from the September EP meeting, the staff inquired of the EP on

- i. Whether BDCs hold investments with single or multiple custodians;
- ii. Are the auditors actually confirming all investments held by a BDC and not including that information in the opinion, or are the auditors not confirming all investments held by a BDC and therefore, not including that information in the opinion.

The EP responded that there is diversity in practice regarding the usage of single versus multiple custodians by BDCs. The EP also responded that absent a regulatory requirement, there may be diversity in practice with some firms confirming 100% of investments, while some may utilize a sampling approach.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the November 16,
2011, 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 company issues.

I. Administrative items/AICPA matters:

1. The Investment Companies Expert Panel (IC EP) welcomed its new members:
 - Amy Edwards, BlackRock
 - John T. Hague, McGladrey & Pullen, LLP
 - John Hildebrand, PricewaterhouseCoopers LLP
 - Quintin I. Kevin, Adams Street Partners LLC
 - Joseph O'Donnell, Moore Capital Management, LP.
2. The September 2011 EP meeting highlights have been posted to the AICPA site at: http://www.aicpa.org/interestareas/frc/industryinsights/downloadabledocuments/inv_ep_minutes/inv_ep_september8_2011.pdf.
The October 2011 EP call highlights are expected to be released shortly.
3. The AICPA staff provided an update on the next editions of the Audit Risk Alert and AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
4. The EP discussed the meetings and conference call schedule for the remainder of 2011 and 2012, and other administrative matters.

II. Accounting/Reporting Issues

1. The EP discussed the current FASB projects on Investment Companies (Topic 946), Investments Property Entities (Topic 973), and Consolidations (Topic 810). Trevor Farber, former FASB staff, joined the EP meeting to provide an overview of these projects. The chairpersons of the AICPA comment letters task forces and staff updated the EP on the current efforts to date, and the EP members shared their thoughts regarding the projects and their anticipated impact on the investment companies industry. The EP noted that as a best practice, comments should be provided to both the FASB and IASB as applicable.

A. Investment Companies project: The EP discussed the history of this project and how it correlates with the ongoing Investment Properties project, particularly regarding the proposed requirement to consolidate entities in which a fund has a controlling financial interest. The proposed ASU on Investment Companies requires an entity to meet all six stated criteria in order to follow investment company accounting, and the EP discussed potential concerns with certain criteria. Regarding the ‘nature of investment activities’ criteria, the EP discussed the impact of the proposed rule on access funds, where multiple investors are in a fund with a single investment. Certain EP members expressed concern with the proposed pooling criteria which would preclude a fund with one investor, or a fund with only affiliated investors, from qualifying as an investment company. Currently there are investment companies such as sovereign wealth funds or collective funds that have one investor, and investment advisers often set up funds for a single investor in order to offer a unique fee structure. The EP also discussed the unit ownership criteria, noting that certain collateralized loan obligation (CLO) entities which do not have equity interests may fail to qualify as an investment company. An EP member discussed the potential impact to the SEC’s definition of a ‘pooled investment vehicle’ for the purposes of applying the SEC Custody Rule. An EP member also noted a potential conflict between a banking requirement to show a collective fund at fair value, and the proposed exposure draft which could scope out collective funds from following fair value accounting. An EP member discussed potential concerns for funds set up for family offices, which may not qualify as an investment company. The EP also discussed a potential issue for employee funds whose governing documents indicate that contributions and redemptions shall occur at NAV calculated on a fair value basis; if fair value accounting can no longer be used for this entity based on the proposed criteria, then this will add a cost burden for advisers to such funds. Lastly, the EP discussed potential difficulties demonstrating the fair value management criterion, for entities that are focused on credit.

In general, the EP discussed the challenges with implementing a rules-based approach to defining an investment company, given the number of scenarios that are currently in practice, and that perhaps certain of the proposed criteria could be ‘required’ while some may be ‘considered’. The EP indicated that the timing of implementing the new guidance could create issues as investors may seek to strategically time their withdrawal from funds, depending on if and when the fund needs to change from fair value accounting model.

Regarding the proposed exception from the consolidation requirement for master-feeder structures, the EP discussed whether there should be an explicit requirement for the master fund’s financial statements to be attached to the feeder fund’s financial statements, as this is currently not explicitly required for nonregistered funds.

Regarding the proposed requirement for fund of funds to consolidate controlling financial interests in investees, the EP discussed the potential challenges involved with obtaining information from the investees in order to produce consolidated financial statements. The presence of noncontrolling interest on the balance sheet may cause confusion to the user of the financial statement in such cases. The EP noted there may be a theoretical inconsistency with requiring such funds to be consolidated, while not requiring consolidation of operating companies. The EP also discussed the difficulties with distinguishing between the requirements to consolidate if a fund owned 100% of an investee, versus if the fund owned 51% of an investee. The EP also discussed the existing look-through disclosure requirements (as explained in Paragraphs 8–10 of FASB ASC 946-210-50) to disclose a fund’s proportionate share

of investments held by the investee that exceed 5% of the fund's net assets. The EP also noted that consolidation of other investment companies may lead to independence issues, since the auditor of the fund needs to provide comfort on consolidated balances of the investee.

Some advisers to investment companies (such as private equity funds or registered investment companies) set up blocker entities specifically to hold one investment. Such blocker entities may be wholly-owned by one fund, while in some cases, various funds hold interests in the blocker. The panel members discussed potential consolidation implications for funds that invest into such blockers under the new proposed guidance for investment companies and consolidation, as currently diversity in practice exists.

- B. Consolidation: The EP discussed how this proposed ASU will replace the deferral that was granted to certain investment companies upon the release of SFAS 167 (ASC Topic 810). The EP discussed the differences between the IASB and FASB consolidation models and noted that generally, similar conclusions may be reached, although the process of how the conclusion is reached may differ under the two models.

Certain EP members expressed concerns with the relevance of certain VIE disclosures when the decision maker is an agent. The EP further discussed the applicability of consolidation to money market funds, and noted that there is a specific question in the exposure draft on this matter.

2. The EP members are developing best practice guidance (non-authoritative) on what would be considered a security and what would be considered a derivative under GAAP for investment companies. Such guidance is expected to be inserted into the next edition of the Guide.
3. The EP discussed the potential impact of the proposed ASU entitled *FASB Seeks Comments on Proposed Technical Corrections to Codification*:
 - a. One correction relates to the conditions for excluding a cash flow statement in investment company financial statements. A change in the investments criterion from substantially all securities being "liquid" to substantially all securities being classified as Levels 1 or 2 in the ASC 820 hierarchy, could impact an entity's assessment of the requirement to include a cash flow statement. The EP discussed this change in light of the SEC's 1940 Act definition of an illiquid security.¹
 - b. The EP will consider amending its Technical Practice Aids within TIS 6910 relating to cash flow statements if the ASU is adopted as is, in order to ensure conformity with the revised ASC 230 (formerly FAS 102) exemption wording proposed in it, and to make sure there are no unintended consequences from the changes.
4. The EP discussed implementation questions relating to ASU 2011-4 *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*:
 - a. ASU 2010-6 required disclosure of significant transfers between Level 1 and 2. ASU 2011-4, which is effective for interim and annual periods starting after December 15, 2011, removes the word 'significant' from this requirement, for public entities. Regarding this change, the EP discussed how this would impact the assessment in determining whether immaterial transfers need to be disclosed. Some entities may consider using qualitative and quantitative materiality thresholds. An EP member noted that since the entity needs to perform an analysis of what the transfers were, and the comparative disclosure requirements it may be easiest to disclose all transfers regardless of materiality.

¹ Refer to page 5 of the document in the attached link. <http://www.sec.gov/rules/final/1986/ic-14983.pdf>. Note that the ten percent limit referred to in this document was subsequently increased to fifteen percent; see Revisions of Guidelines to Form N-1A, [Investment Company Act Release No. 18612](#) (Mar. 12, 1992).

- b. ASC 820-10-55-106 (within ASU 2011-4) states: “For recurring fair value measurements categorized within Level 3 of the fair value hierarchy, this Topic requires a reporting entity to provide a narrative description of the sensitivity of the fair value measurement to changes in significant unobservable inputs and a description of any interrelationships between those unobservable inputs.” The EP discussed how the industry will interpret this requirement and how detailed this narrative description will be. Some registered investment companies may produce a model supporting the significance of the increase/decrease in the value of Level 3 securities based on a significant increase/decrease in the inputs. Alternatively, some entities may provide a simpler directional analysis whereby the relative sensitivity (i.e. increase or decrease) of the inputs included in the presentation required per ASC 820-10-55-103² is discussed. The EP discussed that the level of detail in the narrative description may depend on the nature and complexity of the instrument.
- c. ASU 2011-4 removed the “in-use” and “in-exchange” concepts from Topic 820. In the September 2011 EP meeting, the panel members discussed how the removal of the “in-use” and “in-exchange” concepts would impact private equity funds and business development companies (BDCs) who have historically used the enterprise value approach to value debt and equity instruments when they have control; and, when a private equity fund or BDC has control of the capital stock, whether the enterprise value approach would still be acceptable under ASU 2011-4 or the standard now required each of the instruments to be valued on an instrument-by-instrument basis. The panel members expressed a view that until this removal, using enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP noted that this is a unit of account question and identified the following 3 emerging views:
- A. treat each single instrument (debt or equity) as the unit of account, with all identical securities managed within a single portfolio for valuation purposes. This would result in a change in the enterprise value approach;
 - B. treat equity instruments with voting rights (such as controlling interests) as the unit of account and carve out debt. This would also result in a change in the enterprise value approach;
 - C. treat both equity instruments that have voting rights and other equity and debt instruments as the controlling interest, and, hence, unit of account. This would not result in a change in the current valuation practice.

The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. During the November meeting, the EP continued to discuss this matter and is in the process of drafting a document to be presented to the FASB for clarification.

5. The EP discussed the following scenario: a private equity (PE) firm has control over an investee, and allocates ownership across multiple PE funds. One PE fund may own a significant portion of the investee, while the other PE funds own smaller stakes. The EP considered whether the funds that do not have control apply a control premium when determining their valuation of the investment. The EP discussed the fiduciary responsibility that an adviser has to treat all of its fund products equitably, as well as the challenges of recording a day-one gain or loss due to

² 820-10-55-103 states that: “For fair value measurements categorized within Level 2 and Level 3 of the fair value hierarchy, this Topic requires a reporting entity to disclose a description of the valuation technique(s) and the inputs used in the fair value measurement. For fair value measurements categorized within Level 3 of the fair value hierarchy, information about the significant unobservable inputs used must be quantitative.”

the control premium adjustment for those funds that do not have control. The EP will include this matter in the document on enterprise value, which will be presented to the FASB for clarification.

6. The EP discussed accounting for blocker entities. A blocker is an entity that is introduced into a fund structure for the purpose of blocking undesirable tax effects to the investor and/or to the fund which may result from the nature of the underlying investment(s). A fund is subject to various requirements in order to qualify as a regulated investment company (“RIC”) for tax purposes, resulting in a RIC distributing substantially all of its taxable income to its shareholders and therefore not paying federal or state income tax. One of these requirements is that at least 90 percent of a RIC’s gross income consist of investment income and be derived from ‘qualifying income’ (e.g., dividends, interest, gains from the sale of stocks and securities). A blocker is generally used by a RIC to change the character of non-qualifying income that might otherwise cause a RIC to lose its RIC status. A blocker is organized as a wholly-owned subsidiary of a fund and can be established as either a domestic or foreign subsidiary. Foreign blockers are used for investments, such as commodities, that are not effectively connected with a trade or business in the U.S. Domestic blockers and certain foreign blockers are typically set up for investments such as U.S. partnership interests in operating entities or private companies. The income from the domestic blockers is considered effectively connected with a trade or business in the U.S. The domestic blockers are therefore subject to income tax on the operating income of the investment in the operating partnership as well as the capital gains of the investment upon sale.

An EP member noted the potential challenge in reconciling the literature in Regulation S-X, which precludes a registered investment company from consolidating an entity that is not a registered investment company. Refer to SEC Staff Update section for further discussion.

III. Audit and Attestation Issues

1. During the September 2011 EP meeting, the EP members discussed the cost, time and effort that may be imposed on the investment management industry, if audit firms are rotated periodically. In addition, due to SEC independence rules, certain “Big Four” accounting firms may not be SEC-independent, which may limit options for global companies that seek to utilize such accounting firms. The EP also discussed potential changes to the auditor reporting model, and challenges that would arise if the accounting firms would need to provide an auditors discussion and analysis. During the November EP meeting, the EP members continued to discuss the potential impact of this release and considered requesting feedback from the SEC about the proposal and any other next steps the industry can take to ensure an industry voice is heard about ramifications to the fund industry (for example, additional costs and additional time to issue reports). The EP discussed considerations related to the potential impact on various matters such as 1) audit quality during transition years, 2) potential difficulties with finding a replacement accounting firm with expertise in certain geographic locations, 3) independence implications, particularly for fund complexes that utilize multiple accounting firms to perform audit, advisory, and consulting services, 4) impact on audit committees
2. The EP discussed recent developments at MF Global and the implications on the investment management industry.

IV. SEC Staff Update

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. Custody Rule:

- a. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC staff's FAQ's and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC staff on this matter. During the November 2011 EP meeting, the SEC staff did not have any updates on the inquiry at this time.

2. Other

- a. Earlier this year, the SEC issued Concept Release No. IC-29776 "Use of Derivatives by Investment Companies under the Investment Company Act of 1940" requesting comments on a number of issues, including the potential implications for fund leverage, diversification, exposure to certain securities-related issuers, portfolio concentration and valuation, and other matters. In addition, the Commission invites members of the public to comment on any other matters that they believe are relevant to the use of derivatives by funds. The SEC staff noted that the comment period has closed and that the Commission is currently reviewing comment letters received.
- b. The EP members and the SEC staff discussed the PCAOB's concept releases on auditor independence and audit firm rotation and potential changes to the auditor reporting model. The SEC staff provided a reminder that concept releases are an attempt to gather information and may or may not result in new rules or guidance. The PCAOB will be hosting a roundtable on auditor independence and mandatory audit firm rotation in March 2012; however, a formal agenda has not yet been established. The SEC staff reviews concept releases from the PCAOB and will informally provide any insights or comments to the PCAOB for its consideration. An EP member inquired of the SEC staff's views on transitional auditor independence issues that may arise from mandatory audit firm rotation, due to the fact that some entities currently use a mix of the Big Four firms to perform a variety of services. The SEC staff mentioned that this issue is not specific to the investment management industry, and that this concern may be noted in comment letters received by the PCAOB from the public in general.
- c. The EP and the SEC staff discussed blocker entities that are formed for legal, regulatory, tax, or other business reasons and are wholly-owned by an investment company. The SEC staff discussed that consistent with its previous discussions with the Expert Panel at the meetings in April and September 2011, as described in Rule 3A-02 of S-X, there is an overall presumption that consolidated financial statements are more meaningful than separate statements. The SEC staff reminded registrants to consider the substance as well as the form of the relationship between the investment company and the blocker (or SPV, as appropriate), and whether consolidation more appropriately reflects the overall financial position and results of operations. The SEC staff has not objected when an investment company consolidates a wholly-owned blocker that holds only one underlying investment. The SEC staff noted that generally, consolidation (if appropriate under GAAP)

would provide the most meaningful financial statement presentation, and is an effective way to provide transparency. The SEC staff will continue to monitor the FASB's projects regarding the definition of an investment company and consolidation rules. The SEC staff encourages registrants to consult with the SEC staff on particular fact patterns that pertain to blocker entities and wholly-owned subsidiaries.

- d. The SEC staff discussed the application of IFRS to RICs and noted that the Commission has not yet made a determination as to whether it would require public companies to prepare financial statements in accordance with IFRS. The SEC staff noted that two SEC staff papers are expected to be released in the near future; however these are not expected to address RIC specific issues.
- e. The SEC staff noted that registrants should include the new disclosures required by ASU 2011-04 in their Form N-Q filings. In response to a question from the EP, the SEC staff indicated that ASC 820 stipulates that it need not apply to immaterial items. However, Form N-Q refers to Rule 12b-20 of the Exchange Act which indicates that a registrant shall include additional material information in order to make the schedule not misleading.
- f. The SEC staff provided a reminder to registrants that management has the responsibility of ensuring valuation is performed and reported in accordance with GAAP, ensuring all required disclosures are properly included as it relates to measurement and valuation of securities. For example, for Level 2 securities that are priced by third-party vendors or pricing services, there should be a focus on appropriate internal controls over the use of such third-party vendors or pricing services. This should include obtaining a sufficient understanding of valuation models used by the third-party, including significant inputs and assumptions. The registrant should also have sufficient internal controls over financial reporting to ensure that all amounts presented in the financial statements are supported. An EP member raised a concern that some third-party vendors often do not provide sufficient transparency to allow for an appropriate level of due diligence on prices provided. During upcoming SOX reviews of all industries, registrants may be asked specific questions on these items, and this will assist the SEC staff in developing an understanding of valuation processes utilized.
- g. The SEC staff provided the following comments related to their recent financial statement reviews:
 - i. The SEC staff has observed that certain BDCs have not included the required disclosure of non-qualifying investments in the Schedule of Investments in registration statements and periodic filings with the Commission. The SEC staff reminded registrants of the requirement in Form N-2 (located in Item 8.6c, instruction 1.b.) which indicates that a BDC should provide an indication in its Schedule of Investments of those investments that are not qualifying investments under Section 55(a) of the 1940 Act and, in a footnote, briefly explain the significance of non-qualification.
 - ii. The SEC staff reminded registrants that when performing the asset test under Rule 3-09 of Regulation S-X (which is one of three tests indicated in Rule 1-02(w) to determine whether the financial statements of a subsidiary should be attached to the registrant's filing with the Commission), a registrant needs to perform the tests using the GAAP consolidated financial statements for both the registrant and the subsidiary. Under the asset test, if the registrant's proportionate share of the total assets of an unconsolidated majority-owned subsidiary exceeds 20% of the total assets of the registrant, the financial statements of the unconsolidated majority-owned subsidiary should be attached to the registrant's financial statements. The SEC staff reminded registrants that Rule 1-02(w) indicates the prescribed tests are performed using financial information for both the registrant and its subsidiary prepared in accordance with GAAP including the consolidation of other subsidiaries, as necessary. The SEC staff noted a recent case where a

BDC held an investment in a wholly-owned investment adviser that managed a portfolio of CLOs. In this case, the BDC determined that the wholly-owned adviser was required to consolidate several of the CLOs in accordance with GAAP. Therefore, the BDC concluded that the BDC's proportionate share of the wholly-owned Adviser's consolidated total assets (which included consolidation of the CLOs) was greater than 20% of the BDC's Total Assets. As a result, the BDC concluded that it is required to attach the financial statements of its wholly-owned adviser in its periodic filings with the Commission.

- h.* The SEC staff provided an update to recent discussions with the EP on auditors' reports for BDCs, and whether the auditor's report should include a statement that the auditor confirmed securities owned by the BDC ("Statement"). It is not clear, legally, as to whether confirming all BDC investments is required and whether the auditor's report should include the Statement. The SEC staff consulted with the Division of Investment Management's Office of Chief Counsel and the SEC staff believes that a strong case could be made that confirmation of 100% of the BDC's investments and inclusion of the Statement in the audit report are required. Therefore, the SEC staff believes that auditors should confirm 100% of investments and include the Statement in the auditor's report. The SEC staff observed that many auditors' reports on BDCs do include the Statement. The SEC staff noted that if the Statement is not included in the auditor's report, it may impact the Office of Compliance Inspections and Examinations' (OCIE) risk assessment in determining which BDCs to examine. The SEC staff also noted that the performance of this step is a relevant factor, among all of the facts and circumstances, for the Board to consider when assessing the overall safety of the BDC's assets.
- i.* The EP raised the topic of the exposure drafts on consolidation and the definition of an investment company. The EP members commented that although infrequent, a RIC could have a greater than 50% interest in unaffiliated investment companies, and that there may be operational issues if the registrant is unable to obtain financial information related to the unaffiliated investment companies in order to prepare consolidated financial statements.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the December 15, 2011, 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 company issues.

I. Administrative items/AICPA matters:

1. October Expert Panel (EP) conference call highlights have been posted to http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/DownloadableDocuments/INV_EP_Minutes/INV_EP_October_2011_ConferenceCall.pdf
2. The AICPA staff is finalizing notes from November EP meeting.
3. The AICPA Publications staff provided an update on the Audit Risk Alert and sought EP members' feedback on the timing of EP review and issuance of 2012 AICPA Accounting and Audit Guide Investment Companies and Audit Risk Alert.

II. Accounting/Reporting Issues

1. In the September 2011 EP meeting, the SEC staff discussed variable rate demand (VRD) notes. During the financial statement review process, the SEC staff observed that there were certain funds holding VRD notes with liquidity enhancements (in addition to credit enhancements). The SEC staff learned that only a few large banks provide these liquidity enhancements and that not all mutual funds were disclosing the liquidity enhancements, the liquidity enhancement providers, and the possible credit concentration provided in these arrangements. The SEC staff reiterated that, when funds have investments in securities with liquidity enhancements, funds should consider the guidance in ASC 946-210 regarding identification of 3rd parties providing credit enhancements. The disclosure would include the name of the liquidity provider in the security's description in the Schedule of Investments and discussion of the liquidity enhancement arrangements within the notes to the financial statements. The EP discussed the impact of this guidance on the investment management industry.
2. Regarding the Level 3 rollforward under ASC 820, the EP discussed the presentation of paydowns from investments in debt securities. ASU 2010-6 requires separate disclosure of purchases, sales, issuances and settlements. For some funds, paydowns would be a material component of the rollforward. The EP noted that while entities generally do not disclose paydowns as a separate line item within the rollforward, this may be an effective disclosure depending on the materiality of the

paydowns. The EP also discussed the operational challenges some entities may face in separating paydowns from sales, and how some entities include these items within sales, while others may include such items within settlements, and that there may be diversity in practice. The EP noted that clear disclosure of an investment company's policy is needed in order for the reader to understand the ASC 820 rollforward.

3. In November 2011, FASB issued Proposed Accounting Standards Update (Revised)—Revenue Recognition (Topic 605): Revenue from Contracts with Customers. Page 70 of this proposed ASU provides an example of an entity entering into a contract with a client to provide asset management services. The EP discussed the definition of a “client” for these purposes, and which party the investment adviser should consider as its client; the mutual fund(s) it manages or the investor that bought shares in the fund(s)? The definition of a client may impact the accounting treatment. Regarding recognition of the 12b-1 fee, if the investor is the client, an entity may need to consider the length of time an investor is expected in the fund and develop an expectation of revenue throughout. Typically, advisers have their contracts renewed each year through their distributor, and the fund pays the distributor based on average net assets. Additionally, if the investor is deemed to be the client, then the adviser may need to perform an analysis regarding the adviser's collectability of management and other fees from individual shareholders. The EP will revisit the topic at the next EP call.
4. The AICPA staff and chair of the AICPA comment letter task force on Topic 810 updated the EP on the FASB projects on Investment Companies (Topic 946), Investments Property Entities (Topic 973), and Consolidation (Topic 810) and the task forces' current efforts to date. The comment period for these projects was extended until February 15, 2012.

III. SEC Staff Update

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. Custody Rule:

- a. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC's FAQ's and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. During the December 2011 EP conference call, the SEC staff did not have any updates on the inquiry at this time.
- b. On December 13, 2011, the SEC staff issued a joint set of responses to frequently asked questions (FAQs) relating to auditor independence. They appear at the SEC's custody rule FAQ page at http://www.sec.gov/divisions/investment/custody_faq_030510.htm and also at the

Office of the Chief Accountant's FAQ page

<http://www.sec.gov/info/accountants/ocafaqaudind080607.htm>. The new questions added relate to the following:

- i. Consideration of auditor independence relating to non-audit services performed by an accounting firm engaged to perform services pursuant to the SEC Custody Rule. The Commission's 2003 adopting release (Release No. 33-8183 (January 28, 2003), *Strengthening the Commission's Requirements Regarding Auditor Independence*), states that there is a rebuttable presumption that certain prohibited non-audit services (e.g. bookkeeping, financial information systems design and implementation) will be subject to audit procedures during an audit of the audit client's financial statements. For example, if a pooled investment vehicle is included in the scope of an adviser's surprise examination under the Custody Rule, the accountant performing the surprise examination would be prohibited from compiling the pooled investment vehicle's financial statements.
 - ii. Clarification of the definition of the audit and professional engagement period.
 - iii. Technical clarification that if the auditor is notified prior to issuing their surprise examination report that they will not be engaged to perform the next surprise examination, then the professional engagement period ends with the issuance of the accountant's report for that particular engagement.
- c. The SEC staff discussed the June 2011 Dodd-Frank Rulemaking, under which certain private fund advisers will need to register with the SEC by March 30, 2012, and will, therefore, need to comply with the Investment Advisers Act of 1940 and the SEC Custody Rule. If the adviser is deemed to have custody over client assets, the first surprise examination will generally need to occur in 2012, unless the Audit Provision (as defined in the Custody Rule) is utilized. Rule 206(4)-2(a)(4) indicates that the first surprise examination needs to occur within six months of being subject to the Custody Rule. For example, for an adviser that registers with the SEC on March 30, 2012, the first surprise examination would need to be performed no later than September 30, 2012. The SEC staff reminded the EP that the surprise examinations need to be performed on a surprise basis.

2. Other

- a. The EP inquired of the SEC staff's position on interim effective dates for the second half of a fiscal period; specifically, in relation to new accounting standards that impact accounting policy, such as in the case of ASU 2011-3. The SEC staff indicated that they believed that the application would be similar to application of FASB Statement No. 161 (FAS 161). While FAS 161 allowed retroactive application, ASU 2011-3 should be applied for transactions prospectively. ASU 2011-3 is effective for the first interim or annual period beginning on or after December 15, 2011. As an example for funds with a fiscal year-end of August 31, 2012:
 - i. The guidance would be effective for the period beginning March 1, 2012 for the purposes of the May 31, 2012 Form N-Q and the August 31, 2012 annual Form N-CSR.
 - ii. The guidance is not applicable for the February 29, 2012 semi-annual Form N-CSRS, as it was not effective because the period started before the effective date.
 - iii. The fund will have dual accounting practices/policies for the year ending August 31, 2012, and would disclose both policies in the August 31, 2012 Annual Report, which is consistent with what other non-IM registrants would be disclosing.

The Basis for Conclusions within the ASU, paragraph 22, indicates that ASU 2011-3 should be applied prospectively to both transfers that occur after the effective date and existing transactions that are modified after the effective date. In this example, to the extent that the transaction was entered into prior to March 1, 2012 and is not yet settled, the transaction would be accounted for under the previous guidance. If the entity enters into new transactions (e.g. a Mortgage Dollar Roll transaction is "rolled" forward subsequent to March 1, 2012) or

modifies existing transactions after March 1, 2012, then the new guidance in ASU 2011-3 will be applied.

- b. The SEC staff shared the following observations with respect to the EP's inquiries regarding a recent speech presented at the 2011 AICPA National Conference on Current SEC and PCAOB Developments on the use of pricing service information in informing fair value measurements and disclosure (<http://sec.gov/news/speech/2011/spch120511jpk.htm>)

- i. The EP asked the SEC staff whether the following excerpt from the speech applies to Investment Companies :

“If the pricing service only provides a price for a given CUSIP with no information about the models or assumptions used to price it, management may not have enough information to assess the appropriateness of that price to determine whether it is in conformity with GAAP...”

The SEC staff noted that the controls performed by management to consider fair value measurement information received will be based on facts and circumstances and may need to be responsive to risks that such information is inaccurate or incomplete. The SEC staff indicated that registered investment companies need to ensure that fair value measurements and disclosures are in accordance with GAAP. The certifying officers of registered investment companies need to provide a certification in Forms N-CSR and N-Q indicating that internal control over financial reporting is designed to provide reasonable assurance that financial reporting is reliable and that the financial statements are prepared in accordance with GAAP. Registered investment companies should maintain adequate controls around the recording of fair value measurements which may include performing due diligence at pricing vendors (e.g., understanding the pricing service's valuation techniques, assumptions and models), comparing valuations to other vendors or market information, back testing, price challenges, etc.

- ii. The EP members are concerned that caveats or disclaimers that pricing services sometimes include with its pricing information may affect the procedures management performs to evaluate that information. The SEC staff noted that registrants (and their auditors) need to understand the context of the disclaimers and may need to consider other work performed by management, such as due diligence at the vendor and the overall risk management process, to ensure compliance with fair value measurement standards are being met.
- iii. In response to the EP's question about the valuation procedures for nonregistered investment companies managed by a registered investment adviser, the SEC staff indicated that nonregistered investment companies that prepare GAAP financial statements for purposes of the Custody Rule need to ensure that fair value measurements and disclosures are in accordance with GAAP. Advisers to non-registered funds are required by Rule 206(4)-7 of the Advisers Act to adopt and implement written policies and procedures reasonably designed to prevent violation of the Advisers Act and Rules thereunder.

- c. Regarding use of derivatives, the SEC staff has generally not objected to registrants' derivative footnote disclosures. However, the SEC staff continues to notice that some Management's Discussion on Fund Performance (MDFPs) are vague and do not elaborate when derivatives materially impacted the fund's performance. In her recent speech on November 17, 2011 at the ICI 2011 Closed-End Fund Conference (<http://sec.gov/news/speech/2011/spch111711epr.htm>), Eileen Rominger, Director of Division of Investment Management of the SEC, reiterated the importance of describing in the annual report, any material impact of derivatives or leverage on the performance of the fund. An EP member noted that there are situations when the manager does not separate derivatives performance by fund but rather has an overall derivative strategy for all funds in the

investment company complex, or the manager does not track derivative performance separately from the rest of the portfolio, for each fund. The SEC staff reminded the EP that Item 27(b)(7)(i) of Form N-1a requires MDFPs to discuss the factors that materially affected the Fund's performance during the most recently completed fiscal year, including the relevant market conditions and investment strategies and techniques used by the Fund's adviser.

- d. The SEC staff reminded the EP that Rule 6-07(2)(e) of Regulation S-X requires the amount of brokerage commissions paid to the affiliate broker-dealer(s) in the notes to the financial statements.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the February 2, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. November Expert Panel (EP) call highlights have been submitted for posting.
2. All AICPA Expert Panels are being asked to develop periodic webcasts or webinars on industry-specific issues. The EP members expressed an interest in developing and participating a webcast or webinar. The EP members will provide the AICPA staff with their suggestions regarding topics to be covered.
3. The AICPA staff provided an update on the 2012 AICPA Accounting and Audit Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues

1. In November 2011, FASB issued Proposed Accounting Standards Update (Revised)—*Revenue Recognition (Topic 605): Revenue from Contracts with Customers*. Page 70 of this proposed ASU provides an example of an entity entering into a contract with a client to provide asset management services. In December 2011, the EP discussed the definition of a “client” for these purposes, and which party the investment adviser should consider as its client: the mutual fund(s) it manages or the investor that bought shares in the fund(s). The definition of a client may impact the accounting treatment. Regarding recognition of the 12b-1 fee, if the investor is the client, an entity may need to consider the length of time an investor is expected to be in the fund and develop an expectation of revenue throughout. Typically, advisers have their contracts renewed each year through their distributor, and the fund pays the distributor based on average net assets. Additionally, if the investor is deemed to be the client, then the adviser may need to perform an analysis regarding the adviser’s collectability of management and other fees from individual shareholders. The EP revisited this topic during the February 2012 EP call. The EP members observed that internationally, the client may be considered to be an investor rather than the fund. Since the proposed ASU is not clear on the definition of a “client” in an investment management scenario, the EP anticipates the FASB

may provide more clarity on this during the re-deliberations. The EP members also plan to raise this issue in their comment letters. The FASB is seeking the industry's perspective and already approached several asset management firms to participate in an informal discussion with the FASB staff in March 2012 to better understand potential issues. The EP members and staff considered scheduling a conference call with the AICPA Revenue Recognition comment letter task force to discuss industry concerns.

2. Chairpersons of the AICPA comment letters task forces on FASB ASC Topics Investment Companies (Topic 946) and Consolidation (Topic 810) updated the EP on the current status of the AICPA comment letters to date.
 - a. Regarding the proposed Investment Companies ASU, the EP discussed:
 - i. Proposed disclosure requirements regarding financial support of an investment company's investments, and the potential impact on unfunded term loans, venture capital investments, and special situation investments.
 - ii. Proposed requirement to disclose the nature and extent of any significant restrictions in the ability of investees to transfer funds to the investment company in the form of cash dividends, or interest, or repayment of loans or advances. The EP discussed how the term 'investees' could be defined very broadly, and the potential impact on investment companies.
 - b. Regarding the proposed Consolidation ASU, the EP discussed considerations for a consolidation analysis when a fund invests in another fund that is part of a trust (one of many funds in that trust). The EP members discussed an example on how the proposed guidance in Topic 810 (Flowchart on 810-10-05-06) should be applied for the investor fund, as either a VOE or VIE.
3. As discussed during the November EP meeting, the ASU 2011-4 removed the "in-use" and "in-exchange" concepts from Topic 820. In the September 2011 EP meeting, the panel members discussed how the removal of the "in-use" and "in-exchange" concepts would impact private equity funds and business development companies (BDCs) which have historically used the enterprise value approach to value debt and equity instruments when they have control. When a private equity fund or BDC owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of these concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. During the February 2012 conference call, the EP chair updated the EP that the EP subgroup developed a white paper and will discuss this matter with the FASB staff seeking clarification.
4. The EP members discussed the extent to which ASC 820 "fair value" disclosure is needed for the debt issued by tender option bond trusts and brought onto the balance sheet by open-end funds. ASU 2011-4 requires disclosure of the fair value of financial assets and liabilities, even when those liabilities are not accounted for at fair value (under the fair value option or otherwise). If fair value approximates carrying value, the EP members discussed that it is generally sufficient to simply disclose that fact. The leveling of such instruments in the ASC 820 fair value hierarchy also needs to be disclosed. The EP suggested forming a subgroup to further discuss this topic before the March 2012 EP conference call.

5. As a follow up to the November 2011 EP meeting, the EP held a brief discussion about materiality and disclosures related to ASU 2011-4, particularly regarding implementation considerations for investments priced using broker quotes.

SEC Staff Update

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 SEC's Division of Investment Management has an opening for a Professional Accounting Fellow in its Office of Chief Accountant.
2. **Custody Rule:**
 - a. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC's FAQ's and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. No update was provided by the SEC staff.
 - b. During the February 2012 EP conference call, the SEC staff informed the EP that they recently received a no-action request which asked the SEC staff to permit a 529 Plan to use the audit provision.
 - c. It came to the EP's attention that as part of the SEC's rule making with respect to adviser registration, certain rules were rescinded. Specifically, Rule 203(b)(3)-1, which contained guidance to determine the number of "clients" has been rescinded. The example surprise exam report in the Guide references the old rule (i.e. Rule 203(b)(3)-1) in the third paragraph. The example management's assertion statement also references the old rule. The AICPA staff is in the process of updating the illustrative surprise exam report and assertion in the Guide, as well as on the EP webpage of aicpa.org. The EP members and AICPA staff sought the SEC staff's suggestions regarding revisions to the example report and assertion. The AICPA staff will post a revised report to the aicpa.org website. These changes will also be reflected in the 2012 Guide.
3. **Other**
 - a. The SEC staff is seeking industry feedback and considering developing guidance on the SEC yield calculation. For example, the SEC staff noted there is inconsistency in the calculation and disclosure of the SEC yield for funds that invest in treasury inflation-protected securities (TIPs). The SEC staff observed that some funds include the inflationary adjustment in their yield calculations and some do not.
 - b. During the December 2011 conference call, the EP and SEC staff discussed interim effective dates for the second half of a fiscal period; specifically, in relation to new accounting standards that impact accounting policy, such as in the case of ASU 2011-03.

ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. To illustrate an example, for a fund with a fiscal year-end of August 31, 2012:

- i. The guidance would be effective for the period beginning March 1, 2012 for the purposes of the May 31, 2012 Form N-Q and the August 31, 2012 annual Form N-CSR.
- ii. The guidance would not be applicable for the February 29, 2012 semi-annual Form N-CSR.
- iii. The fund would present dual accounting practices/policies for the year ending August 31, 2012, and disclose both policies in the August 31, 2012 Annual Report.

The Basis for Conclusions within the ASU, paragraph 22, indicates that ASU 2011-03 should be applied prospectively to both transfers that occur after the effective date and existing transactions that are modified after the effective date. In the above example of a fund with a fiscal year-end of August 31, 2012, to the extent that the transaction was entered into prior to March 1, 2012, this transaction would be accounted for under the previous guidance. If the entity enters into new transactions, modifies existing transactions, or rolls over existing instruments (e.g., a Mortgage Dollar Roll transaction) after March 1, 2012, the new guidance in ASU 2011-3 would be applied to such transactions prospectively.

c. Financial statement review comments:

- i. The SEC staff noted a registration statement review whereby a post-effective amendment was filed in December 2011 which incorporated by reference the auditor's consent dated April 2011. The SEC staff expressed a view that an updated consent letter should be filed in such cases, rather than referring to an old consent letter where an extended period of time has lapsed.
- ii. Managed futures funds – in addition to the consolidation scenario on managed futures funds with blockers which was discussed with the EP during the September 2011 EP meeting (see financial statement review comments – consolidation), the SEC staff reviewed other managed futures funds and provided the following observations during the February 2012 EP conference call:
 - (1) Expense ratios – some of the funds invested in a wholly-owned, non-SEC registered Cayman Islands tax blocker (Cayman Blocker) which was consolidated. These funds' financial highlights presented two sets of expense ratios (including and excluding expenses of the consolidated Cayman Blocker) with equal prominence. Since the fund owns 100% of the Cayman Blocker, this presentation may be misleading. The expense ratio including the expenses of the consolidated Cayman Blocker should have been presented with greater prominence in the financial highlights.
 - (2) Disclosure of valuation policies in the footnotes - some funds invested in underlying funds that were neither wholly-owned nor consolidated; however, the notes to the financial statements did not include disclosure on how the investments in those underlying funds were being valued, such as whether the funds were using the practical expedient per ASC 820 to value the investments in those underlying funds. In these situations, the SEC staff reminded funds about the requirements of including a discussion on valuation of these investments in underlying funds and providing disclosures in accordance

with ASC 820-10-50-6A, such as any restrictions on redemptions from the underlying funds.

- (3) Total return swaps – some funds redeemed from an investment in a commodity pool and replaced their exposure to commodities through a total return swap, but did not provide sufficient disclosure of the total return swap in the financial statements. The SEC staff advised that funds investing in total return swaps (and other derivatives), need to disclose the notional amount and identify counterparties when describing the total return swap in the financial statements.

The EP further discussed a scenario where a fund's derivative counterparty was a subsidiary of a large investment bank, and whether the fund should present the subsidiary entity, or the large investment bank, when identifying the counterparty. An EP member expressed a view that disclosing the large investment bank may imply that the investment bank is guaranteeing the fund's assets, when in fact the subsidiary may be bankruptcy-remote.

- iii. The SEC staff noted that recently certain N-14 filings have included pro forma narrative information. The SEC staff provided a reminder that registrants should follow Regulation S-X 11-02(b), and include narrative pro forma information only in those situations when there are a limited number of pro forma adjustments and those adjustments are easily understood. The Staff cited two examples recently filed, one in which the Staff did not object to pro forma narrative information where there were multiple funds merging. However, the Staff also noted another example of a standalone fund merging into a feeder fund of which pro forma narrative information was not allowed. To the extent there are questions, the SEC staff should be contacted to discuss each situation.
- iv. The EP and SEC staff continued discussing valuation of Level 2 securities, as the SEC staff continues to ask management questions during the SOX review process about its use of pricing service information. These questions may be related to the use of the pricing services in complying with the accounting and disclosure requirements in the financial statements, management's certification of internal control over financial reporting (or ICFR), and the basic requirement to maintain books and records.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the March 1, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. November and December Expert Panel (EP) call highlights are available online. February EP call highlights are being reviewed by the EP and SEC staff.
2. As discussed during the February EP conference call, all AICPA Expert Panels are being asked to develop periodic webcasts or webinars for AICPA membership on industry-specific issues. The AICPA staff will schedule a separate conference call with those EP members who expressed interest in developing and participating in the first webcast.
3. Industry reviewers' comments on 2012 proposed conforming changes to the AICPA Accounting and Audit Guide *Investment Companies* (the Guide) are due March 16, 2012.
4. The illustrative surprise examination report for examinations of securities pursuant to Rule 206(4)-2 of the Investment Advisers Act of 1940, which is currently available on the aicpa.org website, will be updated shortly and will be included in the 2012 Guide.

II. Accounting/Reporting Issues

1. The EP discussed and later inquired of the SEC their intentions with respect to the increased focus on private equity (PE) valuation as outlined in a number of recent media articles. One article describes situations where the regulators were concerned that the private equity firm may be using inflated valuations to make the new funds more attractive for investors.
2. The EP continued discussing the asset management industry's concerns relating to the FASB Proposed Accounting Standards Update (Revised)—*Revenue Recognition (Topic 605): Revenue from Contracts with Customers*. Example 13 on page 70 of this proposed ASU includes a scenario of an entity entering into a contract with a client to provide asset management services. The definition of a "client" for these purposes and which party the investment adviser should consider as its client: the mutual fund(s) it manages or the investor that bought shares in the fund(s) is not clear. As the definition of a "client" may impact the accounting treatment, the EP members previously discussed that it should be clarified. Regarding recognition of the

12b-1 fee (a fee paid by the fund out of fund assets to cover distribution expenses and sometimes shareholder service expenses), if the investor is the client, an entity may need to consider the length of time an investor is expected to be in the fund and develop an expectation of revenue throughout that period. Typically, advisers have their contracts renewed each year through their distributor, and the fund pays the distributor a fee based on average net assets. Additionally, if the investor is deemed to be the client, then the adviser may need to perform an analysis regarding the adviser's collectability of management and other fees from individual shareholders. The EP members observed that internationally the client may be considered to be an investor rather than the fund, while in the United States the fund is usually viewed as the client. Since the proposed ASU is not clear on the definition of a "client" in an investment management scenario, the Investment Companies Expert Panel recommended that the AICPA staff comment letter consider including a recommendation that the FASB provide more clarity with respect to the definition of a "client" and for the purposes of the above mentioned scenario consider the fund as the client that would be consistent with what is currently done under US GAAP. An EP member mentioned that there have also been concerns regarding the performance obligations for an asset manager. Certain EP members will be participating in the informal discussions with the FASB staff and will share feedback during the next EP conference call.

3. As previously discussed during the EP meetings and calls, ASU 2011-4 removed the "in-use" and "in-exchange" concepts from Topic 820. When a private equity fund or BDC owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of these concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. The EP subgroup developed a white paper and will discuss this matter with the FASB staff seeking clarification, and will share feedback on the next EP call.
4. The EP members discussed the extent to which ASC 820 "fair value" disclosure is needed for the debt issued by tender option bond trusts and brought onto the balance sheet by open-end funds. ASU 2011-4 requires disclosure of the fair value of financial assets and liabilities, even when those liabilities are not accounted for at fair value (under the fair value option or otherwise). If fair value approximates carrying value, the EP members noted that it is generally sufficient to simply disclose that fact. The leveling of such instruments in the ASC 820 fair value hierarchy will also need to be disclosed under ASU 2011-4.
5. The EP discussed geographic categorization of investments, particularly for Chinese (and to a lesser extent Russian companies), the legal jurisdiction in which they are formed is offshore (Cayman Islands and Bermuda are common). EP members noted diversity in practice where the geographic classification is based on either the legal jurisdiction or the location of principal operations for the same securities. The instructions for classification of investments in the portfolio listing "by related industry, country, or geographic region" originated in the Guide and then were picked up in Regulation S-X. The terms "country" and "geographic region" were never defined in the Guide, which appears to have led to the diversity. The EP members shared that generally geographic classification is based on the concentration of the risk and economic exposure (where the principal business actually takes place). Since the language originated in the Guide and relates to both registered and non-registered funds, the EP members considered developing a definition of "geographic region" and further discussing it with other industry groups and the SEC staff during future meetings and calls, with potential inclusion of that definition into the Guide.

6. The SEC and PCAOB have recently been communicating their concerns about the extent of due diligence procedures performed on third party pricing services. In response to one EP member's question, the EP members generally observed that at this time it may be difficult to determine the type of industry response with respect to such concerns, as some pricing services provide internal control reports (SOC 1, or, formerly SAS 70), but scope out and do not cover valuation, while others may cover certain aspects of valuation but include caveats.
7. The Guide's illustrative financial statements in Exhibit 5-3, as well as paragraph 7.176, show a breakout of paid-in capital and distributable earnings on the balance sheet ("breakout"). For unitized nonregistered funds, this is not a common industry practice, as this breakout is less useful since there is no regulatory requirement regarding distributions, and the funds generally intend to reinvest all profits. The example balance sheet in 7.194, which appears to be specific for cases where investors in unitized nonregistered funds are issued individual classes or series of shares as discussed in 7.132 and 7.164, shows a single line item for net assets that does not show the breakout. An EP member noted per paragraph 7.88 that FASB ASC 946-20-50-11 requires all investment companies to disclose only two components of capital on the balance sheet: shareholder capital and distributable earnings. An EP member noted that many nonregistered funds do not describe distributable earnings in their governing documents. The EP considered adding clarification in the Guide to indicate that this breakout is more commonly presented for registered unitized funds to provide more clarity to the industry. During the next EP call, the EP will also consider whether this needs to be brought to the FASB's staff attention as this requirement is currently codified in the FASB ASC.
8. The EP member inquired how entities have been estimating the collectability of any monies deposited with MF Global. The EP members noted that current practices vary, but the financial statements should disclose significant estimates with respect to this issue.
9. The EP members briefly provided their observations about recent FASB Roundtables on Topic 946 and noted that several EP members and chairperson will be attending the March 16 roundtable in Norwalk, CT. The participants in previously held FASB roundtables generally were not supportive of consolidation requirements proposed by the FASB and hinted towards disclosure recommendations consistent with those suggested in the AICPA comment letter around support and leverage. Few respondents were against the investment entity concept altogether (and instead supported the asset-level approach). EP members observed that consistency among standards between the IASB and FASB would be desirable.

III. SEC Staff Update

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. Custody Rule:
 - a. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC staff's FAQs on the Custody Rule and the application of the custody rule to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP

members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. No update was provided by the SEC staff during the March 2012 EP call.

- b.* During the February 2012 EP conference call, the SEC staff informed the EP that they recently received a no-action request which asked the SEC staff to permit an adviser to a 529 Plan to use the audit provision. No update was provided by the SEC staff.
- c.* It came to the EP's attention that as part of the SEC's rule making with respect to adviser registration, certain rules were rescinded. Specifically, Rule 203(b)(3)-1, which contained guidance to determine the number of "clients" has been rescinded. The example surprise exam report in the Guide references the old rule (i.e. Rule 203(b)(3)-1) in the third paragraph. The example management's assertion statement also references the old rule. The AICPA staff is in the process of updating the illustrative surprise exam report and assertion in the Guide, as well as on the EP webpage of aicpa.org. The EP members and AICPA staff sought the SEC staff's suggestions regarding revisions to the example report and assertion. The AICPA staff will post a revised report to the aicpa.org website. These changes will also be reflected in the 2012 Guide.

2. Other

- a.* The SEC staff noted as an update on money market reform that in her recent speech, the SEC Chairwoman Shapiro covered, among other things, reasons for future money market fund reforms. She discussed two options the SEC is currently considering: floating net asset value (NAV) and imposing capital requirements, combined with limitations or fees on redemption. The full text of that speech is available at <http://sec.gov/news/speech/2012/spch022412mls.htm>
- b.* The SEC staff provided one recent financial review comment regarding a registrant with a recapture plan that extended for five years. The SEC staff provided a reminder of the guidance in ASC 946-20-05-8 and that it is the staff's position that the recapture plan should have a defined period of 3 years or less.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the March 29, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. February 2012 AICPA Investment Companies (IC) Expert Panel (EP) call highlights have been posted to http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Investment_Companies.aspx.
2. The AICPA Publications staff updated the EP members about the status of the 2012 conforming changes update to AICPA Accounting and Audit Guide *Investment Companies* (the Guide) and sought further clarifications from the EP members regarding reviewers' comments received to date.
3. The EP members discussed dates and times of future EP meetings and conference calls.
4. The EP formed a subgroup that will develop a webinar on current IC EP activities and accounting and auditing topics affecting the investment companies industry. The first AICPA IC EP webinar will take place in the summer of 2012.

II. Accounting/Reporting Issues

1. As previously discussed during the EP meeting and calls, ASU 2011-4 removed the "in-use" and "in-exchange" concepts from Topic 820. When a private equity fund or BDC owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of "in-use" and "in-exchange" concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. The EP subgroup developed a white paper and has discussed this matter with the FASB staff seeking clarification. Once finalized, the white paper will be posted to the EP's webpage on aicpa.org.

2. An EP member provided a brief overview of the comment letters submitted in response to the FASB Proposed Accounting Standards Update (Revised)—*Revenue Recognition (Topic 605): Revenue from Contracts with Customers* highlighting the asset management industry’s concerns.
3. The Guide’s illustrative financial statements in Exhibit 5-3, as well as paragraph 7.176, show a breakout of paid-in capital and distributable earnings on the balance sheet (“breakout”). For unitized nonregistered funds, this is not a common industry practice, as this breakout is less useful since there is no regulatory requirement regarding distributions, and the funds generally intend to reinvest all profits. The example balance sheet in 7.194, which appears to be specific for cases where investors in unitized nonregistered funds are issued individual classes or series of shares as discussed in 7.132 and 7.164, shows a single line item for net assets that does not show the breakout. During the March 1, 2012 call, an EP member noted per paragraph 7.88 that FASB ASC 946-20-50-11 requires all investment companies to disclose only two components of capital on the balance sheet: shareholder capital and distributable earnings. An EP member noted that many nonregistered funds do not describe distributable earnings in their governing documents. The EP considered adding clarification in the Guide to indicate that this breakout is more commonly presented for registered unitized funds to provide more clarity to the industry. During the March 29 call the EP considered forming a working group that may bring this issue to the FASB’s staff attention as this requirement is currently codified in the FASB ASC.
4. Regarding entities that prepare combined financial statements, a question arises whether all accounting policies of the entities combined shall be uniform. For instance, one entity within the combined financial statements recognizes incentive fee revenue using Method 1 (i.e. recognizing incentive fee revenue at the end of the contract year) in accordance with Topic No. D-96 *Accounting for Management Fees Based on Formula*. Another entity, however, recognizes the incentive fee revenue quarterly using Method 2 of the same guidance. As both methods are acceptable under GAAP, disclosure of the various policies adopted within the combined financial statements could be considered a potential alternative. [ASC 810-10-45-10](#) indicates that combined financial statements should follow the same policies as would be appropriate in preparing consolidated financial statements. The EP supported this view and noted that consistent policies should apply for all entities when combined financial statements are prepared. The EP member also noted guidance included in paragraph 23 of old ARB 51 (with consolidated financial statements) that states “When combined financial statements are prepared....., intercompany transactions and profits or losses shall be eliminated, and noncontrolling interests, different fiscal periods, or income taxes shall be treated as in the same manner as in consolidated financial statements”.
5. Some private equity funds are not recording contingent earn out payments for investments they have sold. An example may be milestone payments related to the development of a drug/medical device by a portfolio company. The payments are noted in the footnotes as a gain contingency but are not given a fair market value and not recorded on the balance sheet. In other instances, funds estimate the fair value of these payments and record them. The EP members discussed whether instances where such payments are recorded cause an issue for entities using NAV as the practical expedient per ASC 820 (i.e. should the NAV be adjusted to include the FMV of the gain contingency or do financial statements prepared in accordance with GAAP not need to be adjusted)? The panel members discussed that that the fund should first determine whether derivatives guidance applies. If it does not, the fund may make an accounting policy election to either consider such earn out payment as a financial asset and include at fair value in the financial statements or treat it as ASC 450 contingency (exclude from the financial statement but disclose). An EP member suggested that the fund manager could consider reaching out to the portfolio company to better understand the accounting and how conclusions were reached.
6. The EP members were informed of potential tax and financial implications of the proposed amendments in India Budget 2012 for private equity, hedge fund and other alternative investors. The EP will monitor and revisit this topic during the May EP meeting.

III. Audit and Attestation Issues

1. A recent law firm publication indicates that a court declined to dismiss negligence claims against auditors, taking a broad view of what circumstances evidence a duty owed to the audit client's investors. Specifically, the court found that investors, potential investors, and the auditors were in "near privity" (one means of establishing a duty under applicable New York law) because the auditors addressed the reports to shareholders and other stakeholders, and thus found that the investors were part of a "particularized class" of entities whom the auditors knew would rely on their reports. The AICPA report example in 11.02 of the Guide is addressed to "Shareholders and the Board of Directors/Trustees of XYZ Investment Company". A question arose whether the auditors' report example for nonpublic funds should be addressed to both the board of directors and shareholders. (Section 32(a)(4) of the 1940 Act requires auditors of registered investment companies to address their reports to both the board of directors and shareholders.) The EP members discussed this issue and considered whether it would need to be updated in the Guide. The EP members noted that this is a general reporting matter not limited to investment companies, and do not anticipate changes in the current guidance at this time; however, the EP will monitor this issue and continue discussing it at future EP meetings and calls.

IV. SEC Staff Update

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. Custody Rule:
 - a. For an investment adviser registered with the SEC in October 2011 and deemed to have custody of client assets upon registration, the EP raised a question regarding the timing of the first surprise examination. Question I.3 of the SEC staff's FAQs on the Custody Rule states: "For an adviser that becomes subject to the rule after the effective date [of the Custody Rule], the surprise examination must commence within six months after it becomes subject to the rule." The EP inquired whether it is correct to interpret the FAQ to mean that the adviser does not need to have its first surprise examination commence until April 2012 (six months after the registration) or would the first surprise examination need to commence as of a date in the calendar year 2011, in order for the adviser to have satisfied the Custody Rule for the 2011 calendar year.

The SEC staff noted that per the text of the Rule 206(4)-2(a)(4) and per Section III.B (1) of the adopting Release No. IA-2968 (Effective and Compliance Dates beginning on page 51), for advisers that become subject to the rule after the effective date, the first surprise examination must occur within six months of becoming subject to the surprise examination requirement. If the adviser maintains client assets as a qualified custodian (QC), the first surprise examination would need to occur no later than six months after obtaining the internal control report. Therefore, if an adviser registered with the SEC on October 31, 2011 and uses an independent QC, the first surprise examination should commence no later than April 30, 2012; if the adviser is itself a QC, an internal control report must be received no later than April 30, 2012, and the first surprise exam should commence no later than October 31, 2012. The surprise exam should be completed within 120 days from the date selected, and for the adviser that first became subject to the Custody Rule in October 2011, if the surprise exam occurs as of a date in 2012, no additional surprise exam would need to be done until the calendar year 2013.

If the adviser is registered in January 2012, the first surprise examination should occur within six months after the adviser became subject to the Rule. If the adviser to a pooled investment vehicle (PIV) registered with the SEC in January 2012, as long as the PIV distributes its audited financial statements prepared in accordance with U.S. GAAP within

120 days after the PIV's year-end (or 180 days for a fund of funds, or 260 days for a fund of fund of funds) to all limited partners (or members or other beneficial owners) and the audited financial statements were audited by an independent public accountant that is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules, the adviser to this PIV would satisfy the "audit provision" exception in the Custody Rule and would not be required to have a surprise examination in 2012 (this example assumes the PIV does not liquidate in 2012).

The EP also discussed a scenario where an adviser became subject to the Custody Rule when it launched a PIV in November 2011. The adviser did not have an audit of the PIV performed as of December 31, 2011, but will have a surprise exam occur within six months (by May 2012). This PIV does not need an audit performed for 2012 for its adviser to satisfy the Custody Rule. However, if the adviser uses the 2012 surprise exam of the PIV to comply with the Custody Rule for 2011 and 2012 (as opposed to using the audit provision in 206(4)-2(b)(4)), the adviser would need to comply with the notice requirements in 206(4)-2(a)(2) and the account statement requirements in 206(4)-2(a)(3) for the entire period subject to the Custody Rule and the adviser would be required to have a QC maintain the PIV's privately offered securities as per 206(4)-2(b)(2)(ii).

- b. The SEC staff informed the EP members about comments received from recent inspections of registered investment advisers regarding custody of client assets. Certain advisers to PIVs improperly determined custody of client assets and concluded that certain clients' assets were not subject to the Custody Rule when in fact they were. The registered investment advisers should evaluate the types of services they provide to their clients and evaluate whether those client assets are within the scope of the Custody Rule.
- c. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC staff's FAQs on the Custody Rule and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. No update was provided by the SEC staff.
- d. During the February 2012 EP conference call, the SEC staff informed the EP that they recently received a no-action request which asked the SEC staff to permit an adviser to a 529 Plan to use the audit provision. No update was provided by the SEC staff.

- 2. The EP discussed the following issue. Regarding geographic categorization of investments as presented on the schedule of investments, particularly for Chinese (and to a lesser extent Russian companies), the legal jurisdiction in which they are formed may be offshore (Cayman Islands and Bermuda are common). EP members have noted diversity in practice where the geographic categorization is based on either the legal jurisdiction or the location of principal operations for the same securities. The EP indicated that instructions for categorization of investments in the schedule of investments "by related industry, country, or geographic region" originated in the Guide and then

were noted in Regulation S-X. The terms "country" and "geographic region" were never defined in the Guide, which appears to have led to the diversity. The EP members shared that generally geographic categorization is based on the concentration of the risk and economic exposure (where the principal business actually takes place). Since the language originated in the Guide and relates to both registered and non-registered funds, the EP members considered developing a definition of "geographic region".

The SEC staff acknowledged that while its view on categorization is generally consistent with the EP's view that categorization should be based on risk and economic exposure, this is a facts and circumstances determination, where judgment needs to be applied. If a registrant chooses to explain the basis of using geographical categorization by providing additional disclosure, the SEC staff would not be object to such disclosure. An EP member noted that categorization should be determined using a consistent methodology..

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the May 23, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. March 1, 2012, and March 29, 2012, Expert Panel (EP) call highlights have been posted to aicpa.org.
2. The AICPA publications staff informed the EP that the AICPA Accounting and Audit Guide Investment Companies (the Guide) is anticipated for issuance in July 2012. Later this year, the AICPA staff will solicit the EP's feedback for the upcoming Audit Risk Alert Investment Companies.
3. The EP members discussed dates and times of future EP meetings and conference calls.
4. The EP formed a subgroup that will develop a webinar on current EP activities and accounting and auditing topics affecting the investment companies industry. The first AICPA IC EP webinar will take place on June 26, 2012 at 1pm EST.
5. As previously discussed during the EP meeting and calls, FASB Accounting Standards Update (ASU) 2011-04 "Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs" removed the "in-use" and "in-exchange" concepts from Topic 820. When a private equity fund or BDC owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of "in-use" and "in-exchange" concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. The EP subgroup developed a white paper and has discussed this matter with the FASB staff seeking clarification. At this time, the IC EP subgroup and AICPA staff are developing Technical Practice Aids (TPAs) for TIS Section 6910 Investment Companies and will seek feedback from the EP members.

II. Accounting/Reporting Issues

1. The EP members discussed that many funds have previously included disclosure in their footnotes regarding the enactment of the Regulated Investment Company Modernization Act, but now that it is effective, the funds generally

have removed the majority of this transition language, yet retained some language about the Act and its implications for funds, especially when funds have pre-enactment capital loss carryovers that may expire unused.

2. The EP members discussed materiality thresholds for the new required financial statement disclosures for Level 3 securities under ASU 2011-04, and noted that reporting entities may determine a materiality level in deciding whether to present additional information required for Level 3 fair value measurements. The EP discussed challenges with determining a materiality threshold and the importance to view these thresholds qualitatively as well, based on changes from period to period that might be useful to a financial statement user. An EP member noted that some entities are not planning to provide the new quantitative disclosures of significant unobservable inputs for certain types of investments that are not material, and in such cases may provide a reconciliation to the other ASC 820 disclosures where all investments are included. The EP members also shared that some entities may plan on including all required information in Form N-Q filings, and cited the SEC staff comments from the October 2008 EP meeting highlights (regarding including FAS 161 disclosure in Form N-Q, based on a materiality assessment by the preparer) and the February EP 2012 conference call (regarding the implementation of applicable guidance of ASU 2011-03 in interim period filings).
3. The EP members noted the following guidance from the Basis for Conclusions in ASU 2011-04 with respect to the required (for public entities, starting Q1 2012) disclosure of quantitative information for level 3 fair value measurements for entities who report using the practical expedient under ASC 820:

BC89. Some respondents were concerned that the proposed amendments to the disclosure requirements would result in requiring additional disclosures for reporting entities that use, as a practical expedient, the reported net asset value to estimate the fair value of an investment in an investment company entity. The Board concluded that the disclosures about the fair value of those assets and liabilities that are subject to the practical expedient and categorized within Level 3 of the fair value hierarchy would not be meaningful for such instruments because the determination of the level in the hierarchy is made on the basis of the reporting entity's ability to redeem its investment, rather than on the basis of whether the inputs used in the measurement are observable or unobservable.

Certain EP members expressed concern that this information may not be well known to industry practitioners, as the Basis for Conclusions is not included within the FASB ASC Codification. The EP may consider including this guidance in next year's Guide (and 2012 Audit Risk Alert).

4. The Expert Panel shared experiences from Q1 2012 public filings regarding the implementation of ASU 2011-04:
 - a. Regarding disclosure of transfers between levels 1 and 2 in the first period of implementation (which includes the final interim period, such as the final semi-annual period in June 30 audited financial statements or the third quarter for March 31 Form N-Qs), many would revert to a more conservative approach and present all transfers for the entire period (not just 'significant' transfers'). However, members indicated that they may apply a materiality threshold to the transfer disclosures.
 - b. The EP discussed disaggregation of investments for the Level 3 input table and whether the groupings shall be consistent with those used for the leveling tables. The EP members discussed that in presenting quantitative disclosure for Level 3 measurements, an entity must disclose quantitative information about the significant unobservable inputs used in those measurements, while very small immaterial items may be aggregated with other items or even omitted altogether. The EP members noted guidance from ASU 2010-06 regarding the possible need for additional disaggregation for Level 3 fair value disclosures beyond that otherwise used in tabular summaries. An EP member also suggested referring to the FASB Staff Position No. FAS 157-4 "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly" on how to determine the category of assets and liabilities. The EP members noted that no new guidance on how to define an asset class for the purposes of disaggregation was introduced in ASU 2011-04. Whether the leveling hierarchy disclosure and the table of significant unobservable Level 3 inputs ("table") needs to be consistent is a matter of judgment, and the EP expressed a view that the tables need to provide an appropriate level of information based on category and may not match exactly with the other ASC 820 disclosures, including the leveling hierarchy. The disaggregation depends on the nature and risks of the instrument. Some EP members commented that when preparing the

table, ranges of quantitative data are often very broad, which could raise questions about whether the level of disaggregation is appropriate.

- c. Regarding disclosure of “Back-testing” inputs when the entity uses transaction cost to value a Level 3 investment, the EP discussed that paragraph BC 90 within ASU 2011-04 indicates that a reporting entity should not need to create quantitative information (for example, an implied market multiple or future cash flows) to comply with the disclosure requirement if quantitative information other than the prior transaction price or third-party pricing information is not used when measuring fair value; however a reporting entity cannot ignore other quantitative information that is reasonably available.
 - d. Regarding considerations when an entity uses two approaches (income and market), and regarding which approach(es) shall be included in the disclosure, the EP discussed the illustrative disclosure example on page 126 of ASU 2011-04 where only one fair value for investments in ‘direct venture capital investments: healthcare’ is shown, yet the unobservable inputs relating to two valuation approaches are presented. The EP discussed a scenario where an entity uses two approaches, whereby one is the primary method and a secondary method is used solely as a validation measure; in such cases it may be appropriate to only disclose the significant quantitative unobservable inputs for the primary method, while including narrative disclosure that can describe both methodologies that are used in developing fair value measurement.
5. It has been noted that there is diversity in practice on accounting for distributions received from an investment company's investments (i.e., as a capital gain distribution, dividend, or return of capital). In some cases, the investment company may not be aware of the character of the amounts received, or may develop its own accounting policy to account for distributions consistently. The accounting treatment may vary depending on whether the investee has positive earnings and profits (E&P). There may also be diversity in book versus tax treatment. The Guide indicates that “distributions that represent returns of capital should be credited to investment cost rather than to investment income. The FASB ASC glossary defines return of capital as distributions by investment companies in excess of tax-basis earnings and profits.”. EP members shared the following three scenarios where cash distributions are received:
- An investment company (IC) receives a distribution from another IC and character of the distribution does not get determined until after year-end;
 - Private equity fund receives a distribution from corporate investee;
 - Public or private fund receives recap distributions from public companies (1099 forms), and the investee public companies may not determine the character of the distribution until after year-end.

The EP will continue discussing this and consider developing a TPA or expanding the Guide’s discussion on this topic.

6. The EP members continue to monitor potential tax and financial implications of the proposed amendments in India Budget 2012 for private equity, hedge fund and other alternative investors. Earlier in May 2012, it was announced that certain general anti-avoidance rules were proposed to be applicable from financial year 2013-14. The EP discussed the occurrence of entities setting up Mauritius entities in order to make investments in India.
7. Transfers & Servicing (Topic 860) - On March 21, 2012, the FASB added a project to its agenda to reexamine the guidance in FASB Topic 860, with an emphasis on 1) the effective control criteria and 2) financial statement disclosures. While not explicitly mentioning dollar roll transactions, or distinguishing between repurchase agreements and dollar rolls, this project may scope in dollar rolls. On April 9, 2012, the FASB project staff reached out to various industry groups, including the ICI, with a series of questions in an effort to obtain more information, including the motivation to engage in repos or similar types of transactions, how these transactions are priced, how these transactions are being recorded by both parties to the transaction, and whether, since ASU 2011-03, the analysis of whether a repo (or similar transaction) qualifies for sale or secured borrowing accounting changed.
8. Investment Companies – Topic 946 – The panel members shared their views regarding question 14 from the FASB Norwalk Roundtable (afternoon session) and follow-up questions:

Question 14. If you believe that consolidation should not be required for an investment company, do you believe that specific disclosures about assets, liabilities, income, and expenses held by the investee should be required? If so, what should those disclosure requirements be? Should those disclosures be limited to controlled investees or should they be provided for significant investments held by the investment company?

Using the disclosure framework flowchart prepared by an EP member, the EP discussed that some would consider investments of 25% of net assets significant, while others consider a 5% threshold in determining significant investments. The EP also discussed the effects of leverage and accounting treatment of blockers, particularly consolidation considerations.

9. The EP also discussed balance sheet netting and its impact on mutual funds as a result of FASB's new disclosure requirements in ASU 2011-11. An EP member commented that certain of the new disclosure requirements are already considered within ASC 815 disclosures, as well as existing requirements for disclosures of collateral, and that cross-referencing may be utilized rather than repeating information. Industry members are performing internal analyses to determine what information needs to be provided, and how this will be achieved. Certain EP members expressed concern that new required disclosures would consume significant time and resources for mutual funds to prepare financial statement disclosures, and for auditors to audit them.

III. SEC Staff Update

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 Office of the Chief Accountant, Division of Investment Management (the "SEC staff"), joined the EP meeting in person. The SEC staff summarized the projects they are currently working on, questions they are receiving and their involvement on regulatory matters and assisting other Divisions and Offices within the SEC as questions arise.

1. Brief overview of the Office: The Office of the Chief Accountant, Division of Investment Management ("IM-OCA"), serves as a consultation office for the Commission on accounting and auditing issues in the investment management industry. IM-OCA works with various offices in the Division of Investment Management. For example, IM-OCA provides consultations to the accountants performing financial statement reviews, IM's rulemaking office, IM's Chief Counsel's Office, as well as IM's office that reviews Exemptive Applications. IM-OCA also works closely with the Office of Compliance Inspections and Examinations (OCIE) and Enforcement. On occasion, the IM-OCA staff may accompany the OCIE staff on certain examinations to leverage experiences. IM-OCA also works with the Commission's Office of Chief Accountant (OCA) on standard-setting activities, including following FASB projects on Topics 946 and 810, and following the PCAOB's projects. The SEC staff is available for external consultations with registrants and auditors.
2. Update on Division rulemaking and SEC staff projects:
 - a. Money Market Fund (MMF) reform – the SEC staff mentioned the speech of Chairwoman Schapiro at the SEC Speaks conference in February 2012 (<http://www.sec.gov/news/speech/2012/spch022412mls.htm>) which outlined that the SEC is considering two options: 1) floating NAV; and 2) imposing capital requirements, combined with limitations or fees on redemptions. The Chairwoman has met with industry representatives recently seeking feedback. No timetable for the anticipated date of completion of this project was provided.
 - b. Derivatives concept release – this release invited comment on a wide range of issues relevant to funds' derivative usage such as the potential implications for fund leverage, portfolio diversification and concentration, exposure to securities-related issuers, and valuation. The comment period closed in November 2011 and the SEC received approximately 50 comment letters. Some commented that funds should have greater flexibility in determining their own leverage limit when using derivatives, while others asked the Commission to defer any rulemaking until the regulatory framework for swaps under the Dodd-Frank Act (DFA) is completed. The SEC staff also stated that no decision has been made on whether to lift the moratorium that was imposed in 2010 on new and pending exemptive requests for leveraged ETFs or ETFs that use significant derivatives. No update on the proposal for ETFs to operate without obtaining an exemptive order was provided.
 - c. Target date fund rule – this was originally proposed in June 2010, and the comment period for this proposed rule was reopened in April 2012 as a result of investor testing conducted by a 3rd party. For example, investor testing showed that only 36% of respondents knew that a target date fund does not provide guaranteed

income at retirement. The purpose of the proposed rule is to propose disclosures that would be included in marketing materials of target date funds: for example, that the target date fund is not a guaranteed investment and the fund's stated asset allocation is subject to change. The SEC is currently evaluating feedback received.

- d. The SEC staff indicated there is no update on the project to amend Regulation S-X.
- e. Valuation guidance – The SEC staff indicated there is no update on whether the SEC will issue valuation guidance.
- f. A rule 12b-1 proposal was last issued in July 2010. Under this proposal, rule 12b-1 would, among other things, be replaced with a proposed rule 12b-2 and would allow funds to deduct 25 basis points of marketing and servicing fees for distribution activities. Any distribution fees in excess of 25 basis points would be called ongoing sales charges and would be capped by the highest front end sales load charged to any class of shares in the fund. No further update was provided.
- g. CFTC rulemaking – In February 2012, the CFTC adopted rule amendments that will require advisers to certain registered investment companies (RICs) that invest in commodities to register with the CFTC as Commodity Pool Operators (CPOs) unless the RIC complies with certain limitations on trading and marketing restrictions. The CFTC also issued a request for comments on a proposal intended to harmonize certain CFTC and SEC disclosure, reporting and recordkeeping requirements. The Expert Panel members mentioned that the Investment Company Institute and US Chamber of Commerce have filed a court challenge to the CFTC's adoption of this rule.
- h. SEC yield project – this is a two-phased effort to (1) determine whether to provide guidance on SEC yield calculation for Treasury Inflation Protection Securities (TIPS) based on a news article to address diversity in practice regarding consideration of an inflationary adjustment, and (2) continue a longer-term project to determine whether to develop broad SEC guidance on SEC yield calculations.

3. IFRS update – the 2008 IFRS roadmap indicated that the goal was for the SEC to determine in 2011 whether it should proceed with a rulemaking to require US issuers to adopt IFRS.

In May 2011, the SEC staff issued a staff paper Exploring a Possible Method of Incorporation (Condonement Paper). Commenters on the 'Condonement' Paper expressed strong support for the objective of a single set of high-quality globally accepted accounting standards. There was also support for the general premise of an endorsement mechanism, where the FASB would be retained and individual IFRSs would be incorporated into US GAAP. The SEC staff observed that some countries that use an endorsement approach make modifications or additions to IFRSs such as including industry specific guidance. Commenters observed that the FASB would play an important role in endorsing IFRS standards, as the FASB is in the best position to advocate for US investors and capital markets. Commenters also observed that maintaining a strong FASB would preserve the regulatory authority of the SEC and address issues with US GAAP being embedded in US laws and regulations. Some commenters suggested that further progress should be made on the FASB and IASB joint standard setting projects before IFRS is incorporated into the US.

The SEC staff has completed its work plan fieldwork and is in process of preparing a final report and developing an approach to recommend to the Commission. The SEC staff recognizes that there is currently guidance in US GAAP (e.g., FASB ASC Topic 946) that does not have corresponding guidance in IFRSs.

4. The SEC staff provided a brief overview of The Jumpstart Our Business Startups Act (the "JOBS Act") enacted in April 2012. Among other things, the JOBS Act establishes a new definition of "issuer" under the 1933 and 1934 Acts for "emerging growth companies" (generally, annual gross revenues less than \$1 billion). The JOBS Act, among other things, carves out these companies from certain disclosure requirements (e.g., for entities filing an IPO, only 2 years of audited financial statements versus 3 years, and for the MD&A, only 2 years versus 3 years of selected financial data is required) and exempts them from other obligations, such as Sarbanes-Oxley Act Section 404(b) auditor attestations of internal control over financial reporting. The SEC Division of Corporation Finance prepared substantial staff guidance and FAQs on <http://www.sec.gov/divisions/corpfin/guidance/cfjobsactfaq-title-i-general.htm#q18>. The SEC staff highlighted FAQ # 20 (that an investment company registered under the Investment Company Act of 1940 cannot qualify as an emerging growth company) and FAQ # 21 (that business development companies (BDCs) may qualify as emerging growth companies given the existing regulatory regime for BDCs). For example, contrary to registered investment companies, BDCs are subject to many of the disclosures and other requirements from which the JOBS Act provides exemption, such

as Sarbanes-Oxley Act Section 404(b) auditor attestations of management's assessment of internal control over financial reporting, executive compensation disclosure and say-on-pay votes. The SEC staff also indicated that certain emerging growth companies are permitted to have confidential reviews of initial registration statements if filed earlier than 21 days before their road show.

5. The SEC staff's Custody Rule FAQ VI.6 indicates US GAAS must be used for an adviser to meet the "audit provision" allowed under rule 206(4)-2(b)(4). The EP indicated that this presents complications for U. S. registered investment advisers for foreign funds for which the advisers are deemed to have custody, as non-US audit firms may be reluctant to perform audits under US GAAS due to limited familiarity with the standards. There are ongoing efforts to clarify US GAAS while converging towards International Standards on Auditing (ISA). The EP inquired whether there have been any developments on this matter since April 2010 (the last time the EP discussed this with the SEC staff), and whether the SEC staff would be open to potentially allowing for the use of ISA for financial statement audits of funds used to comply with the Custody Rule. The SEC staff referred the EP to the Custody Rule FAQ VI.5 http://www.sec.gov/divisions/investment/custody_faq_030510.htm and noted that, as a general policy matter, the Commission generally does not accept financial statements audited in accordance with ISA. For example, Foreign Private Issuers that use IFRS need to have their audits conducted in accordance with PCAOB standards, not ISA, for filings with the SEC. The SEC staff is aware that the AICPA issued an Analysis on its Clarity Project on the Substantive Differences Between ISA and US GAAS in September 2011. The SEC staff would like to further understand what the local jurisdictions require, how firms are currently complying with the Custody Rule (e.g., are they issuing two reports, one by the local firm and one by the US firm), whether auditing firms are using global audit methodologies that could be used for both US GAAS and ISA, limitations of overseas firms from issuing US GAAS opinions, and the substantive differences of an audit of an investment company between US GAAS and ISA.

6. Custody issues

The SEC staff also mentioned the following topics related to the Custody Rule from previous EP meetings:

- a. During several meetings and calls in 2010 and in April 2011, the SEC staff and EP members discussed the application of Question XII.1 of the SEC staff's FAQs on the Custody Rule and the application of the custody rules to a participant-directed defined contribution plan where one of the investment options is a pooled investment vehicle which has the same adviser as the related person trustee of the plan. According to the FAQ, the adviser must treat the assets of the plan as client assets of which it has custody. The EP member inquired if an adviser can satisfy the custody rule for the plan using the audit provision (or is it not considered a pooled investment vehicle and could not use the audit provision in accordance with Question X.1 of the FAQs). The SEC staff indicated that in these situations all the plan assets are subjected to the custody rule as both the plan and the fund is a client of the investment adviser. The investment adviser cannot avail itself of the audit provision for the defined contribution plan. The SEC staff additionally reminded the EP members that the defined contribution plan's interest in the pooled investment vehicle needs to be held by a qualified custodian (which, for a 1940 Act mutual fund, may be the fund's transfer agent). An EP member indicated that a letter requesting no-action relief has been submitted to the SEC on this matter. No update was provided by the SEC staff.
 - b. During the February 2012 EP conference call, the SEC staff informed the EP that they recently received a no-action request which asked the SEC staff to permit an adviser to a 529 Plan to use the audit provision. No update was provided by the SEC staff.
7. The Expert Panel members and the SEC staff discussed current areas of focus and findings raised by the Office of Compliance Inspections and Examinations (OCIE) and the Enforcement Asset Management Unit (AMU).

The OCIE administers the Commission's nationwide examination and inspection program. Two main goals of an OCIE exam are to: (1) determine compliance with securities laws and regulations and (2) determine safety of client assets. During an OCIE exam, the staff will generally request books and records of the entity, perform interviews with management and employees, analyze the entity's operations, and may visit the entity's offices. The OCIE staff currently includes attorneys, accountants and industry experts, including valuation experts.

The AMU investigates possible violations of securities laws and regulations. The AMU was created in 2010 and is comprised of approximately 70 staff members across several SEC regional offices that focus on investigations of asset management companies. The AMU staff currently consists of attorneys and industry experts with specific experience in hedge funds, private equity funds, mutual funds, fund operations, due diligence and trading. The AMU works closely with other Offices and Divisions within the Commission, such as OCIE and the Division of Investment Management. They also work with the Division of Risk, Strategy and Financial Innovation on developing risk analytics. For registered funds this could result in exams and investigations of investment companies and their Boards of Directors concerning their duties under the Investment Company Act. These analytics assess risks of registered investment advisers and funds and assist in identifying potentially problematic registered investment advisers and funds to further examine or investigate.

a. Current findings of OCIE examinations include:

- i. Deficient compliance programs
- ii. Disclosure, reporting and filing issues

The SEC staff also identified current areas of focus of OCIE which include:

- Complex entities
- Appropriateness of new or risky products
- Fraudulent activities
- Performance and advertising
- Fund governance.

The OCIE has its own webpage on sec.gov that provides information about OCIE, its national examination program, discussion of results of 2011 exams, and 2012 focus areas.

b. Enforcement AMU update (discussion of focus areas and recent cases)

i. Risk Analytic Initiatives include:

- (1) excessive fee arrangements by registered funds, their advisers and boards of directors.
- (2) disclosure and valuation issues in mutual fund bond portfolios,
- (3) preferential redemption by insiders at mutual fund complexes,
- (4) compliance program initiative (to identify those registered investment advisers who are lacking effective compliance programs),
- (5) private equity initiative related to advisers to ‘zombie’ funds, where the adviser decides to not wind down the fund in order to continue collecting management fees which are often their only source of revenue,
- (6) aberrational performance inquiry focuses on suspicious performance returns posted by unregistered and registered hedge fund advisers,
- (7) revenue sharing initiative.

ii. Some other areas of interest include:

- (1) mutual funds – strategies utilized are contrary to disclosed strategies, valuation and performance, board of directors and governance duties, personal trading, and high-risk products;
- (2) private funds – valuation and performance, conflicts of interest, offering issues, deficient third party service providers, and compliance and controls.

Recent enforcement actions involving valuation:

- (1) A large asset management firm was charged and agreed to pay a substantial settlement for not following its fair valuation procedures over a two-week period. In this case, the mutual funds used valuations obtained from pricing sources (broker-dealers or a third-party pricing service) to

value illiquid securities; however, these valuations were substantially in excess of the funds' most recent transaction prices. As a result, several funds had NAVs which were significantly misstated.

- (2) An adviser had to contribute a significant amount to certain of its fixed income funds (in order to make shareholders whole) as a result of a material weakness in internal controls over the validation of third party valuation models. This led to the improper valuation of an individual bond held by several of the funds over a three year period. The material weakness in internal controls resulted from the adviser not having sufficient processes in place to validate third party models on an ongoing basis.

iii. Valuation:

- (1) The EP and SEC staff discussed the valuation of Level 2 securities and the SEC staff's ongoing initiative relating to a registrant's understanding of policies and procedures of third party vendors. The SEC staff has reviewed responses received and is in process of asking a second round of questions to obtain further clarity on certain registrants' responses to certain questions as well as areas where the SEC staff believes there could be control gaps. For example, if an adviser is not using its price challenge process but has it documented as a key control, is it really an effective control?

The SEC staff noted that the focus on valuation is on-going and questions will continue to be posed to registrants during SOX reviews.

The EP inquired about the SEC staff's expectation of asset managers and mutual fund complexes relating to security valuation, what data must be obtained from the vendor, and whether the adviser is expected to obtain data from the pricing service of all information relating to each evaluation and validate all of the evaluated prices and models regularly, or have a general understanding of the methodology and process.

The SEC staff referred to the speech made by Jason K. Plourde, a Professional Accounting Fellow in the Professional Practice Group in OCA, which reminded registrants that determination of fair value must comply with GAAP, that management should maintain appropriate internal controls to prevent or detect material misstatements to financial statements, and have a process in place to ensure that management can assess the effectiveness of controls over financial reporting. The full speech is available at <http://www.sec.gov/news/speech/2011/spch120511jkp.htm>

8. The SEC staff provided a brief overview of the financial statement review process. In accordance with Section 408(c) of the Sarbanes-Oxley Act, at least once every three years the SEC staff reviews financial statements of issuers (RICs are included). The SEC staff in the Division of Investment Management reviews other filings, such as N-Qs and N-14s, and may also review registrants' websites for consistency with the registrant's filings with the Commission. The SEC staff generally provides their comments verbally, and registrants are typically given 30 days to respond to those comments. Generally, comment letters and response letters between the staff and registrants will ultimately be disseminated to the public unless there is confidential information. Beginning January 1, 2012, the SEC staff disseminate filing review correspondence no earlier than 20 days after the filing review is complete. The SEC staff shared the following financial statement review comments:
 - a. The SEC staff has recently provided financial statement comments around the disclosure requirements for non-consolidated subsidiaries. The SEC staff has observed an increase in funds making significant investments in non-registered entities. For example, the SEC staff has seen an increase in registration of mutual funds that employ some type of alternative investment strategy, such as Managed Futures Funds, that invest in non-registered investment companies. And the SEC staff has also seen an increase by BDCs investing in non-registered investment companies or other entities.

The SEC staff noted that if a Fund's investment in an unconsolidated entity exceeds certain thresholds, the SEC staff expects the audited financial statements of the unregistered unconsolidated entity to be included with the fund's filing.

Article 3-09 of Regulation S-X describes requirements for when separate financial statements of a significant subsidiary (e.g., unconsolidated non-registered investment company) should be provided with the reporting fund. Article 3-09 refers to the three tests included in Article 1.02(w) of Regulation S-X to determine whether the investee is a significant subsidiary. When performing the tests in Article 1.02(w), S-X requires the use of GAAP financial statements which would include the consolidation of any underlying subsidiaries if required under GAAP. Article 3-09 states that, generally, the separate financial statements required must be audited. It also explains that, insofar as practicable, the separate financial statements required should be as of the same dates and for the same periods as the reporting fund. The separate financial statements should be prepared in accordance with Regulation S-X and include a full schedule of investments.

In April 2010, the SEC staff expressed a view that in a case where a RIC invests 25% or more of its net assets in a nonregistered investment company, the RIC should provide the underlying fund's audited financial statements. The underlying fund's financial statements should be prepared in accordance with Regulation S-X, including a schedule of investments with the same level of detail as for the RIC itself (i.e., both presenting either a complete schedule of investments in the shareholder report, or a summary schedule under S-X Rule 12-12C in the shareholder report together with a complete schedule in the RIC's Form N-CSR filing).

The SEC staff stated that if a subsidiary is not consolidated, and it does not meet the criteria to attach financial statements described above, registrants should consider whether summarized financial information needs to be included based on Article 4-08(g) of Regulation S-X. Article 4-08(g) requires disclosure in the notes to the financial statements of a summarized balance sheet and income statement. Article 1-02(bb) of Regulation S-X, which contains the requirements for the summarized financial information, allows for the use of more meaningful information in the summarized balance sheet and income statement for specialized industries, such as investment companies. 4-08(g) explains that, insofar as practicable, the summarized financial information should be as of the same dates and for the same periods as the reporting fund.

The SEC staff encouraged registrants to consult on the accounting and disclosure requirements for funds' investments in nonregistered unconsolidated entities.

- b. The SEC staff observed that a BDC accrued income on a payment-in-kind (PIK) security, thereby increasing its cost; however, the valuation of that PIK security remained unchanged. This resulted in the BDC recording interest income and a decrease in change in unrealized gain/loss, and had a net impact of zero on the income statement; however, incentive fees were earned on the investment income component. Given that the cost was increased with no increase to valuation, the SEC staff questioned whether the valuation of the security was appropriate, and whether the PIK income should have been accrued.
- c. A registered fund invested over 90% of its assets into another fund, and did not have any other investments, but did not include financial statements of the underlying fund rather, it was stated that the financial statements of the underlying fund were mailed separately to the shareholders and they were also not included on the website. When an investment in another fund is that significant, financial statements of the underlying fund should be attached, consistent with master-feeder financial statement presentation. Further, the registrant's investments in the fund were shown as Level 1, while the underlying fund portfolio contained mostly Level 3 securities. Showing only Level 1 could be misleading. Funds following this fact pattern should include supplemental disclosure noting the underlying fund's portfolio mostly consists of Level 3 securities and refer to the fair value hierarchy in the financial statements of the underlying fund. Alternatively, the fund could include the underlying fund's fair value hierarchy in its financial statements. The SEC staff referred to the SEC staff guidance in December 2008 EP meeting highlights, which states, in part, that the SEC staff "would not object if the feeder fund either refers to the financial statements of the master fund in its financial statements or presents the [master fund's] "level" disclosure in its own financial statements."

9. The SEC staff provided the following comments on N-14 filings:

- a. The SEC staff continues to receive consultations on including narrative pro forma financial information within Form N-14. In order to utilize narrative pro forma presentation, Rule 11-02(b) of Regulation S-X indicates that there must be a limited number of pro forma adjustments which can be easily understood.
- b. Regarding the accounting survivor analysis: in cases where one entity has limited operations and another entity has established operations, the SEC staff may request an analysis of the determination of the survivor entity.

The funds should ensure that their analysis is robust, especially for a fund with limited operations being named a survivor. For instance, when a fund is merging with a shell company, that shell should generally not be deemed the accounting survivor. The concern is that poor performance could be merged into another entity and not fully disclosed to shareholders.

10. Expense ratios: when too many expense ratios are presented in financial highlights, the disclosure may become cluttered and difficult for shareholders to understand. The SEC staff prefers seeing the ratio of all expenses, as included in the Statement of Operations, to average net assets (gross expense ratio) and net expenses to average net assets within financial highlights; other ratios, if appropriate, may be included in a footnote to the financial highlights with a lesser prominence.
11. In response to an EP inquiry that the Form N-1A instructions for the Management's Discussion of Fund Performance (item (b)(7)), #10 (page 56) indicates that this "Item" is not required for new funds, the SEC staff commented that if the fund is in existence for less than 6 months, MDFP is not required.
12. The SEC staff provided the following comments regarding Form N-MFP:
 - a. Form N-MFP must be filed no later than the fifth business day of each month unless the business day is a federal holiday. When stock markets are closed, this does not mean it is also a federal holiday. For example, one third of money market funds did not file Form N-MFP on Good Friday, which is not a federal holiday. The SEC staff also referred to "Notice to Form N-MFP Filers" on the SEC's website. See <http://sec.gov/divisions/investment/imannouncements/formn-mfp-im.htm>
 - b. SEC staff has resources who review these filings on a real time basis and are available for consultation
 - c. To be classified as a Treasury Repo, Treasury repurchase agreements should be "fully collateralized" by Treasury securities and no other security types should be utilized. To the extent any security other than a Treasury is used as collateral, the repurchase agreement should not be categorized as a Treasury Repo. (the SEC staff referred to Item 31 of the Form)
 - d. When the fund or class is dissolved during the month, the Form N-MFP should still be completed, even if there are limited operations; in completion of the form in this instance it would be acceptable to the Staff to answer many of the questions as 'not applicable'.
 - e. When the fund is a feeder fund (answer "yes" within question 7), the questions that follow should be answered based on information pertaining to the master fund that the feeder is invested in, not the feeder fund.
 - f. When responding to certain items (particularly 26,27, and 37-39 which call for identification of the issuer, the issue's title, and any demand feature providers, guarantee providers or other types of enhancement providers), such as identification of the title and issuer, and demand feature providers, complete names for that information should be furnished rather than acronyms or ticker symbols.
 - g. The information requested in Item 32 should disclose information related to collateral of the repo, rather than the counterparty of the repo.
13. The SEC staff provided an XBRL update noting that the schedule of investments and financial statements continue to be part of the voluntary filing program. In 2012, the risk/return taxonomy has been updated for minor technical changes. The SEC staff also encourages registrants to continue to use the test filing function to determine whether the filing will pass EDGAR validation.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the September 13, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. May 23, 2012, Expert Panel (EP) meeting highlights are being finalized.
2. The AICPA publications staff will be seeking industry reviewers' input on the 2012 AICPA Audit Risk Alert - *Investment Companies Industry Developments* (INV ARA) in late September.
3. The EP discussed timing of remaining Expert Panel meetings and conference calls for the 2012 calendar year.
4. Rob Fabio, Adeel Jivraj, John Hague, and Irina Portnoy developed and presented the first IC EP webinar on June 26, 2012.
5. EP chair discussed EP composition for 2012-2013 volunteer year and thanked outgoing EP member Nancy Grimaldi for her contributions to the profession and Expert Panel.
6. As previously discussed during EP meetings and calls, ASU 2011-04 removed the "in-use" and "in-exchange" concepts from Topic 820. When a private equity fund or BDC owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of "in-use" and "in-exchange" concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. Earlier this year, the EP subgroup developed a white paper and discussed this matter with the FASB staff seeking clarification. Based on information in that white paper, the IC EP subgroup developed a Technical Practice Aids (TPAs) drafts for TIS Section 6910 Investment Companies. At this time, the subgroup is awaiting feedback from FinREC members.

II. Accounting/Reporting Issues

1. Proposed Accounting Standards Update (ASU), *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*. The EP members discussed certain decisions reached by the FASB since the May 23, 2012 meeting, such as:

- a. An entity regulated under the SEC’s Investment Company Act of 1940 (the 1940 Act) would be an investment company for accounting purposes.
- b. Entities not regulated under the 1940 Act would be required to comply with specific criteria and consider some other typical characteristics to be an investment company.
- c. Accounting for controlling interests in another investment company:
 - i. Investment companies would not be required to measure controlling interest in another investment company at fair value.
 - ii. Current guidance in ASC 946-810-45-2 and 946-810-45-3 would be retained (consolidation of a non-investment company by an investment company is not allowed, unless non-investment company provides services to an investment company).
 - iii. In a master-feeder structure, a feeder fund would attach the financial statements of a master fund along with its own financial statements.
- d. The parent company will retain investment company accounting used by its subsidiaries in consolidation.

As noted above, the FASB decided that rather than requiring an investment company to account for its interest in another investment company at fair value, it would not provide guidance on the measurement of such interests and would instead allow investment companies to continue current industry practice. This is a reversal from a previous tentative decision. The FASB decided that to improve transparency about an investment company’s interests in other investment companies, reporting entities should disclose certain additional information for each significant interest in an unconsolidated investment company.

The EP members discussed the FASB’s recent decision to amend paragraph 946-210-50-9 to require all investment companies (registered and nonregistered) to disclose each investment owned by an investee fund that represents a significant portion (rather than those that exceed 5 percent) of the reporting investment company’s net assets at the reporting date. ASC 946-210-50-9 currently states: “if the reporting investment company’s proportional share of any investment owned by any individual investee exceeds 5 percent of the reporting investment company’s net assets at the reporting date, each such investment shall be named and categorized as discussed in paragraph [946-210-50-6](#).” The EP members debated what constitutes “significant”. The EP would like to further understand the rationale for FASB changing the current threshold of 5% to “significant” and may engage in dialogue with FASB, and eventually consider developing a technical practice aid, to determine a methodology that could be applied consistently throughout the industry. EP members discussed how there are different considerations for registered (RICs) versus nonregistered investment companies, as information is publicly available to investors in RICs, while there may be operational challenges for nonregistered investment companies regarding availability of audited information from the investee fund, as well as the timing of obtaining such information from the investee fund. The EP also discussed whether the information utilized in this disclosure would need to be as of the reporting entity’s balance sheet date, or if it could be as of the investee’s most recent audited fiscal year-end, if coterminous information is not readily available. Regarding the proposed requirement to disclose debt of the significant investee, an EP member expressed concern with how debt is defined, and whether it will include securities sold short, and bank debt.

During the meeting, EP members observed that, at this time, they do not anticipate significant changes to current practice as a result of the recent FASB decisions, other than increased disclosure. Topic 946 is currently silent on the consolidation of blocker entities by investment companies, and so diversity in practice exists, especially for nonregistered investment companies with less than 100% ownership in such blocker entities. The EP members, however, acknowledged that an investment company would generally consolidate a wholly-owned blocker.

2. Proposed ASU — *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*. Three primary questions arise:
 - a. whether investment companies should be in the scope of this new guidance;
 - b. which expenses should be accrued in the liquidation basis financial statements, as there appear to be two possible options:

- i. All expenses that are expected to be incurred throughout the liquidation period
- ii. All expenses that are expected to be incurred throughout the liquidation period that are directly associated with the liquidation (i.e. exclude those costs that would continue to be incurred had it not been in liquidation)

The EP members are aware there is diversity in practice, and there is often uncertainty regarding how long the liquidation period will last, especially if the investment company holds illiquid investments. EP members noted that the FASB may need to consider clarifying whether only specific expenses incurred throughout the liquidation period and directly related to the liquidation need to be accrued, or all expenses that are expected to be incurred throughout the liquidation period would need to be accrued. An EP member expressed concern with the proposed requirement to accrue for income earned throughout the liquidation period (such as interest income), as this may create double-counting of income if certain assets reflected at fair value on the balance sheet are already considering future cash flows.

- c. considerations for limited life entities. Proposed 205-30-25-3 states: *“If a plan for liquidation was specified in an entity’s governing documents at the entity’s inception (for example, limited-life entities), then liquidation is imminent when significant management decisions about furthering the ongoing operations of the entity have ceased or they are substantially limited to those necessary to carry out a plan for liquidation other than the plan specified at inception.”*

The proposed ASU also states that indicators that a plan for liquidation might differ from that which was specified in the governing documents include the following: the date that liquidation is expected to conclude is earlier or later than the contractually stated expiration date of the entity, or that the entity’s governing documents were amended since inception. However, many funds extend the termination date for various reasons, and it may not be appropriate for this to cause the fund to be considered in liquidation.

Other topics of concern include the handling of contingent liabilities and taxes (ASC 740) in liquidation.

- 3. The EP discussed the definition of a nonpublic entity and the impact to nonregistered funds regarding ASU 2011-04 implementation. The ASC 820 definition of nonpublic entity is as follows: Any entity that does not meet any of the following conditions:
 - a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.
 - b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
 - c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
 - d. It is required to file or furnish financial statements with the Securities and Exchange Commission.
 - e. It is controlled by an entity covered by criteria (a) through (d).

The ASC master glossary defines control as “The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise”. This could scope in nonregistered investments companies that are controlled by a public company (for example, when an adviser that is a public entity consolidates a private fund it owns, that private fund’s stand-alone financial statements would be treated as those of a public entity under the current ASC 820 definition of a nonpublic entity).

The FASB staff is considering a project to define public and nonpublic entities, which may impact the application of ASU 2011-04 for such entities. The EP members believe that currently, under such tentative guidance from the FASB Private Company Council, certain entities, including a consolidated subsidiary of an entity that is a public company, could be considered a private company. This guidance contradicts the current definition of nonpublic entity guidance in ASC 820 provided above. The EP members may consider asking the FASB for clarification, and may also form a working group to develop a potential TPA to further clarify the definition of a nonpublic (private) entity for the purposes of applying the disclosure requirements of ASU 2011-04.

- 4. The EP members discussed funds that use tender option bond (TOB) financing in light of the SEC’s release on March 29, 2012, of an “Issues of Interest” item published by the SEC staff in the Division of Investment Management. The EP

discussed this topic with the SEC staff. Please refer to the SEC Staff Update in these meeting highlights for further discussion.

5. For mutual funds investing in zero-coupon bonds, a question has arisen on what interest rate industry practitioners are presenting in their schedule of investments. Zero coupon bonds are defined in the AICPA Audit and Accounting Guide *Investment Companies* (the Guide) as debt instruments that make no periodic interest payment but are issued at a deep discount from their face value. The EP members observed that in practice, companies generally disclose a zero coupon and do not present a calculated current yield or original yield on the security. A yield would be presented, however, for a Treasury Bill or short-term security.
6. In a master-feeder structure, a feeder fund has an investment in a master fund which presumably has an initial cost basis and a fair value. Exhibit 5-4 in the Guide does not include presentation of the feeder's cost of the investment in master. The EP members noted that it is consistent with current practice regarding the presentation of the cost basis of the feeder fund's investment in the master (typically, cost basis for a feeder fund's investment in a master fund is not presented).
7. Balance Sheet Netting - In an effort to better clarify new disclosures required under ASU 2011-11 (Topic 210 Balance Sheet (Offsetting)), EP members discussed an example disclosure provided by an EP member. Some believe that for a mutual fund that currently must follow Regulation S-X and a) has outstanding derivatives, b) pledges and discloses collateral, c) presents items gross on the balance sheet and d) discloses counterparty credit risk in the footnotes, the disclosure requirements of ASC Topic 815 and 825 would already apply and a tabular disclosure under newly amended Topic 210 may not be meaningful, and may be redundant to the fund's shareholders. The EP members observed that in preparing for the new disclosure requirements, funds should consider identifying all current disclosures, identifying new disclosures that would be required under Topic 210, and then determining whether the new disclosures are meaningful. EP members noted guidance in ASC 210-20-50-4 that states, in part, that information required (in ASC 210-20-53) should be presented in tabular format, separately for financial assets and financial liabilities, "unless another format is more appropriate". An EP member discussed the potential benefit to the financial statement user if all required disclosures on offsetting are included in one place in the footnotes. Some believe that if certain financial instruments are presented gross on the balance sheet and already disclosed under different GAAP requirements in the notes to financial statements, they may not need to be presented separately again to satisfy ASU 2011-11 disclosure requirements.

The EP members also considered the impact of the new requirements on repos, securities lending, and spot contracts associated with the settlement of security trades. Particularly for spot contracts that are directly associated with the settlement of a trade, the EP members questioned whether these are recognized eligible assets, and the usefulness of presenting these contracts in the offsetting disclosures, as these contracts often settle on the following day.

An EP member discussed the effective date for ASU 2011-11, noting that adoption is required for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. Therefore, for mutual funds with a June 30, 2013 year-end, the new disclosures would not apply for the semi-annual period beginning on January 1, 2013.

8. Transfers & Servicing – an EP member shared observations from recent discussions with the FASB on this topic. This project is intended to improve existing accounting and disclosures guidance for repurchase agreements and similar transactions.
9. With respect to the SEC Yield calculations, the EP members discussed that given the financial reporting character of the swap income, which is considered capital for GAAP purposes, there is a view that swap income should be excluded from the SEC Yield calculation. Since diversity in practice exists whether or not swap income should be included in SEC Yield calculations, the EP will raise the issue with the SEC during the October EP conference call or November EP meeting.
10. An EP member inquired when the following guidance was added to the Guide, whether it is codified and what is the scope of this requirement:

AAG 7.126 - A fund may receive other payments from affiliates for reasons other than those described in 946-20-05-2. An evaluation must be made to determine whether to disclose the payments on the statement of operations or the statement of changes in net assets. Regardless of the type of payment received, the fund should separately disclose the payments received in the respective financial statement, show the impact on the total return relating to

such items in the financial highlights, and provide narrative disclosure of the reasons why such payments were made.

The EP members discussed that this paragraph first appeared in the SEC Comments and Observations section of 2009 Investment Companies Industry Developments Audit Risk Alert. The EP discussed the topic at the April 28, 2010, EP meeting and decided to include this language from the 2009 Audit Risk Alert into the 2010 Guide where it now appears. Market timing and late trading settlements or payments by an affiliate/administrator for an NAV error not caused by the two reasons highlighted in paragraph 7.121a and b (processing error) also may cause payment from an affiliate or administrator. The EP members noted that related party guidance also should be considered in such cases.

11. A financial transaction tax (FTT) was recently enacted by the French government on the purchase of equity securities of companies with a capitalization above 1 billion Euro. (It also may apply to credit default swaps on these companies.) The tax is effective August 1, and may be at a rate of 0.2%. An EP member inquired whether the tax should be accounted for as part of investment cost or as tax expense. EP members believe this tax would generally be accounted for as part of investment cost.

III. Audit and Attest Issues

1. The Department of Labor (DOL) issued a final rule on October 25, 2011, that became effective December 27, 2011, which revised the Pension Protection Act of 2006 to make investment advice more accessible for those who have investments in 401(k) plans and IRAs. The revision now allows fiduciary advisers to receive compensation from investment vehicles they recommend if either (1) the investment advice they provide is based on a computer model certified as unbiased and as applying generally accepted investment theories, or (2) the adviser is compensated on a "level-fee" basis (i.e., fees do not vary based on investments selected by the participant). The rule identifies circumstances where an annual "audit" needs to be performed in order for an adviser to meet the exemption. Areas to be covered in the audit include determining that (emphasis added):
 - *Any investment advice is based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time;*
 - *Any investment advice takes into account investment management and other fees and expenses attendant to the recommended investments;*
 - *Any investment advice takes into account information relating to age, time horizons (e.g., life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences of the participant or beneficiary;*
 - *No fiduciary adviser that provides investment advice receives from any party directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that varies depending on the basis of a participant's or beneficiary's selection of a particular investment option.*

The EP members discussed some challenges that may arise in opining on the above items, particularly the underlined phrases. Auditors are concerned that the criteria indicated in the rule may not be easily measurable, and also questioned the form of the report that would be used. EP members will revisit this topic at a future meeting.

2. The Audit Provision under the Custody Rule requires that US GAAS auditing standards be used (refer to Custody Rule FAQ VI.5 http://www.sec.gov/divisions/investment/custody_faq_030510.htm). This presents complications for registered investment advisers (RIA) for foreign funds. Non-US audit firms may be reluctant to perform audits under US GAAS due to limited familiarity with the standards. There are ongoing efforts to clarify US GAAS while converging towards International Standards on Auditing Standards (ISA). In the May 2012 meeting, the EP discussed this matter with the SEC staff. In the September 2012 EP meeting, an EP member asked the EP about the frequency of cases where an RIA to overseas funds needs to incur an additional cost or burden in order to comply with this requirement for US GAAS. The EP expressed a view that the issue exists but may not be widespread. No further discussion on this topic is anticipated at this time.
3. Rule 17Ad-13 transfer agent report in 11.32 (2011 version) of the Guide is based on a template likely agreed with SEC Trading and Markets (formerly, Markets & Regulation) a number of years ago. (Trading and Markets, not Investment Management, is responsible for regulation of transfer agents.) EP members recently noted that a) in many more instances than had likely existed when the report was last updated, transfer agent data processing systems are

maintained by large third-party organizations and provided contractually on a "remote" basis and b) in some instances, registered transfer agents have outsourced substantially all of their actual processing to other agents, retaining only a small piece of the overall function themselves. (The latter most often happens when an advisor wants to maintain the direct investor contact in a telephone center, and for that reason registers as a transfer agent, but outsources all the actual processing to a third party.) While SEC Forms TA-1 and TA-2 allow the transfer agent to advise the SEC of the identities of any other transfer agents to which functions have been outsourced, and Form TA-2 actually provides a check box to indicate "Some" or "All" for the extent of outsourcing, the report template in the Guide does not allow for similar recognition of divided responsibility for various transfer agent functions. Part of this is a function of AICPA standards themselves, which generally do not allow for an auditor to refer to an SSAE 16 report of other auditors in issuing an audit (or attest) opinion. Thus, the 17Ad-13 report as it currently appears in the Guide essentially requires the auditor (along with management in its assertion) to take responsibility for all aspects of the transfer agent function, including outsourced functions, when the actual operations under management's control may be extremely limited, with the rest of management's responsibility limited to the monitoring of processing by third parties. Particularly where the SEC is already on notice of outsourcing through the TA-2, an EP member expressed concern that the extent of the responsibility being taken by the auditor for transfer agent processing functions in the report is incompatible with the extent of the actual transfer agent activities declared to the SEC by the registrant itself.

An EP member inquired whether other EP members similarly perceive an issue in the current reporting template, and whether the EP may want to pursue an effort with the SEC Trading & Markets to propose an alternative reporting framework, potentially using the "mapping" used for "qualified custodian" internal control reports issued to assist in Rule 206 compliance as a guide, which could make it clear which functions have been outsourced, in order to be more consistent with current transfer agent outsourcing practices. An EP member noted that management is ultimately responsible for maintaining controls over the transfer agent function it outsources and management has to have oversight procedures in place over those controls. The EP may revisit this topic at a future meeting.

4. EP members shared experiences from recent PCAOB inspections.

IV. SEC Staff Update

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 SEC staff introduced Matt Giordano as a new Assistant Chief Accountant in the SEC's Division of Investment Management.
2. With respect to the EP's request to discuss any next steps the SEC may take regarding money market regulations given the recent announcement that a money market fund reform proposal will not be released publicly by the SEC, the SEC staff did not provide any additional comments.
3. An EP member inquired about the status of the CFTC's proposed rule "Harmonization of Compliance Obligations for Registered Investment Companies Required to Register as Commodity Pool Operators." The SEC staff did not comment on this matter, as it is a CFTC rulemaking.
4. The EP members inquired about an update on the SEC yield project. As previously communicated during the May 2012 EP meeting, this is a two-phased effort to (1) determine whether to provide guidance on the SEC yield calculation for Treasury Inflation Protection Securities (TIPS) to address diversity in practice regarding consideration of an inflationary adjustment, and (2) continue a longer-term project to determine whether to develop broad SEC guidance on SEC yield calculations. With respect to Phase 1, the Investment Company Institute (ICI) has formed a working group consisting of funds that hold TIPS with a goal of providing a recommendation.
5. With respect to an IFRS update and its impact on funds, as indicated in previous EP meeting highlights, the 2008 IFRS roadmap indicated that the goal was for the SEC to determine in 2011 whether it should proceed with a rulemaking to require US issuers to adopt IFRS. The SEC staff issued a final report in July 2012 (<http://sec.gov/spotlight/globalaccountingstandards/ifrs-work-plan-final-report.pdf>).

9. The SEC staff has provided no-action relief to investment advisers to 529 plans, specifically stating that “the SEC staff would not recommend enforcement action to the Commission under Section 206(4) of the Advisers Act and Rule 206(4)-2 thereunder against a registered investment adviser if it treats the 529 Plan for which it is a program manager as a pooled investment vehicle for purposes of the custody rule.” The SEC staff noted a listing of required factors in order to rely on this letter for no-action relief, including:

- a. The 529 Plan is a college savings plan;
- b. The 529 Plan’s recordkeeper is registered as a transfer agent with the Commission under Section 17A of the 1934 Act;
- c. The 529 Plan’s custodian(s) is a “qualified custodian” as such term is defined in Rule 206(4)-2(d)(6) under the Advisers Act;
- d. The 529 Plan assets are subject to annual audit as defined in Rule 1-02(d) under Regulation S-X and the audit is conducted in accordance with GAAS;
- e. The 529 Plan’s annual audit is conducted by an independent public accountant that: (i) is registered with, and subject to regular inspection as of the commencement of the professional engagement period, and as of each calendar year-end, by, the PCAOB in accordance with its rules; and (ii) meets the standards of independence in Rule 2-01(b) and (c) under Regulation S-X;
- f. The audited financial statements of the 529 Plan are prepared in accordance with GAAP.
- g. The annual financial statements are annually provided to the state agency of instrumentality responsible for oversight of the 529 Plan within 120 days of the end of the 529 Plan’s fiscal year;
- h. The annual financial statement are made available to all existing 529 Plan accountholders via the 529 Plan’s website; and
- i. The Program Manager will ensure that the 529 Plan accountholders are provided written notification of the availability of the financial statements no later than the delivery of the accountholders’ next regularly scheduled quarterly account statement. Such notice may either be included with or on such statement or sent separately. The notice shall advise the accountholder of a website where such financial statements may be accessed and provide the accountholder information regarding how to contact the 529 Plan to obtain a hardcopy of such financial statements in lieu of accessing them online. A hardcopy of the financial statements shall be provided by mail within 3 business days of an accountholder requesting such a copy.

For full text of the letter, visit <http://sec.gov/divisions/investment/noaction/2012/ici090512.htm>.

10. The SEC staff shared the following financial statement review comments:

- a. The SEC staff discussed a recent registration statement filed by a business development company (BDC). The BDC held a material investment in an unregistered co-investment funding vehicle which made loans to private companies. The BDC did not consolidate the co-investment vehicle because it did not have control. The SEC staff required the BDC to update its registration statement to include certain summarized financial statement information (balances from balance sheet and income statement) as well as a full schedule of investments despite the fact that this co-investment vehicle was not using investment company accounting. This is because the detailed loan portfolio is material information to the BDC’s investors given the size of the BDC’s investment in the co-investment vehicle. Going forward, the SEC staff requested that the BDC’s quarterly and annual filings include a detailed schedule of investments and summarized financial information of the co-investment vehicle. In cases where a BDC or fund has such a significant unconsolidated investment in a nonregistered entity, registrants should consider the guidance in Regulation S-X Rule 3-09 and Rule 4-08(g) in connection with determining whether to attach financial statements of the subsidiary or include summarized financial statement information, including a schedule of investments.
- b. The SEC staff noted diversity in practice regarding the fee table presentation in Form N-1A when a fund consolidates a wholly owned subsidiary. Some registrants are including the subsidiary’s expenses in “Acquired Fund Fees and

Expenses” (AFFE), while other registrants are retaining the character of the subsidiary’s expenses. The SEC staff reminded registrants of Item 3, Instruction 3 in such cases, and noted that the character of the expenses at the subsidiary level should be retained when populating the fee table in Form N-1A, as the subsidiary is consolidated.

- c. The SEC staff discussed credit risk-related contingent feature disclosures. Examiners noted that certain funds did not include all required disclosures identified in ASC 815-10-50-4H. There are currently six disclosure requirements in this paragraph, two qualitative and four that are quantitative in nature. The SEC staff noted divergence in disclosure practices, and reminded registrants to carefully evaluate counterparty agreements in order to identify all features that need to be disclosed. Some registrants had qualitative disclosures about triggers (e.g. a percentage decrease in a Fund’s net assets or NAV) but lacked the required quantitative disclosures. These disclosures should be included in the notes to financial statements, as they are required by GAAP in ASC 815.
- d. The SEC staff and EP members discussed credit valuation adjustments (CVAs) for derivative contracts, and the extent to which investment companies are including CVAs for OTC derivative contracts, particularly when the instruments are not fully collateralized. The SEC staff referred to the 2008 “Dear CFO Letter” issued by the Division of Corporation Finance, which suggested including disclosures in the MD&A about how credit risk affected the valuation of its derivative assets and liabilities. The SEC staff reminded registrants that in accordance with ASC 820, CVAs are required to be included in the fair value measurements of derivative assets and liabilities, and may need to be considered when registrants use quotes from brokers or pricing services in developing fair value measurements.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the October 11, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. The May 23, 2012 Expert Panel (EP) meeting highlights have been finalized and will be available on aicpa.org shortly. The EP is currently reviewing meeting highlights from the September 2012 EP meeting.
2. The EP was informed about timing of the industry review of the 2012 AICPA Audit Risk Alert - *Investment Companies Industry Developments* (INV ARA).
3. As previously discussed during EP meetings and calls, ASU 2011-04 removed the “in-use” and “in-exchange” concepts from Topic 820. When a private equity fund or business development company (BDC) owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of “in-use” and “in-exchange” concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. Earlier this year, the EP subgroup developed a white paper and discussed this matter with the FASB staff seeking clarification. Based on information in that white paper, the IC EP subgroup developed Technical Practice Aids (TPAs) draft for TIS Section 6910 Investment Companies. At this time, the subgroup is evaluating feedback from FinREC members and others.

II. Accounting/Reporting Issues:

1. Regarding the proposed Accounting Standards Update (ASU), *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*: In the September 2012 meeting, the EP members discussed the FASB’s recent decision to amend paragraph 946-210-50-9 to require all investment companies (registered and nonregistered) to disclose each investment owned by an investee fund that represents a significant portion (rather than those that exceed 5 percent) of the reporting investment company’s net assets at the reporting date. ASC 946-210-50-9 indicates: “if the reporting investment company’s proportional share of any investment owned by any individual investee exceeds 5 percent of the reporting investment company’s net assets at the reporting date, each such investment shall be named and categorized as discussed in paragraph [946-210-50-6](#)”. The FASB also recently

tentatively decided to require an investment to disclose the following for significant investments in another investment company (investee fund):

- a. A description of the investee fund (name and category)
- b. The percentage of the reporting investment company's net assets invested in the investee fund
- c. The total assets of the investee fund
- d. The total debt outstanding of the investee fund
- e. The net assets of the investee fund
- f. The expense ratio of the investee fund
- g. The proportionate ownership interest in the investee fund.

During the September EP meeting, the EP members discussed how there are different considerations for registered (RICs) versus nonregistered investment companies, as certain information is already publicly available to investors in RICs, while there may be operational challenges for nonregistered investment companies regarding availability of audited information from the investee fund, and timing of obtaining such information from the investee fund. During the October conference call, an EP member informed the EP that they informally reached out to the FASB staff to discuss the FASB's tentative decisions with respect to the disclosures and inquired whether the proposed disclosures would be subject to an exposure period. At this time, the EP is awaiting the FASB staff's response. The EP will continue monitoring this development and will consider determining a methodology that could be consistently considered throughout the industry.

2. ASU 2011-04 (820-10-50-2bbb) requires nonpublic entities to disclose significant unobservable inputs used in the valuation for each class of assets and liabilities: "For fair value measurements, categorized within Level 3 of the fair value hierarchy, a reporting entity shall provide quantitative information about the significant unobservable inputs used in the fair value measurement." ASU 2011-04 does not amend guidance on disaggregation that existed in 820-10-50-2B. For a private equity (PE) fund that has diversified investments and has a limited number of disaggregated asset classes, there is a question about how this disclosure will be prepared, and the usefulness of providing wide ranges of inputs across an asset class. The EP members shared views regarding the impact of the new disclosure requirements on PE funds and noted that, consistent with the example provided in ASU 2011-04, a tabular disclosure of quantitative information about the inputs used in the fair value measurement of assets may include, but is not limited to, the fair value of the asset, valuation technique(s) used to measure fair value, the inputs used to measure fair value, the ranges of the inputs, and the weighted averages of the inputs. An EP member discussed the importance of including the weighted average of the inputs in the quantitative information disclosures, as an EP member is aware that the SEC recently requested a registrant to include a weighted average of the inputs in its quarterly filing.
3. A Working Draft has been issued of a new chapter in the AICPA Accounting and Valuation Guide: *Investments in Privately Held Company Equity Securities Issued as Compensation*. Chapter 8, "Inferring Value From Transactions in a Private Company's Securities". The new chapter provides a framework on how to evaluate private transactions and secondary market transactions and their relevance for estimating fair value of the other securities within an enterprise. New draft Q&As are issued on this topic. An EP member shared that some in the private equity and venture capital funds community are concerned that this working draft (although nonauthoritative when issued as final) may have unintended consequences when determining fair value for investment companies.
4. The EP members discussed the recently issued Accounting Standards Update No. 2012-04—*Technical Corrections and Improvements* changes criteria for inclusion of cash flow statements by investment companies. To be exempt from the requirement to provide a statement of cash flows, substantially all of investment company's investments must be measured using either Level 1 or Level 2 inputs (previously, substantially all of investment company's investments needed to be "highly liquid"). This ASU is effective "immediately upon issuance" (which is October 1, 2012.) While this standard is effective for any period ending on or after October 1, 2012, the EP would like to further understand how financial statements in progress at the time of issuance should be treated (e.g., 8/31/12 1940 Act fund financial statements; private funds unissued as of October 1; or September 30, 2012 financials (since 9/30/12 was a Sunday, no

financial statements had yet been prepared for 9/30 period-ends). The EP also inquired the SEC staff's expectations for registrants with respect to the 1940 Act Funds (refer to the SEC Staff Update section of these meeting highlights). The EP members observed that other than the cash flows impact, no other significant changes are anticipated as a result of issuance of this ASU.

III. Audit and Attest Issues

1. The Expert Panel discussed timing of communication of the audit firm with audit committees in light of the recently issued PCAOB Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to other PCAOB Standards*. Footnote 43 in the Auditing Standard (AS) No. 16 states:

43/ Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

This exception currently enables large fund complexes with individual funds' fiscal year-ends that are spread throughout the year to have quarterly audit committee meetings (rather than monthly audit committee meetings). Some are interpreting the changes to Auditing Standard 16 to require certain communications to take place prior to issuance of the opinion for each individual fund within large fund complex. This interpretation of Auditing Standard No. 16 may cause audit committees to move to a monthly meeting schedule (so that they can receive and discuss the required communications prior to issuance of each opinion). Yet, others believe, from PCAOB's 2010 Proposing Release No. 2010-001 and the 2012 adopting release (No. 2012-004), that the PCAOB did not intend to change current practice for investment companies.

EP members observed that, unless the PCAOB or the SEC issue clear guidance regarding application of this Standard for mutual fund complexes, some may interpret that communications between the auditor and audit committee must take place before issuing the auditor's opinion; however, the nature of such communication may be flexible (for example, through a conference call or e-mail).

Some believe that it is a best practice to have monthly communication between audit committee and audit firm.

The EP members also discussed that, if the frequency of these communication increases for large fund complexes with different reporting periods for individual funds, it may present an additional burden to the registrants, as the funds may incur additional costs in preparing meetings.

The Commission has not yet approved this Standard.

2. The Expert Panel discussed situations where a fund holds a significant amount of securities valued in good faith by the board, and the auditor disagrees with board's determination of fair value (resulting in material misstatement). The EP discussed the following hypothetical scenario:

A fund has significant Level 3 securities. After 12/31 year end, the auditor begins audit procedures, and disagrees with the value placed on the Level 3 securities by the board of directors. The amount of the holding is material and the change in fair value assigned to the Level 3 securities would cause the NAV to change. The auditor refuses to issue an opinion unless the fund changes the fair value assigned to the Level 3 securities. If the fund changes value assigned to Level 3 securities (and NAV changes) does this mean fund had an NAV error immediately prior and subsequent to 12/31? If the fund refuses to change the fair value, the audit firm will not issue an opinion, and the fund would not be in compliance with SEC rules, and would be limited in its ability to issue new shares.

The question arises whether, in this situation, an auditor can issue a qualified "subject to" opinion, whether the SEC would accept such an opinion, and if there any other ways to resolve this situation.

The EP discussed that the Letter of Andrew Barr, Chief Accountant of the SEC, to Robert Maynard, Chairman-Committee on Investment Companies of the AICPA (December 16, 1970) on the form of audit opinion relating to fair valuation procedures stated that the Commission would accept a qualified (a "subject to" opinion with an emphasis paragraph regarding fair value securities (which now would be considered a level 3 valuation).

The EP members, however, noted that although an emphasis of the matter paragraph may be allowed, the SEC would generally not accept anything other than an unqualified audit opinion. The issue has been previously discussed during August 2007 Expert Panel meeting. The August 2007 Expert Panel meeting highlights, stated, in part:

The Expert Panel acknowledged that the question of the SEC Staff reaction to the emphasis of matter paragraph has come up previously, and the Expert Panel understanding was that the SEC Staff view was to accept it without penalty to the issuer (as long as there is no qualification). The Expert Panel wanted to confirm this view. The SEC Division of Investment Management ("Division") Staff confirmed that the emphasis of matter paragraph is not viewed as a qualification, and as such, will not raise concerns with the Division Staff. The SEC Staff also indicated that they did confirm with the Division of Corporation Finance their views relating to the emphasis of matter paragraph. The SEC staff also indicated that they would expect the language used in the emphasis of the matter paragraph to be tailored and track closely with the disclosure requirements under SFAS 157.

IV. SEC Staff Update

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 staff joined the Expert Panel conference call to discuss the following questions presented by the EP members:

1. During the September 2012 Expert Panel meeting, the EP members discussed that given the financial reporting character of the swap income, which is considered capital for GAAP purposes, there is a view that swap income should be excluded from the SEC Yield calculation. The EP members are aware that the Investment Company Institute (ICI)'s 1999 SEC Yield "white paper" included a statement that "Gain or loss on options and futures do not produce income for purposes of the SEC yield calculation." Since diversity in practice exists, the EP sought the SEC staff's view whether or not swap income should be included in SEC Yield calculations. The SEC staff asked whether diversity in practice began when registered investment companies started to account for swap income as a capital gain in the financial statements subsequent to a speech by the SEC staff in 2003 at the AICPA National Conference on Current SEC Developments (<http://www.sec.gov/news/speech/spch121103gaf.htm>). For example, some registered investment companies may have changed their SEC Yield calculation methodologies to conform with the financial statement presentation while others may not have. TIPS may be another item where diversity exists. The SEC staff and EP will continue discussing this topic at the future meeting.
2. The EP members discussed that recently issued Accounting Standards Update No. 2012-04—*Technical Corrections and Improvements* is effective "immediately upon issuance" (which is October 1, 2012). The EP inquired about the SEC staff's expectations for registrants with respect to the 1940 Act Funds that have financials in progress at the time of issuance, for example, 8/31 1940 Act fund financials; or all September 30, 2012 financials (since 9/30/12 was a Sunday, no financials had yet been prepared for 9/30 period-ends). The EP does not believe there would be a significant impact on funds as a result of this ASU, but certain loan funds and funds that invest in mortgage-backed securities may be affected. The SEC staff will discuss this issue at a future meeting.
3. During their financial statement reviews, the SEC staff noted that certain fund complexes did not include all of the required disclosures about lines of credit, specifically, regarding commitment fees on the unused portion of the line of credit. Rule 6-04.3(b) of Regulation S-X requires registrants to disclose the information required under Rule 5-02.19(b) of Regulation S-X regarding unused lines of credit for short-term financing and Rule 5-02.22(b) of Regulation S-X regarding unused commitments for long-term financing arrangements. Such information should include the amount and the terms of the unused line of credit, unless insignificant.

4. The Expert Panel discussed the timing of communication of the audit firm with the audit committee in light of the recently issued PCAOB Auditing Standard No. 16 and shared some questions about potential conflict in interpreting requirements of the Standard with Rule 2-07 of Regulation S-X. The SEC staff encourages comment letters from the constituents.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the November 8, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. The May 23, 2012, Expert Panel (EP) meeting highlights are available on http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/DownloadableDocuments/INV/INV_EP_Minutes/2012/INV_EP_May23_2012_Meeting.pdf. The meeting highlights from the September 2012 EP meeting and October 2012 conference call are being finalized.
2. The AICPA publications staff updated the EP on the current status and timing of the 2012 AICPA Audit Risk Alert - *Investment Companies Industry Developments* (INV ARA).
3. As previously discussed during EP meetings and calls, ASU 2011-04 removed the “in-use” and “in-exchange” concepts from Topic 820. When a private equity fund or business development company (BDC) owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of “in-use” and “in-exchange” concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. Earlier this year, the EP subgroup developed a white paper and discussed this matter with the FASB staff seeking clarification. Based on information in that white paper, the IC EP subgroup developed Technical Practice Aids (TPAs) draft for TIS Section 6910 Investment Companies. At this time, the subgroup is evaluating feedback from FinREC members and others.
4. The EP is considering developing and presenting another webinar on the financial reporting, audit and attest issues affecting investment companies.

II. Accounting/Reporting Issues:

1. Regarding the proposed Accounting Standards Update (ASU), *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*: In the September 2012 meeting, the EP members discussed the FASB’s recent decision to amend paragraph 946-210-50-9 to require all investment companies (registered and nonregistered) to disclose each investment owned by an investee fund that represents a ‘significant’

portion (rather than those that exceed 5 percent) of the reporting investment company's net assets at the reporting date. ASC 946-210-50-9 currently indicates: "if the reporting investment company's proportional share of any investment owned by any individual investee exceeds 5 percent of the reporting investment company's net assets at the reporting date, each such investment shall be named and categorized as discussed in paragraph [946-210-50-6](#)". The FASB also recently tentatively decided to require an investment to disclose several items for significant investments in another investment company (investee fund).

During the September 2012 EP meeting, the EP members discussed how there are different considerations for registered (RICs) versus nonregistered investment companies, as certain information is already publicly available to investors in RICs, while there may be operational challenges for nonregistered investment companies regarding availability of audited information from the investee fund, and timing of obtaining such information from the investee fund. During the October EP conference call, an EP member informed the EP that they informally reached out to the FASB staff to discuss the FASB's tentative decisions with respect to the disclosures and inquired whether the proposed disclosures would be subject to an exposure period. At this time, the EP is awaiting the FASB staff's response. During the November EP call, the EP members shared that the FASB held an Education Session on this topic on November 6, 2012 which primarily focused on real estate investments. At this time, the Board anticipates issuing the final Standard in the first half of 2013. The EP continues monitoring this development and will consider determining a methodology that could be consistently considered throughout the industry.

2. The EP members discussed how funds use broker quotes and vendor prices for the purposes of the fair value disclosure and leveling within the ASC 820 fair value measurement hierarchy. Certain funds may use broker quotes to price investments and classify them as Level 3. However, there may be pricing services (such as IDC) that price the same securities at a price close to these broker quotes, and, therefore, these may be able to be categorized as Level 2. There also may be situations where the same security is classified as Level 2 in one period, based on the price received from a pricing service, and, based on the quote from a broker, as Level 3 in another period.

The EP members shared that generally, reporting entities use vendor prices, when available, and, when vendor prices are not available, they use broker pricing. The EP members noted that in some cases the prices provided by the pricing service may simply be transmitting quotes they received from brokers. Regardless of the source, however, reporting entities would need to analyze all information available about the inputs used in vendor prices or broker quotes before determining whether Level 2 or Level 3 would be appropriate. As some vendor prices and/or broker quotes may not provide sufficient transparency, a reporting entity's management should attempt to obtain sufficient understanding about valuation techniques and models used in these prices. The reporting entity may consider comparing valuations received to market information and information received from other vendors, if available, and perform back testing. The EP acknowledged certain challenges about obtaining transparency of inputs used in broker quotes, yet, noted that not all broker quotes would necessarily be considered a Level 3 input.

The EP members also noted that FASB FSP 157-3 "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" provides guidance on how vendor prices and broker quotes need to be considered in assessing observable and unobservable inputs for the fair value measurement.

The SEC and the PCAOB continue to focus on the registrant's validation of prices received from third-party vendors for the purposes of determining the fair value measurement levels. Reporting entities should continue performing due diligence of the pricing services, review procedures, develop and test qualitative and quantitative methodologies, perform comparison analysis and back testing, and consider hiring an outside valuation specialist, when necessary.

Consistent with paragraph BC 90 of ASU 2011-04, when a reporting entity uses significant unobservable inputs that it did not develop, such as unadjusted prices from third parties, for fair value measurements categorized as Level 3, a reporting entity should not need to create quantitative information about inputs used, but would disclose that it used broker quotes (however, a reporting entity cannot ignore other quantitative information that is reasonably available.)

3. Several (solvent) European countries, like Germany and Denmark, and the European Financial Stability Fund, have recently issued bonds at auction that ended up paying negative interest rates. The EP began discussing how to account for the negative rate in the statement of operations (i.e., whether it would be considered negative interest income,

interest expense, or a realized loss). The EP members will consider developing an illustrative example for EP discussion at a future meeting or call.

4. ASU 2012-04, Technical Corrections, revised the scope exemption for an entity to prepare a statement of cash flows, and indicates:

For an investment company.... to be exempt from the requirement to provide a statement of cash flows, all of the following conditions must be met:

- a. During the period, substantially all (emphasis added) of the entity's investments were carried at and classified as Level 1 or Level 2 measurements in accordance with Topic 820
- b. The entity had little or no debt, based on the average debt outstanding during the period, in relation to average total assets.....
- c. The entity provides a statement of changes in net assets.

Also, as noted in the November 2011 EP meeting highlights, "a change in the investments criterion from substantially all securities being "liquid" to substantially all securities being classified as Level 1 or 2 in the ASC 820 hierarchy, could impact an entity's assessment of the requirement to include a cash flow statement. The EP discussed this change in light of the SEC's 1940 Act definition of an illiquid security.¹"

During the November 2012 EP conference call, the EP revisited that discussion and observed that some securities held by open-end registered investment companies classified within Level 3 may be liquid. The panel noted a long-standing industry practice of using a 10% threshold for the securities held in Level 3 (those considered "illiquid" in prior accounting guidance) and a 10% threshold for debt outstanding during the period in evaluating criteria whether an investment company should be providing a statement of cash flows. The EP members do not anticipate investment companies changing their accounting policy as a result of issuance of this ASU.

5. A Working Draft of a new chapter in the AICPA Accounting and Valuation Guide: *Investments in Privately Held Company Equity Securities Issued as Compensation*. Chapter 8, "Inferring Value From Transactions in a Private Company's Securities" chapter provides a framework on how to evaluate private transactions and secondary market transactions and their relevance for estimating fair value of the other securities within an enterprise. At the October conference call, an EP member shared that some in the private equity and venture capital funds community are concerned that this working draft (although nonauthoritative when issued as final) may have unintended consequences when determining fair value for investment companies. During the November 2012 conference call, the EP members observed that the guidance in this Accounting and Valuation Guide is intended for valuations of the securities issued as compensation, and not necessarily for equity investments measured in accordance with Topic 820. An EP member also inquired whether debt and equity instruments held by a business development company need to be bifurcated for valuation purposes in connection with this new chapter as well as draft TPAs being developed by the EP (refer to item I.3 above). The EP members observed that since Topic 946 does not specify the unit of account, the entity may determine that the fair value would be maximized in a transaction that involves both the debt and equity positions, and those positions may be grouped as long as other guidance in GAAP does not prohibit such grouping. If other accounting guidance that specifies a unit of account is considered; however, the answer may change.
6. The FASB recently decided to revisit scope of balance sheet offsetting guidance (Accounting Standards Update No. 2011-11, *Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities*) and tentatively limited it to derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending arrangements. The proposed ASU is anticipated soon and will have a 25-day comment period. When finalized, the ASU would be effective for annual and interim reporting periods beginning on or after January 1, 2013. The EP members shared that this project resulted from certain questions that arose regarding whether trade receivable and trade payables and unsettled regular way trades, and exchange-traded securities, among other items, are within the scope of ASU 2011-11. The clarified scope of the offsetting guidance is intended to simplify accounting and legal analysis of master netting arrangements.

¹ Refer to page 5 of the document in the attached link. <http://www.sec.gov/rules/final/1986/ic-14983.pdf>. Note that the 10 percent limit referred to in this document was subsequently increased to fifteen percent; see Revisions of Guidelines to Form N-1A, [Investment Company Act Release No. 18612](#) (Mar. 12, 1992).

III. Audit and Attest Issues

1. An EP member inquired about an illustrative examination report on a transfer agent's internal control pursuant to SEC Rule 17Ad-13; specifically, whether this example report should include an inherent limitations paragraph (this illustrative report is presented in paragraph 11.35 of the 2012 AICPA Audit and Accounting Guide *Investment Companies*). The 2008 edition of the Guide included such paragraph in the example report as well as explanation that the report was prepared based on AT 501. In 2008, AT 501 was superseded by SSAE 15 and now only applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements; therefore, the examination report on a transfer agent's internal control under the SEC Rule 17Ad-13 currently follows the guidance under AT101. The reporting requirements serve as a minimum of what needs to be included in the report. Since an inherent limitation paragraph is not a requirement in AT 101, the EP considered including this paragraph as optional wording in the illustrative examination report in the future editions of the Guide.
2. During the October 2012 conference call, the EP discussed the timing of communication of the audit firm with audit committees in light of the recently issued PCAOB Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to other PCAOB Standards*. Footnote 43 in the Auditing Standard (AS) No. 16 states:

43/ Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

This exception currently enables large fund complexes with individual funds' fiscal year-ends that are spread throughout the year to have quarterly audit committee meetings (rather than monthly audit committee meetings). Some are interpreting the changes to Auditing Standard 16 to require certain communications to take place prior to issuance of the opinion for each individual fund within a large fund complex. This interpretation of Auditing Standard No. 16 may cause audit committees to move to a monthly meeting schedule (so that they can receive and discuss the required communications prior to issuance of each opinion). Yet, others believe, from [PCAOB's 2010 Proposing Release No. 2010-001](#) and PCAOB's 2010 Proposing Release No. 2010-001 and the 2012 adopting release (No. 2012-004), that the PCAOB did not intend to change current practice for investment companies.

EP members observed that, unless the PCAOB or the SEC issue clear guidance regarding application of this Standard for mutual fund complexes, some may interpret that communications between the auditor and audit committee must take place before issuing the auditor's opinion; however, the nature of such communication may be flexible (for example, through a conference call or e-mail), unless otherwise required by the Standard.

The EP members also discussed that, if the frequency of these communication increases for large fund complexes with different reporting periods for individual funds, it may present an additional burden to the registrants, as the funds may incur additional costs in preparing for meetings.

The SEC has not yet approved this Standard. During the November 2012 conference call, the EP briefly revisited this topic but did not identify any new considerations. The EP will continue monitoring this development.

3. The EP members shared views with respect to the extent of testing existence and valuations of investments for business development companies (BDCs):
 - a. With respect to testing existence of investments held by BDCs, the EP noted that during the November 2011 EP meeting, the SEC staff indicated that a strong case could be made that confirmation of 100 percent of a BDC's investments and inclusion of a statement in the auditor's report that the auditor confirmed 100 percent of the securities owned by the BDC are required. This topic is also covered in the upcoming 2012 AICPA Investment Companies Industry Audit Risk Alert.
 - b. An EP member also shared that the PCAOB recently challenged the financial information (such as budgets and cash flows) received by BDCs from the underlying portfolio companies and why the auditor did not corroborate the information received (through inquiry or confirmation of the underlying portfolio companies). The EP

members noted that to the extent the valuation is being driven from future earnings or growth reports, the PCAOB would anticipate the additional work done by registrant and auditor to validate completeness and accuracy of information received, especially as it relates to the future projected financial information. BDCs may be performing their own projections and use unaudited quarterly information and internal cash flow projections to support their valuations, and the auditors are being challenged to support and document their understanding about assumptions and inputs used by BDCs.

IV. SEC Staff Update

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. An EP member noted, in a recent financial statement review, a high yield bond fund (an open-end registered investment company, and not a business development company (BDC)) was requested to break out, if material, on the face of the statement of operations the amount of income received from payment-in-kind (PIK) securities. While Article 6-07 of Regulation S-X does require that the “bases for recognition and measurement” of “non-cash dividends” (i.e., accounting policy) be disclosed, and that “any other category of income” (which appears to refer to “other income”, not “interest income”) exceeding 5% of gross investment income be detailed, the EP is not aware of a requirement in either S-X or GAAP requiring PIK interest income to be broken out from other interest income. While in this case the fund determined the amount was not material, so the question became moot, more generally, the EP would like to understand if this is now an SEC staff position.

The SEC staff indicated that the question originally arose in connection with BDCs. The SEC staff position is that BDCs with a material amount of PIK interest should present the PIK as a reconciling item on the cash flow statement or in a footnote to the cash flow statement. For example, the SEC staff reminded registrants that PIK should not be included in other line items such as purchases and sales. Also, as noted in the January 13, 2011, EP meeting highlights, when securities pay interest partially in cash and partially in kind, registrants should disclose that a portion of the interest is PIK and should disclose both the cash and PIK rates in the schedule of investments (SOI) or in a footnote to the SOI.

Registrants are encouraged to consult with the SEC staff when there is a material amount of PIK income and the registrant does not present a statement of cash flows.

2. The EP asked the SEC staff whether a consent is required of the independent registered public accounting firm if no financial statements of any kind and no "expertization" language referring to the firm are included/incorporated in a registration statement. Some believe that no consent is necessary in those instances, but on occasion fund counsel will insist on one whenever the firm name appears in almost any context, even when simply being named (along with the custodian) as required by Item 19 of Form N-1A or the equivalent in other forms. Based on Sections 7 and 11 of, and Rule 436 under, the Securities Act of 1933, the SEC staff believes a consent would not be required of the independent public accounting firms where the accounting firm is merely named on the forms filed with the SEC.
3. During the September 2012 Expert Panel meeting, the EP members discussed that given the financial reporting character of swap income, which is considered capital for GAAP purposes, there is a view that swap income should be excluded from the SEC Yield calculation. The EP members are aware that the Investment Company Institute (ICI)'s 1999 SEC Yield “white paper” included a statement that “Gain or loss on options and futures do not produce income for purposes of the SEC yield calculation.” Since diversity in practice exists, the EP sought the SEC staff’s view whether or not swap income should be included in SEC Yield calculations. The SEC staff asked whether diversity in practice began when registered investment companies started to account for swap income as a capital gain in the financial statements subsequent to a speech by the SEC staff in 2003 at the AICPA National Conference on Current SEC Developments (<http://www.sec.gov/news/speech/spch121103gaf.htm>). For example, some registered investment companies may have changed their SEC Yield calculation methodologies to conform with the financial statement presentation while others may not have. TIPS may be another item where diversity exists. The SEC staff and EP will continue discussing this topic at future meetings.
4. During the October conference call, the EP members discussed that recently issued Accounting Standards Update No. 2012-04—*Technical Corrections and Improvements* is effective "immediately upon issuance" (which is October 1, 2012.) The EP inquired about the SEC staff’s expectations for registrants with respect to the 1940 Act Funds that have financials

in progress at the time of issuance, for example, 8/31/12 1940 Act fund financials; or all September 30, 2012 financials (since 9/30/12 was a Sunday, no financials had yet been prepared for 9/30 period-ends). On the October EP call, the SEC staff indicated that they would discuss this issue at a future meeting. During the November EP call, the SEC staff indicated that they would expect to see application of ASU 2012-04 by the registrants for periods ending on or after October 1, 2012 (for example, in the 10/31/2012 financial statements). The SEC staff also reminded the panel that registrants should follow disclosure guidance in SAB 74 in regards to new financial pronouncements that are issued but not yet adopted.

5. The SEC staff was requested to provide feedback on ASU 2011-04 disclosures identified in its financial statement reviews. The SEC staff commented on the use of wide ranges of unobservable inputs in tabular disclosures in accordance with ASU 2011-04. In one situation, where the valuation technique used was discounted cash flow model, and disclosure had a wide range of discount rates being used, the registrant was asked to provide a weighted average range of the discount rate, consistent with illustrative disclosures included in ASC 820-10-55.

The SEC staff also referred to the SEC Corp Fin staff remarks at the recent AICPA Banking Conference (<http://www.sec.gov/news/speech/2012/spch091212sc.pdf>) discussing themes of comments which Corp Fin staff have been giving to registrants. One of the themes was regarding the use of multiple valuation techniques for certain classes of instruments, where such valuation techniques are not bifurcated and there is no disclosure of the fair value under each valuation technique. The SEC staff provided an example of a BDC with senior debt in Level 3, where both a discounted cash flow valuation technique and market comparable valuation technique were used, each technique used for different holdings within senior debt. The fund only provided total fair value for the total senior debt and did not separately disclose the fair value derived from the discounted cash flow technique and the fair value derived from the market comparable technique.

6. The EP sought the SEC staff's views on the following scenario. A registered investment adviser (RIA) launches a private fund which is an advisory client. In November 2012 the private fund accepts capital commitments from investors. The fund does not call capital from investors until January 2013, and does not make any investments on behalf of investors during 2012, and there is no cash activity in 2012. A question arose whether the adviser needed to satisfy the Custody Rule with regard to this fund for 2012. The SEC staff commented, that based on this fact pattern, the adviser would not need to satisfy Custody Rule requirements for 2012, since the adviser is not holding clients funds or securities (a capital commitment does not meet the definition of funds or securities under the custody rule).

A follow-up question was then asked by an EP member whether the same conclusion would apply when the RIA called capital and received the cash, but did not use the proceeds to buy any securities during 2012. The SEC staff indicated that under this second fact pattern, the adviser would be deemed to have custody of client assets and would need to satisfy the Custody Rule for 2012, even though there is no trading activity yet in 2012. The rationale is that the adviser, after receiving the cash proceeds from the capital call, is holding client funds, within the meaning of the custody rule.

7. On the October 2012 call, the EP discussed the timing of communication of the audit firm with the audit committee in light of the recently issued PCAOB Auditing Standard No. 16 and shared some questions about potential conflict in interpreting requirements of the Standard with Rule 2-07 of Regulation S-X. The SEC will take action on this Standard by December 17, 2012. The SEC staff suggested the audit firms could either submit a comment letter to the SEC or reach out to the PCAOB to request further clarification.
8. An EP member is aware of at least one instance where a Form ADV-E filing for a custody rule surprise examination reached its 120 day deadline on October 29, where both the adviser's and the accountant's (which technically is responsible for filing the report on IARD) offices were closed due to Hurricane Sandy. The SEC was also closed but the IARD was open to accept filings. The report was filed as soon as both were open. The EP member inquired whether the client or the accountant needs to contact the Commission about the late filing. The SEC issued a press release on November 5 to extend the filing deadlines for those affected by the hurricane Sandy (<http://sec.gov/news/press/2012/2012-220.htm>). Based on this fact pattern, the SEC staff would recommend the adviser prepares an explanation of why the filing was late for their own files (in the event of an SEC inspection) and contact the SEC directly if there are any questions.

The SEC staff inquired whether the EP is aware of any potential issues with the financial statement distribution of registered and nonregistered funds (to satisfy the 120 days distribution requirement under the Custody Rule) due to Hurricane Sandy. The EP noted that any issues seemed to be isolated and that this was not a pervasive issue.

9. The Commission posted an overview of securities lending by registered funds which describes the operational mechanics of securities lending arrangements by registered investment companies. It also includes a chronological list of no-action letters from the SEC and the areas addressed in each no-action letter - <http://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm>.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2013 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the December 12, 2012, 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 company issues.

I. Administrative items/AICPA matters:

1. The highlights from the September 2012 Expert Panel (EP) EP meeting and October 2012 conference call have been posted to http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Investment_Companies.aspx. November 2012 conference calls highlights are being finalized.
2. The AICPA publications staff updated the EP on the current status of the 2012 AICPA Audit Risk Alert - *Investment Companies Industry Developments* (INV ARA) and discussed with the EP the anticipated timing of industry review of the 2013 conforming changes to the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
3. The EP considered updating certain illustrative report examples in chapter 11 of the Guide to reflect the changes due to the Clarity Project. The clarified SASs are effective for audits of financial statements for periods ending on or after December 15, 2012. The EP also suggested updating the illustrative reports currently available on the EP webpage and making other affected auditor's reports available on the EP webpage on aicpa.org. The updated reports will also be included in 2013 Guide.
4. The AICPA will develop a new Revenue Recognition Guide after the issuance of the final Revenue Recognition Standard. This guide will include revenue recognition guidance for about 15 industries, including investment management. Representatives of the Investment Companies EP will participate in the industry task force to develop industry guidance that will be included in this AICPA Revenue Recognition Guide as well as the Investment Companies Guide.
5. Members of the EP will participate in the task force that will develop a new AICPA Accounting and Valuation Guide "Determining Fair Value of Portfolio Company Investments of Venture Capital and Private Equity Firms."
6. EP members considered topics and timing for the next EP webinar.
7. As previously discussed during EP meetings and calls, ASU 2011-04 removed the "in-use" and "in-exchange" concepts from Topic 820. When a private equity fund or business development company (BDC) owns both debt and equity instruments, the question arises whether they would need to value these instruments as a single unit of account or value each instrument individually. In addition, when using enterprise value, whether it is appropriate to

assume a change of control in the transaction which would trigger debt being called at par, and therefore lead to debt being valued at par. The panel members expressed a view that until removal of “in-use” and “in-exchange” concepts, it was clear that the use of the enterprise value approach to value debt and equity instruments when a private equity fund or BDC has control would have been appropriate. The EP members have observed that it may be challenging to determine that debt and equity represent the same unit of account. Earlier this year, the EP subgroup developed a white paper and discussed this matter with the FASB staff seeking clarification. Based on information in that white paper, the IC EP subgroup developed Technical Practice Aids (TPAs) draft for TIS Section 6910 Investment Companies. At this time, the subgroup is evaluating feedback from FinREC members and others.

8. The EP considered dates for 2013 EP calls and meetings.

II. Accounting/Reporting Issues:

1. During the September 2012 EP meeting, the EP discussed the definition of a nonpublic entity and the impact to nonregistered funds regarding ASU 2011-04 implementation. The ASC 820 definition of nonpublic entity is as follows: Any entity that does not meet any of the following conditions:
 - a. Its debt or equity securities trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally.
 - b. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
 - c. It files with a regulatory agency in preparation for the sale of any class of debt or equity securities in a public market.
 - d. It is required to file or furnish financial statements with the Securities and Exchange Commission.
 - e. It is controlled by an entity covered by criteria (a) through (d).

The ASC master glossary defines control as “The direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise”. This could scope in nonregistered investments companies that are controlled by a public company (for example, when an adviser that is a public entity consolidates a private fund it owns, that private fund’s stand-alone financial statements would be treated as those of a public entity under the current ASC 820 definition of a nonpublic entity).

The FASB staff is considering a project to define public and nonpublic entities, which may impact the application of ASU 2011-04 for such entities. The EP members believe that currently, under such tentative guidance from the FASB Private Company Council, certain entities, including a consolidated subsidiary of an entity that is a public company, could be considered a private company. This guidance contradicts the current definition of nonpublic entity guidance in ASC 820 provided above. The EP members may consider asking the FASB to further clarify the definition of a nonpublic (private) entity for the purposes of applying the disclosure requirements of ASU 2011-04.

2. ASU 2011-04, particularly ASC 825-10-50-2E, introduced new leveling disclosure requirements for items that are presented at fair value in the footnotes only. ASC 820-10-50-2F states: “A nonpublic entity is not required to disclose the information required by paragraph 820-10-50-2(bb) and (g) and paragraph 820-10-50-2E unless required by another Topic.” The EP discussed this requirement and the implications for nonpublic entities where the entity’s total assets are greater than \$100 million on the date of the financial statements or derivative financial instruments are held during the period, as noted in ASC 825-10-50-3. The EP members noted implications of these new disclosure requirements for hedge funds with total assets over \$100 million and debt. These entities would need to disclose debt at fair value and identify assumptions used in fair value measurement of debt. The EP members considered updating fair value leveling disclosures in the 2013 Guide. Subsequent to this conference call, the FASB added a project to its technical agenda to clarify whether nonpublic entities are subject to a particular disclosure requirement in Topic 825 arising from the issuance of ASU 2011-04. The Board decided to amend Topic 825 to clarify that nonpublic entities are not required to provide the fair value hierarchy level disclosure in paragraph 825-10-50-10(d) for items disclosed at fair value but not measured at fair value in the statement of financial position (for

example, debt borrowing by an investment company). The Board directed the staff to draft an Exposure Draft for vote by written ballot. The Exposure Draft will be issued in January 2013 with 15-day comment period.

3. Concerning ASU 2011-04 and the enhanced disclosure requirements for Level 3 inputs in the new table, the EP discussed whether investments in other funds for which the practical expedient is being utilized for determination of fair value, but the investments in other funds are considered to be Level 3 assets due to redemption restrictions, would be required to be included in that table. EP members noted guidance in paragraph BC 89 of ASU 2011-04, which states that the disclosures about the fair value of those assets that are subject to the practical expedient and categorized as Level 3 would not be meaningful for such instruments. The EP did, however, share a view that in certain cases, the practical expedient may need to be adjusted in order to comply with US GAAP and such adjustments may need to be considered for the Level 3 input table.
4. The EP members discussed accounting for agency placement fees. Some capitalize and amortize agency placement fees similar to offering costs, while others expense these fees. EP members noted that an investment partnership that continually offers its interests usually defers offering costs incurred prior to the commencement of operations and then amortizes them. More guidance on offering costs and “continuous offering” terminology can be found in TIS section 6910.23, “Accounting Treatment of Offering Costs Incurred by Investment Partnerships” and TIS section 6910.24, “Meaning of ‘Continually Offer Interests’”.

The EP discussed that business development companies (BDCs) have ongoing placement fees incurred in shelf registration. Paragraph 8.32 of the Guide indicates:

8.32. Some closed-end funds and business development companies offer stock through shelf registration statements. According to TIS section 4110.10, “Costs Incurred in Shelf Registration” (*AICPA, Technical Practice Aids*), legal and other fees incurred for a stock issue under a shelf registration should be capitalized as a prepaid expense. When securities are taken off the shelf and sold, a portion of the costs attributable to the securities sold should be charged against paid-in-capital. Any subsequent costs incurred to keep the filing “alive” should be charged to expense as incurred. If the filing is withdrawn, the related capitalized costs should be charged to expense.

For private equity funds, the EP noted that industry practice is generally to defer placement agent fees and charge to capital when called. EP noted that the fund may have negative capital if placement fees are greater than seed capital.

5. An EP member revisited a topic about the identification of the ‘client’ for purposes of revenue recognition from an asset manager perspective (fund versus ultimate investor) and inquired whether new views have emerged since the EP first discussed this topic during December 2011 and February 2012 conference calls, since there were differences of opinion previously. As noted above, the Expert Panel will form a task force that will identify transactions which may be impacted by the future revenue recognition standard.
6. The EP members were informed about the credit valuation adjustments (CVAs) on derivative instruments discussion that took place at the December 2012 ICI Accounting/Treasurers Committee meeting. This issue was previously discussed by the EP with the SEC staff during the September 2012 EP meeting. At that time, the SEC staff and EP members discussed CVAs for derivative contracts, and the extent to which investment companies are including CVAs for OTC derivative contracts, particularly when the instruments are not fully collateralized. The SEC staff referred to the 2008 “Dear CFO Letter” issued by the Division of Corporation Finance, which suggested including disclosures in the MD&A about how credit risk affected the valuation of derivative assets and liabilities. The SEC staff reminded registrants that in accordance with ASC 820, CVAs are required to be included in the fair value measurements of derivative assets and liabilities, and may need to be considered when registrants use quotes from brokers or pricing services in developing fair value measurements. The EP members also noted that documentation should include that consideration was given to CVAs.
7. The EP discussed current practice regarding the ROCSOP (return on capital statement of position) adjustment and whether mutual fund groups are presenting distributions on the statement of changes in net assets and short-term capital gain distributions and distributions of foreign currency gains as capital gain distributions on the statement of changes in net assets. The EP member inquired if mutual funds use the captions “distributions in excess of...” when they have distributions of gain or income that exceed the GAAP balances in the undistributed income or accumulated gain accounts and if mutual funds reclassify amounts when there is a permanent difference between

the book and tax character of the income (short-term capital gains or foreign currency gains) that will be distributed in the following fiscal year. The EP expressed a view that some call them “distributions” or “overdistribution of investment income” but do not necessarily use that terminology for the statement of net assets.

8. The EP members discussed ASU 2011-11 and the applicability to repurchase / reverse repurchase agreements and securities lending / borrowing arrangements and derivatives.

III. Audit and Attest Issues

1. Representatives of Rothstein, Kass & Company, P. C., joined the meeting via conference call to seek views and request clarifications from the EP regarding the PCAOB / SEC focus on the use of third-party pricing services (TPPS) in regards to Level 2 type investments. There have been various developments in the past 18 months regarding the topic: the creation of the PCAOB Pricing Sources Task Force (the “Task Force”), the remarks by Jason K. Plourde before the 2011 AICPA National Conference on Current SEC and PCAOB Developments, and EP discussions related to this topic.

In various PCAOB inspection reports covering the year-end 2010 and also in some of the most recent inspection reports, the following verbiage was found as a specific audit failure related to the audit of fair value measurements:

“The Firm’s primary substantive procedure to test the fair values of certain financial instruments was to obtain prices from outside pricing services but, the fair value measurements the Firm obtained were from the same pricing service that the issuer had used.”

The topic of using the *same pricing service* as a primary substantive test also was revisited during the Task Force’s presentation at the PCAOB Standing Advisory Group (SAG) Meeting on November 9, 2011. The Task Force had a full hour devoted to them during this semi-annual SAG meeting. Although this issue was not at the forefront of their focus, it was specifically brought up twice during this meeting by other SAG members.

Questions:

- a. Both the verbiage found in the PCAOB inspection reports and the dialogue which occurred during the PCAOB SAG Meeting on November 9, 2011 seem pretty definitive. Does the EP have a similar view if the audit firm is performing an audit of a private fund?
- b. Would it still be an acceptable audit procedure if an audit firm were to obtain fair value measurements from the same TPPS used by a private fund if the following criteria are met:
 - i. The audit firm documents its understanding of the methodologies and inputs used to determine the fair value
 - ii. The audit firm performs additional procedures such as analytical procedures, back-testing, etc.
 - iii. The TPPS in question is a large well-known industry-accepted vendor
 - iv. The audit firm has reviewed the client’s policies and documentation surrounding its internal controls and due diligence surrounding the fair values obtained from the TPPS, including but not limited to:
 - (1) Well documented challenge process
 - (2) Periodic “deep dives”
 - (3) Back-testing

EP members discussed that many audit firms prefer to use a different pricing vendor than what client uses, when available. In all situations, the EP members stressed the importance of getting behind inputs and assumptions, reviewing recent trades, and performing back testing, and well documenting all work performed.

As previously discussed during the November 2012 EP conference call, the EP members also noted that in some cases the prices provided by the pricing service may simply be transmitting quotes they received from brokers.

Finally, the EP members observed that in sample testing of valuations, differences identified in independent valuations of a sample may need to be extrapolated to the whole portfolio.

2. During the October 2012 conference call, the Expert Panel discussed the timing of communication of the audit firm with audit committees in light of the recently issued PCAOB Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to other PCAOB Standards*. Footnote 43 in the Auditing Standard (AS) No. 16 states:

43/ Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

This exception currently enables large fund complexes with individual funds' fiscal year-ends that are spread throughout the year to have quarterly audit committee meetings (rather than monthly audit committee meetings). Some are interpreting the changes to Auditing Standard 16 to require certain communications to take place prior to issuance of the opinion for each individual fund within large fund complex. This interpretation of Auditing Standard No. 16 may cause audit committees to move to a monthly meeting schedule (so that they can receive and discuss the required communications prior to issuance of each opinion). Yet, others believe, from PCAOB's 2010 Proposing Release No. 2010-001 and the 2012 adopting release (No. 2012-004), that the PCAOB did not intend to change current practice for investment companies. EP members observed that, unless either the PCAOB or the SEC issues clear guidance regarding application of Auditing Standard 16 for mutual fund complexes, some may interpret that communications between the auditor and audit committee must take place before issuing the auditor's opinion; however, the nature of such communication may be flexible (for example, through a conference call or e-mail). The EP members also discussed that, if the frequency of these communications increases for large fund complexes with different reporting periods for individual funds, it may present an additional burden to the registrants, as the funds may incur additional costs in preparing for meetings. The Commission has not yet approved this standard. During the December 2012 conference call, the EP revisited this topic and may consider outreach to the PCAOB on this matter. There is a view that the PCAOB did not intend to change current practice; therefore, current practice would continue. The EP will revisit this topic at future calls.

3. The Department of Labor (DOL) issued a final rule on October 25, 2011, that became effective December 27, 2011 which revised the Pension Protection Act of 2006 to make investment advice more accessible for those who have investments in 401(k) plans and IRAs. The revision now allows fiduciary advisers to receive compensation from investment vehicles they recommend if either (1) the investment advice they provide is based on a computer model certified as unbiased and as applying generally accepted investment theories, or (2) the adviser is compensated on a "level-fee" basis (i.e., fees do not vary based on investments selected by the participant). The rule identifies circumstances where an annual "audit" needs to be performed in order for an adviser to meet the exemption. Areas to be covered in the audit include determining that:

- *Any investment advice is based on generally accepted investment theories that take into account the historic risks and returns of different asset classes over defined periods of time;*
- *Any investment advice takes into account investment management and other fees and expenses attendant to the recommended investments;*
- *Any investment advice takes into account information relating to age, time horizons (e.g., life expectancy, retirement age), risk tolerance, current investments in designated investment options, other assets or sources of income, and investment preferences of the participant or beneficiary;*
- *No fiduciary adviser that provides investment advice receives from any party directly or indirectly, any fee or other compensation (including commissions, salary, bonuses, awards, promotions, or other things of value) that varies depending on the basis of a participant's or beneficiary's selection of a particular investment option.*

During previous meetings, the EP members discussed some challenges that may arise in opining on the above items, particularly the underlined phrases. Auditors are concerned that the criteria indicated in the rule may not be easily measurable, and also questioned the form of the report that would be used. EP members revisited this topic at the

December meeting but did not note significant new developments. Certain legal firms may be performing these types of engagements.

4. During the November 2012 conference call, the EP discussed whether the illustrative examination report on a transfer agent's internal control pursuant to the SEC Rule 17Ad-13 should include an inherent limitations paragraph (this illustrative report is presented in paragraph 11.35 of the 2012 Guide). The 2008 edition of the Guide included such paragraph in the example report as well as an explanation that the report was prepared based on AT 501. In 2008, AT 501 was superseded by Statement on Standards for Attestation Engagements (SSAE) 15 and now only applies when a practitioner is engaged to perform an examination of the design and operating effectiveness of an entity's internal control over financial reporting that is integrated with an audit of financial statements; therefore, the examination report on a transfer agent's internal control under SEC Rule 17Ad-13 currently follows the guidance under AT101. The reporting requirements serve as a minimum of what needs to be in the report. Since an inherent limitation paragraph is not a requirement in AT 101, the EP considered including the following paragraph as optional wording in the illustrative examination report in future editions of the Guide:

[The following optional inherent limitations paragraph may be added to reports]

Because of inherent limitations in any internal control, material inadequacies, as defined in Rule 17Ad-13(a)(3), due to error or fraud may occur and not be detected. Also, projections of any evaluation of the internal control over the transfer agent and registrar functions to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

5. The EP shared a view that if an auditor finds material noncompliance (for example, if client assets, which should have been held at a qualified custodian, were not held with such qualified custodian, or if customer statements were not sent quarterly) which were remediated during the custody audit period, an auditor would be required to report such finding to the SEC within one business day.
6. AU-C Section 501 states, in part:

When investments in securities are valued based on an investee's financial results, excluding investments accounted for using the equity method of accounting, the auditor should obtain appropriate audit evidence to support the investee's financial results, as follows:

- a. Obtain and read available financial statements of the investee and the accompanying audit report, if any, including determining whether the report of the other auditor is satisfactory for this purpose.
- b. If the investee's financial statements are not audited, or if the audit report on such financial statements is not satisfactory to the auditor, apply, or request that the investor entity arrange with the investee to have another auditor apply, appropriate auditing procedures to such financial statements, considering the materiality of the investment in relation to the financial statements of the investor entity.**

The EP members shared views about current practice by auditors to satisfy (b) for private equity fund investments in portfolio companies. That may include corroborating information at the underlying company level, obtaining information from other sources (investee's financial statements is one, but not the only input used in valuation); receiving the most recent audited financial statements, monitoring controls at the reporting entity including due diligence, and conducting retrospective review of audited financial statements. The EP noted that all work should be well documented and support the procedures performed.

7. The EP discussed the following question: for a registered fund where an announcement to close the fund is made after the fund's year end and the closing will take place after the N-CSR will have been filed, should a modification to the audit opinion for going concern be made because there is a substantial doubt about the entity's ability to continue as going concern? The EP expressed a view that an auditor would typically not modify the opinion but would include subsequent event disclosures. The auditor may also consider including an emphasis of matter paragraph.

IV. SEC Staff Update

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 staff joined the Expert Panel meeting via conference call to discuss the following questions presented by the EP members:

1. The SEC staff announced that John Russo is leaving the SEC. The Office of the Chief Accountant in the SEC's Division of Investment Management is looking for another Assistant Chief Accountant to be chosen for Spring 2013 (resumes are due by February 1, 2013).
2. The EP members sought the SEC staff's views about using the "distributed yield of the underlying funds" or the "SEC Yield of the underlying funds" when calculating the SEC Yield for funds of funds (FoF). In practice, an EP member indicated most use the distributed yield of the underlying funds method (distributed yield/income; actual income earned and annualized for non-daily distributing funds). However, a question was posed as to whether a FoF should use the underlying funds' SEC Yield and take a weighted average of those values. The SEC staff may address this question at a future meeting.
3. Custody Rule comments:
 - a. A registered investment adviser (RIA) manages a private fund from January 1 through November 30, 2012. The fund liquidates as of November 30, 2012. The adviser does not manage any other private funds, and the adviser de-registers from the SEC on December 15, 2012. In response to the EP's question whether the adviser needs to satisfy the Custody Rule with regard to this fund for 2012, the SEC staff indicated that the adviser needs to comply with the Custody Rule for 2012, which may include a liquidation audit.
 - b. The SEC staff noted that certain Custody Rule transitional guidance discussed in Section I, "Compliance Dates," of the SEC staff's custody rule FAQs is no longer applicable to RIAs. The transitional items in Section 1 were only applicable for RIAs who were subject to the Custody Rule at the rule's effective date (March 12, 2010) but are not applicable to those RIAs that became subject to the Custody Rule subsequent to the Custody Rule's effective date.
 - c. The SEC staff provided the following observations in connection with recent OCIE findings:
 - i. To use the "audit provision" allowed under 206(4)-2(b)(4) of the Custody Rule the audit must meet the requirements of U.S. GAAS. (FAQ VI.6 http://sec.gov/divisions/investment/custody_faq_030510.htm).
 - ii. For pooled investment vehicles (PIVs), the financial statements of the PIV generally must be prepared in accordance with U.S. GAAP. However, PIVs organized outside of the United States, or having a general partner or other manager with a principal place of business outside the United States, may have their financial statements prepared in accordance with accounting standards other than U.S. GAAP so long as they contain information substantially similar to statements prepared in accordance with U.S. GAAP (e.g., audited schedule of investments, audited financial highlights, etc.). Any material differences with U.S. GAAP must be reconciled. The SEC staff indicated certain offshore funds intended to use IFRS financial statements to satisfy the Custody Rule but did not include an audited schedule of investments or audited financial highlights. In this instance, the SEC staff believes the offshore fund's financial statements would need to include an audited schedule of investments and audited financial highlights to satisfy the Custody Rule. (FAQ VI.5 http://sec.gov/divisions/investment/custody_faq_030510.htm)
4. The EP sought the SEC staff's comments on the Statement on Money Market Funds as to Recent Developments made by Commissioner Luis A. Aguilar on December 5, 2012. (text of that speech is available at <http://www.sec.gov/news/speech/2012/spch120512laa.htm>). The SEC staff did not provide further comments about this Statement, but offered a brief summary of certain alternatives identified in the Financial Stability Oversight Council's "Proposed Recommendations Regarding Money Market Mutual Fund Reform" (full text is available at:

<http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%202013,%202012.pdf>):

- a. Floating NAV;
- b. Stable NAV with NAV Buffer of up to 1 percent to absorb day-to-day fluctuations in the value of the fund's portfolio securities and allow the fund to maintain a stable NAV. The NAV buffer would be paired with a requirement that 3 percent of a shareholder's highest account value in excess of \$100,000 during the previous 30 days — a minimum balance at risk (MBR) — be made available for redemption on a delayed basis.
- c. Stable NAV with a risk-based NAV Buffer of 3 percent to provide explicit loss-absorption capacity that could be combined with other measures to enhance the effectiveness of the buffer and potentially increase the resiliency of MMFs. Other measures could include more stringent investment diversification requirements, increased minimum liquidity levels, and more robust disclosure requirements.

The comment period on this proposal ends January 18, 2013.

5. The SEC staff provided the following observations on recent financial statement reviews with respect to ASU 2011-04:
 - a. There appears to be diversity in practice regarding the extent of unobservable inputs included in quantitative disclosures. The SEC staff noted an example of two funds within different fund complexes where a discounted cash flow model was indicated as a valuation technique. One fund disclosed only the discount rate as an unobservable input while the other fund included unobservable inputs such as growth rate, recovery rate, etc. along with the discounted cash flow rate. The SEC staff noted that all significant unobservable inputs used in the calculation of fair value should be included.
 - b. The SEC staff commented on the use of wide ranges of unobservable inputs in tabular disclosures in accordance with ASU 2011-04. In one situation, where the valuation technique used was discounted cash flow model, and disclosure had a wide range of discount rates being used, the registrant was asked to provide a weighted average range of the discount rate, consistent with illustrative disclosures included in ASC 820-10-55.
 - c. Certain funds did not address the valuation process for level 3 measurement in the footnotes to the financial statements. The SEC staff noted that this disclosure should be included in the audited section of the financial statements (footnotes to the financial statements) rather than included in the MDFP (or MD&A for BDCs).
 - d. Some investment companies were not disclosing a description of the interrelationship of unobservable inputs used and how those interrelationships may magnify or mitigate the effect of changes in the unobservable inputs on fair value.
 - e. During the November conference call, the SEC staff referred to the SEC's CorpFin staff remarks at the recent AICPA National Conference on Banks & Savings Institutions regarding the use of multiple valuation techniques for certain classes of instruments, where such techniques are not bifurcated by fair value under each valuation approach. The SEC staff provided an example of a BDC with senior debt in Level 3, where both a discounted cash flows valuation technique and market comparable valuation technique were used, each technique used for different holdings within senior debt. The fund only provided total fair value for the total senior debt and did not separately disclose the fair value derived from the discounted cash flow technique and the fair value derived from the market comparable technique. The remarks are available at <http://sec.gov/news/speech/2012/spch091212sc.pdf>.
 - f. An EP member noted that the example included in the ASU shows a security type with two types of techniques and the fair value is not bifurcated between the two techniques. Another concern noted by an EP member is if the amount of investments included in the disclosure is very small compared to overall assets and/or level 3 assets; and so the question arises how useful is it to break out further; e.g., if 1.5% of total assets are included in the table, the usefulness of breaking it out further seems minimal (versus a fund that has a much higher percentage of its assets included within the disclosure). The SEC staff responded that the answer depends on facts and circumstances and noted guidance in BC86 of ASU 2011-04 (the objective of the disclosure is not to

enable a user to replicate values but to provide enough information to the user to assess whether the reporting entity's views are significantly different from their own).

6. The SEC staff received an inquiry regarding how to report "open repurchase agreements" with no legal stated maturity date that can be settled within one business day on Form N-MFP. For the purpose of completing Form N-MFP, the maturity date to be included on the Form would be "the next business day" for an open repurchase agreement that could be called by either party within one business day. The SEC staff believes that WAM and WAL would be one day. In addition, the SEC staff inquired as to how open repurchase agreements are being disclosed in the Schedule of Investments in the financial statements. Some EP members noted they see the open repurchase agreement tickmarked in the Schedule of investments as "redeemable on demand" or "payable on demand".
7. The SEC staff noted remarks made by Brian Croteau, Deputy Chief Accountant, SEC's Office of the Chief Accountant, at the AICPA 2012 SEC/PCAOB Developments conference regarding use of third-party pricing services. Remarks made noted that while there are reasons to be encouraged by the progress, this is still an area where attention is necessary. For example, Brian reminded registrants of the importance of developing and maintaining internal controls to provide management with the basis to take responsibility for the financial statements. One area in particular that may warrant increased focus is ensuring that adequate controls are in place and operating effectively to identify when securities begin to become thinly traded so that necessary changes to the valuation approach and related measurement and disclosures would be made on a timely basis. The full text of this speech is available at <http://www.sec.gov/news/speech/2012/spch120312btc.htm>.
8. The EP asked the SEC staff to comment on a recent allegation by the Division of Enforcement against eight mutual fund directors of Morgan Keegan that the directors caused the funds to violate the federal securities laws by failing to adopt and implement meaningful fair valuation methodologies and procedures and failing to maintain internal control over financial reporting (<http://www.sec.gov/litigation/admin/2012/ic-30300.pdf>). For example, the SEC alleged that the funds' valuation procedures did not include any mechanism for identifying and reviewing fair-valued securities whose prices remained unchanged for weeks, months, and even entire quarters. While the SEC staff could not comment specifically on the case, the staff reminded the EP that fair value is a focus throughout the SEC.
9. The SEC staff discussed an enforcement case where KCAP Financial, Inc., a BDC, materially overstated the value of its investment portfolio which resulted in an overstated NAV of approximately 27% and a restatement of financial statements. This BDC primarily held debt securities and CLOs. The BDC used an enterprise value methodology to determine fair value for certain non-controlled debt holdings which resulted in many securities being valued at par. The enterprise valuation methodology for debt holdings of non-controlled companies did not take into account market-based activity and did not reflect an exit price in accordance with GAAP. In addition, the BDC ignored quotes from 3rd party pricing services and concluded all trades of debt securities the BDC owned reflected distressed transactions, despite guidance in FSP FAS 157-3 that even in times of market dislocation, it is not appropriate to conclude that all market activity represents distressed sales or forced liquidations. The BDC also valued 2 of its largest CLOs at cost which did not consider certain market-based activity. Furthermore, public filings were materially misleading related to CLOs as they noted the use of a discounted cash flow method that incorporated current market data to value the CLOs, while in reality they did not since they were valued at cost. The text of the order can be found at <http://www.sec.gov/litigation/admin/2012/34-68307.pdf>.

10. On December 6, 2012, Norm Champ, the director of the SEC's Division of Investment Management, during a speech at the American Law Institute Continuing Legal Education Group's Conference, announced that the Division staff would no longer defer consideration of exemptive requests under the Investment Company Act relating to actively managed exchange traded funds (ETFs) that intend to invest in derivatives. This is provided any such exemptive request includes two specific representations to address some of the concerns that led to the Division's decision to defer consideration of these types of applications. These representations are: (i) that the ETF's board periodically will review and approve the ETF's use of derivatives and how the ETF's investment adviser assesses and manages risk with respect to the ETF's use of derivatives; and (ii) that the ETF's disclosure of its use of derivatives in its offering documents and periodic reports is consistent with relevant Commission and staff guidance. The full text of this speech is available at <http://www.sec.gov/news/speech/2012/spch120612nc.htm>.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2013 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the January 29, 2013, 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 company issues.

I. Administrative items/AICPA matters:

1. The November 2012 conference call and December 2012 meeting highlights are being finalized.
2. The Investment Companies Technical Q&As TIS Section 6910.34-35 have been launched into production and should be available through online subscription on cpa2biz.com by third week of February.
3. The AICPA publications staff informed the EP that 2012 AICPA Audit Risk Alert *Investment Companies Industry Developments* (INV ARA) is now available on cpa2biz.com and in hard copy.
4. The AICPA publications staff also updated the EP on timing of experts' review of the 2013 conforming changes to the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
5. The EP updated certain illustrative report examples in chapter 11 of the Guide to reflect the changes due to the Clarity Project. The clarified Statements on Auditing Standard (SASs) are effective for audits of financial statements for periods ending on or after December 15, 2012. The updated illustrative reports are for audits of nonregistered investment companies, and are available at http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Investment_Companies.aspx. The updated reports will also be included in 2013 Guide.
6. The next Investment Companies EP webinar is scheduled for Tuesday, April 16, 2013, starting at 2 pm ET. The EP identified balance sheet offsetting disclosures and implementation issues in connection with ASU 2011-04 as potential topics. The EP is currently seeking volunteers to present this 1 hour webinar.
7. The EP discussed timing and locations of 2013 in-person EP meetings.
8. The EP was informed that the Government Accountability Office is conducting a study on costs of surprise examinations under the SEC Custody Rule.

II. Accounting/Reporting Issues:

1. Regarding the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Investment Companies (Topic 946), the EP members heard a brief recap of the January 23rd FASB Board Meeting and the potential disclosure impact of funds that invest in other funds, especially around what constitutes a significant

investment, availability of data, and FASB's next steps. The EP scheduled a conference call to discuss the FASB's decision on disclosure requirements for funds that invest in other funds, including:

- a. Defining significant at 5% (establishment of a "bright line")
- b. Not allowing referencing of funds that are publicly available (disclosure required for all funds – public and private)
- c. Disclosure would be as of the most recent audited date for the investee fund(s), and not as of the period end of the investor fund

On this call, the EP will also discuss FASB's outreach on issues associated with this tentative decision.

2. Regarding Balance Sheet Offsetting (Topic 210), the EP discussed implementation of the standard, including determining which eligible financial assets and liabilities are in scope or out of scope, and the reasons that support those positions. The EP also discussed how the entities plan to disclose (by counterparty or by financial instrument type) and whether it would be reasonable to develop a materiality threshold for the disclosure based on counterparty or financial instrument type. Subsequent to the January 2013 EP call, FASB issued Accounting Standard Update No. 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*.
3. The FASB issued for public comment its [proposal](#) to improve financial reporting about repurchase agreements and other transfers with forward agreements to repurchase transferred assets. Proposed ASU, *Transfers and Servicing (Topic 860)—Effective Control for Transfers with Forward Agreements to Repurchase Assets and Accounting for Repurchase Financings* would clarify the guidance for distinguishing these transactions as either sales or secured borrowings and improve disclosures about them. The comment period ends on March 29, 2013. The EP discussed the potential impacts to funds, particularly those funds that invest in dollar rolls and currently account for these transactions as purchases and sales. The EP will continue discussing this ASU during the February 2013 conference call.
4. Regarding ASU 2011-04 implementation, there are cases where a private equity fund considers both the income and market approach. For an example investment:
 - a. Market approach has range of 100-120 and uses two different inputs (EBITDA multiple, and market comparables)
 - b. Income has range of 140-160 and uses two inputs (discount rate, and growth rate)

Ultimately the investment may be valued based on a weighting of the methods or primarily on one valuation method, depending on facts and circumstances.
 - c. A value of 130 for the investment is selected based on the entity's judgment, and this value falls outside both ranges (100-120 and 140-160)
 - d. There are 25 other investments in the asset class, each with unique input (DCF, growth rate, EBITDA, market comparable) numerical values

The EP members discussed that a narrative discussion would be needed on the process and how the fair values are determined. An EP member expressed a view that with respect to the presentation of the asset class, both the income and market approaches can be presented as well as information on the weighting utilized.. The EP members acknowledged that disclosure of the interaction between multiple techniques is a continued focus of the SEC staff during financial statement reviews.

5. A question arose on whether borrowed bonds need to be considered debt for the purposes of the calculation used in the determination of whether an investment company needs to present a statement of cash flows. In a borrowed bond agreement, the fund borrows a bond from a counterparty in exchange for cash collateral with the commitment that the security and the cash will be returned to the counterparty and the fund, respectively, at a mutually agreed upon rate and date. Certain agreements have no stated maturity and can be terminated by either party at any time. Borrowed bond agreements are entered into primarily in connection with short sales of bonds.

Earnings on cash collateral and compensation to the lender of the bond are based on agreed upon rates between the Fund and the counterparty. The value of the underlying cash collateral approximates the market value and accrued interest of the borrowed bond. To the extent that a borrowed bond transaction exceeds one business day, the value of the cash collateral in the possession of the counterparty is monitored on a daily basis to ensure the adequacy of the collateral. As the market value of the borrowed bond changes, the cash collateral is periodically increased or decreased with a frequency and in amounts prescribed in the borrowed bond agreement.

Based on the guidance in paragraph 7.143 of the Guide, which is presented below, an EP member expressed a view that borrowed bonds fully secured by cash would be excluded from the leverage balance in the cash flow calculation:

According to TIS section 6910.25, "Considerations in Evaluating Whether Certain Liabilities Constitute 'Debt' for Purposes of Assessing Whether an Investment Company Must Present a Statement of Cash Flows" (AICPA, Technical Practice Aids), although presented in the "Liabilities" section of the statement of assets and liabilities, options sold or written (whether covered or uncovered), short sales of securities, and other liabilities recorded as a result of investment practices are not necessarily debt; rather, their classification depends on the nature of the activity. Certain transactions (for example, securities lending, mortgage dollar rolls, or short sale transactions) may have a practice of being entered into solely for operating purposes (similarly to unsettled purchases of securities) or as an investing strategy (similarly to covered options written), and the investment company either retains the proceeds in cash accounts or uses them to invest in securities that are cash equivalents under FASB ASC 230. In such cases, the proceeds from the transaction should not be considered debt for purposes of assessing whether the conditions in the previous paragraph are met.

III. Audit and Attest Issues

1. During the October 2012 conference call, the Expert Panel discussed the timing of communication of the audit firm with audit committees in light of the recently issued PCAOB Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to other PCAOB Standards*. Footnote 43 in the Auditing Standard (AS) No. 16 states:

43/ Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

This exception currently enables large fund complexes with individual funds' fiscal year-ends that are spread throughout the year to have quarterly audit committee meetings (rather than monthly audit committee meetings). Questions have arisen whether the changes to Auditing Standard 16 to require certain communications to take place prior to issuance of the opinion for each individual fund within large fund complex. This interpretation of Auditing Standard No. 16 may cause audit committees to move to a monthly meeting schedule (so that they can receive and discuss the required communications prior to issuance of each opinion). Alternatively, there were questions on whether the PCAOB's 2010 Proposing Release No. 2010-001 and the 2012 adopting release (No. 2012-004), that the PCAOB had intended to change current practice for investment companies. EP members observed that, unless the PCAOB or the SEC issue clear guidance regarding application of this Standard for mutual fund complexes, some may interpret that communications between the auditor and audit committee must take place before issuing the auditor's opinion; however, the nature of such communication may be flexible (for example, through a conference call or e-mail). The EP members also discussed that, if the frequency of these communication increases for large fund complexes with different reporting periods for individual funds, it may present an additional burden to the registrants, as the funds may incur additional costs in preparing meetings. The SEC approved this Standard in December 2012. During the January 2013 EP call, the EP reaffirmed its view that the timing of communications has not changed as a result of issuance of Auditing Standard 16, but noted that audit committees may decide to modify the timing of meetings. The EP also discussed whether a material weakness or significant deficiency identified by the auditor during the audit would need to be communicated to the chair of the audit committee or the whole committee.

2. During the December 2010 EP meeting, the SEC staff and the EP members discussed situations where a pooled investment vehicle may need two audit opinions: one issued by a firm registered with, and subject to regular inspection by, the PCAOB and another issued by a local auditor to satisfy a local regulator requirement. In that

meeting, the SEC staff said it would not object to including two audit opinions with one set of financial statements and did not object to advisers distributing a letter to their investors explaining why there are the two audit opinions. During the January 2013 call, the EP revisited this topic in connection with a question about a second firm (local auditor) being identified in the Form ADV and, therefore, also needing to be registered with and subject to the inspection by the PCAOB. The EP expressed a view that to satisfy the Custody Rule, the second firm would also need to be registered with and inspected by the PCAOB.

IV. SEC Staff Update

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 staff joined the Expert Panel conference call to discuss the following questions presented by the EP members:

1. During the December 2012 EP meeting, the EP members sought the SEC staff's views about using the "distributed yield of the underlying funds" or the "SEC Yield of the underlying funds" when calculating the SEC Yield for funds of funds (FoF). In practice, an EP member indicated most use the distributed yield of the underlying funds method (actual distributed income from investee fund to the investor fund). However, a question was posed as to whether a FoF should use the underlying funds' SEC Yield and take a weighted average of those values. During the January 29, 2013 EP conference call, the SEC staff indicated that they are consulting internally on this question along with other questions received on the SEC Yield calculation. The SEC staff will then determine whether to issue guidance on the calculation more broadly to the Industry. The SEC staff encourages registrants to contact them directly on an individual basis to discuss specific SEC Yield calculation questions.
2. The EP and SEC staff discussed the following scenario: a registered investment adviser (RIA) manages two private funds that have been winding down operations. No securities were held by these funds during 2012 or January 2013; the only assets held during this time were cash and escrow receivables. The funds continued operations through 2012 and early 2013 solely in order to pay the final cash distribution to the partners. Further details of the funds:
 - a. XX Partners L.P.: During 2008, XX sold its last investment and \$10K was recorded as an escrow receivable. At 12/31/12, XX held \$12K in cash, of which the majority was related to the receipt of the escrow on 12/31/12 (the last day of 2012). Final distribution to partners occurred on 1/31/13.
 - b. X Holdings, L.P.: Approximately \$20K was held in cash at 12/31/11. At 12/31/12, X held \$35K in cash. Escrow proceeds were received during the middle of 2012 and final distribution to partners occurred on 1/31/13.

The EP inquired whether the RIA is required to satisfy the Custody Rule with respect to the above two funds during 2012 and 2013 and if so, whether the funds can satisfy the audit provision by undergoing a 12-month audit as of 12/31/12, and having no audit performed for the month of January 2013; OR undergoing a 13 month liquidation audit (covering the period from 1/1/12 through 1/31/13), and issuing the financial statements by April 30, 2013 (within 120 days of December 31, 2012) in order to meet the 120 day audited financial statement distribution requirement. The SEC staff indicated that there would generally be a need for an audit for the 12/31/12 year-end (1/1/12 – 12/31/12) and the stub period (1/1/13 -1/31/13) and in such case two sets of audited financial statements should be presented (for the 12 month calendar year and the stub period) and the financial statements would need to be distributed within 120 days of the respective period end. Alternatively, the SEC staff indicated a 12-month audit (1/1/12-12/31/12) and a one month audit (1/1/13-1/31/13) could be performed and the respective financial statements could be included in the same audit report as long as the fund included two balance sheets (as of 12/31/12 and 1/31/13), and two income statements, two statements of changes in net assets, and two statements of cash flows (if required) for the year ended December 31, 2012 as well as the period ended January 31, 2013 (the stub period). The SEC staff encourages registrants to consult directly with the SEC staff with questions related to particular fact patterns.

3. The SEC staff noted that certain business development companies (BDCs) are not considering applicability of Rules 3-09 and 4-08(g) of Regulation S-X in their filings. During the May 2012 EP meeting, the SEC staff indicated that they have seen an increase by BDCs investing in nonregistered investment companies or other entities. Please refer to the SEC Staff Update section of May 2012 EP meeting highlights for more information and overview of Rules 3-09 and 4-08(g) of Regulation S-X. During the January 2013 call, the SEC staff stated their position is that both of these Rules apply to BDCs.
4. The SEC staff noted it had received questions regarding the 3.8% tax on net investment income imposed on certain taxpayers by the Health Care and Education Reconciliation Act of 2010, which is effective as of 1/1/13. Questions related to whether this tax should be included or excluded in the calculation of after-tax returns required by Item 26(b) of Form N-1A. The SEC staff is currently formulating a conclusion.
5. The SEC staff noted that certain registered funds of funds have investments in underlying funds that are redeemable only on an annual basis and are being classified as level 2 investments in the fund of fund's fair value hierarchy. The SEC staff believes if a fund can only redeem from an underlying fund on an annual basis, the investment should be classified as level 3 in the fair value hierarchy. An EP member discussed the leveling of quarterly redemptions. The SEC staff noted they generally would not object to funds with the ability to redeem on a quarterly basis being classified as level 2 in the fair value hierarchy which is consistent with industry practice based on the conclusions reached in the AICPA's Technical Practice Aid (section 2220.25).
6. The SEC staff provided a reminder that registrants who include a summary schedule of investments in financial statements that are mailed to shareholders must file an audited full schedule of investments (per Form N-CSR, instruction item 6). There should be a separate opinion accompanying the audited full schedule of investments in item 6. The 2012 Guide has two illustrative examples and can be found in paragraph 11.20 of the 2012 Guide.
7. There have been recent instances where regulated investment companies are purchasing portfolios from private funds. The SEC staff described an example fact pattern whereby a new open-end fund was going to create its portfolio shortly after effectiveness of its Registration Statement by purchasing the assets of a pre-existing private fund where the shareholders of the pre-existing private fund would become shareholders of the new open-end mutual fund. When this occurs, the SEC staff encourages registrants to reach out to the SEC staff directly to determine what the SEC staff's expectations would be with regards to what kinds of financial statement and other information would need to be included in the registrant's registration statement prior to its effectiveness. Depending on facts and circumstances, the SEC staff may request registrants to file multiple years of audited financial statements of the private fund that are compliant with Regulation S-X and/or an audited Special Purpose Schedule of Investments to be Acquired. The SEC staff may also request registrants to file updated unaudited financial statements of the private fund or an updated unaudited Special Purpose Schedule of Investments to be Acquired depending on the timing of the filing and the year-end of the private fund. Furthermore, the SEC staff may request registrants to provide additional disclosures and historical information about the assets to be acquired. In considering what information may need to be included, consideration should be given such that investors of the existing private fund do not have more information than potential investors of the new fund (or BDC as applicable) about the product being offered.
8. The SEC staff shared observations from their review of material discrepancy letters issued by the accounting firms and received by the Office of Compliance Inspections and Examinations (OCIE). Themes include:
 - a. The auditor's report stated that the RIA did not engage an independent public accountant to perform a surprise examination within the required time period because the RIA was not aware of such requirement;
 - b. There was no notification within the RIA's quarterly account statements sent to their clients urging them to compare the quarterly account statements received from the qualified custodian to those quarterly account statements received from the RIA.
 - c. The RIA did not have a reasonable basis for believing the qualified custodian was sending account statements on at least a quarterly basis.
9. An EP member inquired whether the SEC staff is considering providing their financial statement review comments in writing (as opposed to verbal communication). The SEC staff indicated they are not aware of any planned changes to current practice.

10. In response to an EP member's question, the SEC staff confirmed that, as required by the Sarbanes-Oxley Act, all public companies, including regulated investment companies are subject to the financial statement review process at least once every three years (SOX Review). The SEC staff noted there may be instances where funds are reviewed more frequently than once every three years. An example would be if a targeted review was performed based on new products or emerging areas in the market. If the fund was selected for a targeted review, a full SOX Review might be performed.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2013 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the February 26, 2013, 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 company issues.

I. Administrative items/AICPA matters:

1. The November 2012 conference call highlights are available on http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/DownloadableDocuments/INV/INV_EP_Minutes/INV_EP_November8_2012_ConferenceCall.pdf and December 2012 meeting highlights are being finalized.
2. The next Investment Companies Expert Panel (EP) webinar is scheduled for Tuesday, April 16, 2013, starting 2 pm ET. The EP has identified updates on Topic 946 *Investment Companies* and balance sheet offsetting disclosures as potential topics.
3. The AICPA publications staff updated the EP on the current status of 2013 conforming changes to the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. Topic 946 Investment Companies – EP representatives participated in several separate conference calls with FASB Board members and staff regarding the potential disclosure impact on funds that invest in other funds, especially around what constitutes a significant investment and availability of data as part of FASB outreach efforts to the investment companies industry.
2. The EP discussed recording of substitute payments (dividend income less foreign withholding tax) on foreign equity securities that have been lent by a fund on the ex-dividend date. A question has arisen as to whether the dividend income and foreign withholding tax should be recorded gross or net (and what current practice is). The EP expressed a view that, as a general practice, gross reporting is used.
3. The EP revisited the accounting for recovery of EU tax withholdings based on the European Court of Justice’s 2012 decision. There is a possibility that some money may actually be paid in 2013. The EP members understand that these issues could extend to both registered and non-registered funds. On the February 2013 conference call, the EP discussed whether FAS 5 (ASC 450) or ASC 740 (Income Tax) is the relevant guidance for evaluating the potential recovery. An EP member expressed a view that the answer is based on how the original tax withholdings were characterized; for example, if the withholding is the equivalent of income tax in the foreign country (in which case ASC 740 appears to apply) or some other tax (which would be outside of ASC 740’s scope, thus under FAS 5). The EP

members also started discussing when recognition of the recovery by the fund would be appropriate, and how the amount would be estimated, and if it cannot be estimated, whether disclosure would be appropriate and when. The EP will continue discussing this topic at a future conference call.

4. The EP was updated on the initial efforts of “The Determining Fair Value of Portfolio Company Investments of VC/PE Firms” AICPA Task Force.
5. Topic 860 – Transfers & Servicing – the EP continued discussing the recently issued ASU and the potential impacts to funds, particularly those funds that invest in dollar rolls and currently account for these transactions as purchases and sales. The EP members discussed FASB’s intent on this project, particularly, around effective control. The EP will continue discussing this topic at future meetings.

III. SEC Staff Update

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 staff joined the Expert Panel conference call to discuss the following questions presented by the EP members:

1. The Office of Compliance Inspections and Examinations (“OCIE”) announced the National Examination Program’s [2013 examination priorities](#) for (i) investment advisers and investment companies; (ii) broker-dealers; (iii) clearing and transfer agents; and (iv) market oversight. For full text, please visit <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>.
2. Certain initial registration statements are being filed which include a description of a recoupment plan period of 5 years. It is the SEC staff’s position that the recoupment plan should have a defined period of 3 years or less, and if the plan exceeds 3 years, the fund would need to accrue a liability for the recoupment expenses. This topic was previously discussed at April 2011 and March 2012 EP calls.
3. The SEC staff has observed certain registrants using a “market yield” valuation methodology in valuing their debt investments in non-controlled companies which includes developing a range of market yields and comparing the contractual interest rate of the security to the range of market yields. When looking at the values estimated under this approach, the SEC staff noted that the values consistently reflected par. The SEC staff was concerned the Company’s methodology appeared to focus on validating par, rather than determining the point within the range most representative of fair value. The SEC staff reminded management of its responsibility to ensure that its methodology, and resulting estimates, are consistent with ASC 820 and, more specifically, ASC 820-10-35-54F which indicates, among other things, that “The objective is to determine the point within the range that is most representative of fair value under current market conditions. A wide range of fair value measurements may be an indication that further analysis is needed.”
4. The SEC staff discussed the SEC’s complaint against Yorkville Advisors LLC and their executives. The complaint alleges Yorkville Advisors and their executives did not adhere to Yorkville’s stated valuation policy, ignored negative information about certain investments, and withheld that information from the auditors, which enabled Yorkville to carry some of its largest investments at inflated values and, in turn, inflated NAV. Yorkville allegedly increased the reported value of its assets to increase assets under management, claim higher management and incentive fees and maintain positive year end performance. For more information, visit <http://www.sec.gov/litigation/complaints/2012/comp-pr2012-209.pdf>
5. The SEC staff informed the EP of a new “Issue of Interest” posted to the SEC’s website regarding the application of the 3.8% tax on net investment income imposed on certain taxpayers by the Health Care and Education Reconciliation Act of 2010 and its effect on the calculation of after-tax returns required by Instruction 4 to both Item 26(b)(2) and (3) of Form N-1A. The “Issue of Interest” notes registrants should include the 3.8% tax when calculating the after tax return and it should be included in the calculation of the highest individual marginal federal tax rate as described in Form N-1A. Similarly, this tax should be included in calculating the tax on qualified dividend income and

long-term capital gains or any tax benefit resulting from capital losses required by Instruction 7 to Item 26(b)(3) and it should be included in the calculation of the highest individual federal long-term capital gains tax rate. For the full text of the release, please refer to

<http://www.sec.gov/divisions/investment/issues-of-interest.shtml#after-tax>

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2013 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the May 22, 2013, 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 company issues.

I. Administrative items/AICPA matters:

1. The January and February 2013 call highlights are being finalized.
2. On May 10, 2013, Rob Fabio, Maryna Tully, Paul Ricci, and Irina Portnoy developed and presented the second AICPA Investment Companies Expert Panel (EP) webinar on emerging issues in the investment companies industry. The webinar generated great interest and a large number of participants. The EP considered timing and topics for future EP webinars.
3. The AICPA publications staff informed the EP about the timing of experts' review for the 2013 AICPA Audit Risk Alert - *Investment Companies Industry Developments* (INV ARA). The AICPA staff informed the EP that the AICPA Investment Companies Revenue Recognition Task Force is reviewing a listing of implementation issues associated with the proposed revenue recognition standard. The Task Force will hold their first meeting in June 2013.

II. Accounting/Reporting Issues:

1. The EP members discussed recent activities regarding the FASB/IASB project on Investment Companies. The EP members previously participated in drafting an AICPA FinREC comment letter on the proposed Accounting Standards Update (ASU) on Topic 946 and recently reviewed and provided comments on a fatal flaw draft. The final ASU is anticipated by June 30, 2013. The EP members observed that, if read literally, the current draft may exclude index funds from its scope because it may be viewed that index funds do not have an exit strategy. An EP member expressed a view that the Basis for Conclusions of the final ASU should specifically state that index funds are intended to be in the scope of the final ASU. However, it was noted that the Basis for Conclusions is not codified.

The EP members also noted that the fatal flaw draft changes language around the indefinite deferral of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, limiting the deferral to only those entities that qualify as investment companies under the new guidance, and those real estate funds for which it is industry practice to apply measurement principles (measuring investment assets at fair value on a recurring basis) and to issue financial statements using guidance that is consistent with the measurement principles in the new guidance (i.e., those entities that don't technically qualify under the new guidance will not be subject to the deferral).

The EP briefly discussed whether the FASB may address additional disclosure guidance for investments in other investment companies as a separate project (the FASB had performed extensive industry outreach to determine whether additional disclosures should be required for an investment company investing in other investment companies), but noted that it is not a high priority for the FASB at this time.

2. A question has arisen as to whether a money market fund (MMF) with a floating NAV would continue to be classified as a cash equivalent under ASC Topics 230 and 305 (currently, a MMF is included as an example of cash equivalents in these topics). EP observed that recently issued proposed ASU *Technical Corrections and Improvements* that revises the definition of cash equivalent continues to include a MMF as an example of a cash equivalent. One EP member noted that the floating aspect may change the classification of a MMF as a cash equivalent because the “principal” amount can fluctuate (a MMF becoming more like any other mutual fund) and that the FASB may need to consider providing guidance on this issue in the future. Some EP members believe that it would not be a dramatic change, as a MMF’s value currently changes daily, and companies may continue to make an accounting policy election to treat a MMF as a cash equivalent [Update: the June 2013 proposed rule “Money Market Fund Reform; Amendments to Form PF” specifically indicates that, generally, “a floating NAV would meet the definition of a “cash equivalent.”] The ICI staff mentioned that the Securities and Exchange Commission (SEC) will hold a meeting on the floating NAV proposal in June 2013 and that it is anticipated that a floating NAV would be considered for prime funds.
3. Financial Instruments Project – the EP discussed the status and potential impact of this joint FASB/IASB financial instruments project on investment companies. The EP discussed that the original proposed ASU would have required investment companies to carry non-recourse liabilities used to acquire investments at fair value; through earnings (since the associated investments are carried at fair value through earnings). The EP also discussed whether money market funds that carry assets at amortized cost would need to separately disclose fair value for those assets. An EP member expressed a view that if amortized cost is an appropriate estimate of fair value for that asset, there is no requirement to further disclose a second fair value. The EP also noted that the proposed standard would require any change in value for an equity security to be recorded through earnings (as opposed to OCI), and how it would create volatility in income and impact current practice for investment advisers and other corporate entities that invest in mutual funds since mutual fund shares are equity securities.
4. EP members continued discussion of accounting for potential refunds of European dividend withholding tax. The EP member expressed a view that when viewed as a fund’s income tax, the technical answer would be to follow ASC 740 guidance on refunds, which essentially would result in a receivable for the refund if it is “more likely than not” (MLTN) that the tax position would be sustainable and then identifying the greatest amount of refund that is more likely than not to be received. One EP member noted that when funds pass-through the foreign tax credit to the shareholders, it may be possible to take a view that these potential refunds of tax are not the fund’s income tax. Some expressed a view that they prefer the gain contingency accounting which is a more conservative approach and easier to apply, for example, in situations, where refunds are not material to the fund complex, and nothing is booked until actual receipt of cash refund. It was noted that this is likely not the technically correct approach. The EP will revisit this topic during future conference calls.
5. EP members shared current practices related to accounting for the inflation/deflation adjustment to the principal amount of inflation-protected securities. For tax purposes, the inflation/deflation adjustment is considered to be income in the period that it occurred. EP members noted that this is also the method commonly used for book accounting. Inflation adjustments can have more significant impacts on inflation-protected securities issued by foreign governments where inflation fluctuates significantly. The EP members pointed out that FAS 133 explains that inflation adjustments are closely related to interest rates and should be recorded as interest income and also mentioned that a technical GAAP accounting view may be the use of the effective interest method (developing an effective yield based on the estimated timing and amount of future cash flows) similar to the EITF 99-20 model.
6. The EP discussed various implementation issues on balance sheet offsetting, including:
 - a. Whether ASU 2013-01 is applicable to futures transactions, and if these transactions are in scope, what would be presented in column 1 of the disclosure: unrealized gain/loss on the schedule of investments or the variation

be applicable to other types of investment companies. The EP observed that practice varies, and that if a distribution results in a return of capital, a disclosure at an interim date may be appropriate. The EP also noted that majority of registered investment companies do not book ROC SOP adjustment in interim financial statements.

10. The EP members discussed that the SEC is considering whether SEC guidance on valuation should be developed and whether it should focus on accounting or auditing. EP members believe that if the SEC develops incremental guidance on valuation, it should be consistent with existing accounting guidance in FASB ASC Topic 820 and auditing guidance issued by the PCAOB. However, many are skeptical that additional guidance is needed.

The SEC is also continuing to focus on fund directors' responsibilities over valuing securities without readily determinable market values, specifically, on directors delegating the valuation process to management and concentrating on oversight responsibility over valuation. The EP members acknowledged that in other industries, directors do not have a responsibility over valuation.

The SEC staff is also inquiring about the audit requirement for 100% testing of valuation of securities having readily available market quotations. Recent PCAOB inspections highlighted increased scrutiny regarding inputs and assumptions the client and the auditor are using, even if different models are being used. The EP members expressed a concern that movement towards a 404 approach for registered investment companies would result in incremental time and cost.

III. SEC Staff Update

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 meeting in person. The SEC staff announced that Alan Dupski will join the Chief Accountant's Office as an Assistant Chief Accountant in June.

The SEC staff summarized the projects they are currently working on, questions they are receiving and their involvement on regulatory matters and assisting other Divisions and Offices within the SEC as questions arise.

1. Brief overview of the Office: The Division of Investment Management's Chief Accountant's Office (IM-CAO), serves primarily as a consultation office for the SEC on accounting and auditing issues related to the investment management industry. IM-CAO works with various offices in the Division of Investment Management. For example, IM-CAO provides consultations to the accountants in the Disclosure Review Office who perform financial statement reviews (currently, a significant amount of time is being spent on business development companies' (BDCs') filings), IM's Rulemaking offices (e.g., possible valuation guidance and proposed money market reform), IM's Chief Counsel's Office, as well as IM's Exemptive Applications Office. IM-CAO also works closely with the Office of Compliance Inspections and Examinations (OCIE) and the Enforcement Division. IM-CAO also works with the SEC's Office of Chief Accountant (OCA) on standard-setting activities impacting investment companies and advisers, including following FASB projects on Topics 946 and 810, and following the PCAOB's projects. The SEC staff is available for external consultations with registrants, auditors and counsel.
2. Update on Division rulemaking and SEC staff projects: Consistent with a recent speech made by Norm Champ, Director of the SEC's Division of Investment Management, in March 2013 (<http://www.sec.gov/News/Speech/Detail/Speech/1365171515032>), at the May Expert Panel meeting, the SEC staff highlighted three current short-term priorities:
 - a. MMF reform, as evidenced in the May 1, 2013, Chair White's speech at the ICI's General Membership Meeting - <http://www.sec.gov/news/speech/2013/spch050313mjw.htm>.
 - b. Identity Theft Red Flags – On April 10, in a joint rulemaking with the CFTC, the SEC adopted rules requiring broker-dealers, investment companies, investment advisers, and certain other SEC regulated entities to adopt

programs to detect red flags and prevent identity theft. These rules transferred identity theft rulemaking responsibility and enforcement authorities from the FTC to the SEC and CFTC for entities they regulate.

- c. Valuation guidance – the SEC and the staff provided various forms of valuation guidance in the past (including, the 1940 Act and rules thereunder, Accounting Series Release Nos. 113 and 118 as well as multiple industry letters and no-action letters) and there have been Enforcement cases relating to valuation. ASR 118 contains legal valuation guidance, but also includes audit guidance (e.g., ASR 118 requires auditors to independently verify at the balance sheet date quotes of all securities for which market quotations are readily available). At this time, IM is considering whether to recommend the SEC amend or supplement existing SEC valuation guidance. At the ICI’s March 2013 Mutual Funds and Investment Management Conference, Norm Champ announced the IM Division’s recent meetings with industry stakeholders on valuation such as the ICI, registrants, and accounting firms and Norm also requested additional input from the industry on valuation. For Norm Champ’s speech go to <http://www.sec.gov/News/Speech/Detail/Speech/1365171515448>. Among other things, IM-CAO is interested in whether the industry believes current auditing guidance included in ASR 118 should be modified. For example, should the SEC permit auditors to use a sampling approach when testing valuations at year-end or should the SEC permit auditors to test controls over valuation to potentially reduce substantive valuation testing at year-end?
3. The SEC staff also provided an overview of the following other longer-term regulatory initiatives:
- a. Summary prospectus for variable annuity products.
 - b. A rule that would allow ETFs to operate without obtaining individual exemptive relief.
 - c. Enhancement of fund disclosures about operations and portfolio holdings – the SEC staff is looking into ways to improve the quality and usefulness of information funds provide to investors and the SEC and eliminate duplicative filings or disclosures. For example, the SEC staff is considering making changes to the format and frequency of portfolio holdings disclosures. The SEC staff is looking at ways to consolidate information that funds report on different forms (including N-CSR, N-Q, and N-SAR) and will consider potential additional disclosures for open-end and closed-end funds, similar to Forms PF and N-MFP.
 - d. Review of rules for private fund advisers - In connection with the increase in and variety of private fund advisers that registered with the SEC as a result of the Dodd-Frank Act, the SEC staff is reviewing the Investment Advisers Act of 1940 to determine which rules need to be updated.
 - e. Derivatives – most recent was a derivatives concept release in 2011, including how derivatives should be treated under Section 18; the staff is analyzing feedback on the concept release to determine next steps.
- The SEC staff also highlighted the Risk and Examinations Office (REO), which is a new office within the IM Division responsible for analyzing and monitoring the risk-taking activities of investment advisers, investment companies, and the investment management industry. REO also assists the IM Division’s staff in understanding the characteristics, risks and benefits of complex investment products and reviewing disclosures of these products. REO works closely with OCIE and while REO will conduct its own exams, REO staff may join OCIE examiners on visits to registrants.
- The SEC staff noted that the IM Division’s website has been revamped. For example, a Topical Reference Guide was created that reorganized existing guidance. The accounting and auditing section of that website contains guidance such as Dear CFO letters, FAQs, no action letters, and other SEC staff guidance as well as links to various rulemaking releases (<http://www.sec.gov/divisions/investment/guidance.shtml#accounting>).
- Additional links, such as links to enforcement cases on valuation, will be added to that section.
- The IM Division is actively looking at guidance to disseminate to the industry. The IM Division hired a Communications Lead to find out areas of guidance that people are seeking. Over the last few years, the IM staff has issued guidance in the form of “Issues of Interest.” Beginning in March 2013, IM staff started issuing guidance in a new format called an “IM Guidance Update” (recent updates are labeled 2013-01 - [Filing Requirements for Certain Electronic Communications](#) and 2013-02 - [Compliance With Exemptive Orders](#)).
4. The EP members and the SEC staff discussed significant finding areas identified by OCIE as well as some areas of focus.

OCIE administers the SEC's nationwide examination and inspection program. They perform exams of regulated entities including advisers and the funds or BDCs they manage using a risk based approach. OCIE exams are designed to determine whether there is compliance with securities laws and regulations and typically include a review of the safety of client assets. During an exam, the staff typically requests books and records of the entity, performs interviews with management and firm employees, and analyzes the entity's operations. In many cases, an exam will include an on-site visit to the entity's offices and will often conclude with an exam summary letter that may highlight compliance or internal control deficiencies or weaknesses to which the registrant must respond to in writing.

OCIE has encountered a number of significant findings during recent examinations. For example, SEC staff highlighted the following:

- a. Compliance Programs:
 - i. Inadequate Board consideration of certain compliance information and/or documentation of the assessment of the adequacy of compliance policies and procedures.
 - ii. Failure to implement adequate policies and procedures (including oversight of service providers) with respect to certain business activities.
 - iii. Failure to have policies and procedures in place to assist in ensuring that all material disclosures are made.
- b. Filings:
 - i. Omissions of material fact or inadequate disclosure regarding investment company filings, examples include:
 - (1) Failure to file forms and/or filing inaccurate forms; and,
 - (2) Certification of financial statements without appropriate disclosures.
- c. Governance:
 - i. Failure to evidence consideration of relevant information during the 15(c) process, including:
 - (1) The full compensation of the adviser;
 - (2) The potential impact of the adviser's financial condition on its ability to adequately provide services to the funds; and,
 - (3) Peer comparisons for service providers.
 - ii. Failure to review and question certain administration services expenses charged to funds.
 - iii. Failure of advisers and service providers to provide full and fair disclosure of all material facts and conflicts of interest to fund directors, potentially hampering the board's ability to make informed decisions.
- d. Valuation:
 - i. Inadequate valuation policies and procedures.
 - ii. Valuation decisions that contradict practices outlined in the fund's policies and procedures or disclosure documents.
 - iii. Failing to maintain documentation when overriding valuations received from a third party pricing service.

OCIE focus areas: OCIE has concerns in the areas described below which include, but are not limited to:

- Alternative and hedge fund investment strategies in open-end funds, ETFs and variable annuity structures - the focus is on assessing whether:
 - Leverage, liquidity and valuation policies and practices comply with regulations;

- Boards, compliance personnel and back-offices are staffed, funded and empowered to handle the new strategies; and,
 - Whether the funds are being marketed to investors in compliance with regulations.
- Conflicts of interest related to allocation of investment opportunities where the focus is on the appropriate controls being in place to monitor the side-by-side management of performance-based fee accounts with non-incentive fee-based accounts with similar investment objectives. Advisers managing accounts that do not pay performance-based fees (e.g., most mutual funds) side-by-side with accounts that do pay performance-based fees (e.g., most hedge funds) face unique conflicts of interest.
 - Payments for distributions in guise where the focus is on the wide variety of payments made by advisers and funds to distributors and intermediaries, and the adequacy of disclosure made to fund boards about these payments as well as the board's oversight of the same. These payments go by many names and are purportedly made for a variety of services, most commonly revenue sharing, sub-TA, shareholder servicing and conference support. OCIE will assess whether such payments are made in compliance with regulations (e.g., Rule 12b-1) or whether such payments are instead payments for distribution and preferential treatment.
 - MMFs – Among other things, OCIE is focusing on whether firms are conducting stress testing, what factors they are considering when stress testing and what the results are. Rule 2a-7 requires MMFs to periodically stress test their ability to maintain a stable share price based on hypothetical events, including changes in short-term interest rates, increased redemptions, downgrades and defaults, and changes in spreads from selected benchmarks.
 - Compliance with Exemptive Orders – Where applicable OCIE will focus on compliance with previously granted exemptive orders, such as those related to closed-end funds and managed distribution plans, employee securities companies, ETFs and the use of custom baskets, and those granted to fund advisers and their affiliates permitting them to engage in co-investment opportunities with the funds. The SEC staff noted there is an “IM Guidance Update” related to compliance with exemptive orders which was issued in May which is located on the website (refer to <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-02.pdf>).

OCIE has a dedicated webpage at <http://www.sec.gov/about/offices/ocie.shtml>. The website includes SEC staff letters and National Exam Risk Alerts. OCIE has also recently posted its National Exam Program Priorities for 2013 to its website (<http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>).

5. The SEC staff provided a brief overview of the Disclosure Review Office's financial statement review process. In accordance with Section 408(c) of the Sarbanes-Oxley Act, at least once every three years the SEC staff reviews filings, including financial statements, of all issuers (RICs and BDCs are included). The SEC staff in the Division of Investment Management consists of 10 accountants, which includes 2 specializing in insurance products. The accountants review annual financial statements and may also review semi-annual financial statements, N-Qs, N-14s, and any other filing on the SEC's website. The accountants also review the registrant's website to ensure what is depicted on the registrant's website is consistent with what is filed with the SEC. The SEC staff generally provides financial statement review comments verbally, and registrants are generally required to respond in writing within 30 days. Generally, comment letters and response letters between the SEC staff and the registrants will be disseminated to the public at least 20 days after the completion of the review. At the May 2013 Expert Panel meeting, the SEC staff shared the following financial statement review comments:
 - a. Business development companies:
 - i. As previously stated during the May 2012 EP meeting, Rule 3-09 of Regulation S-X describes requirements when separate financial statements of a majority-owned unconsolidated significant subsidiary should be filed by the registrant. Rule 3-09 refers to the three tests described in Rule 1-02(w) of Regulation S-X to determine whether the investee is a significant subsidiary. When performing the tests in Rule 1-02(w), as described in the Note to paragraph (w), Regulation S-X requires the use of GAAP financial statements, which would include the consolidation of any underlying subsidiaries if required under GAAP. Rule 3-09

describes the circumstances under which the separate financial statements required must be audited. It also explains that, insofar as practicable, the separate financial statements required should be as of the same dates and for the same periods as the reporting fund. The separate financial statements of an unconsolidated significant subsidiary that is an investment company for accounting purposes should be prepared in accordance with Regulation S-X which would include a full schedule of investments. During the May 2013 EP meeting, the SEC staff described a recent BDC registration where the BDC had a wholly owned subsidiary, which was a CLO. The management of the BDC concluded that the CLO triggered one of the significant subsidiary tests in Rule 1-02(w) and that audited financial statements of the CLO should be filed by the BDC pursuant to Rule 3-09. Instead of filing the CLO's audited financial statements, the BDC included the CLO's financial statements, without the audit opinion, in a footnote to the BDC's financial statements and marked the footnote as unaudited. The SEC staff indicated when a BDC triggers Rule 3-09 and is required to file audited financial statements of the significant subsidiary, the subsidiary's financial statements should be filed under either Item 8 or Item 15 of Form 10-K, and should not be included in an unaudited footnote to the registrant's financial statements.

- ii. The SEC staff mentioned if a registrant is required to file the financial statements of an unconsolidated majority owned subsidiary under Rule 3-09, but the financial statements of the majority owned subsidiary will not be filed until after the original due date of the registrant's Form 10-K, the registrant must include Rule 4-08(g) summarized financial information in its audited financial statements. This is described in section 2420.5 of the Division of Corporation Finance Financial Reporting Manual. (<http://www.sec.gov/divisions/corpfin/cffinancialreportingmanual.pdf>)
- iii. The SEC staff was asked if, for a significant subsidiary for which a registrant is required to include summarized financial information in its notes to the financial statements in accordance with Rule 4-08(g) of Regulation S-X, it would be acceptable to file separate audited financial statements of the significant subsidiary which are compliant with GAAP and Regulation S-X in lieu of summarized financial information required by Rule 4-08(g) of Regulation S-X. The SEC staff indicated the filing of GAAP and S-X compliant separate audited financial statements in lieu of summarized financial information would be acceptable and referred to the applicable guidance in the SEC Staff Accounting Bulletin Topic 6K.4b, Question 1 (<http://www.sec.gov/interps/account/sabcodet6.htm#K>).
- iv. The SEC staff discussed BDCs and other investment companies forming by acquiring partial or full loan portfolios of private funds before or after the effectiveness of the initial registration statement. For example, many BDCs have formed by acquiring full or partial loan portfolios prior to the effectiveness of the registration statement, and recently, an open-end mutual fund planned to acquire a private fund's assets shortly after the registration statement became effective. Questions arise about whether the private fund's financial statements or other information should be included in the registration statement. In considering what information may need to be included, consideration should be given such that investors of the existing private fund(s) do not have more information than potential investors of the new registrant about the product being offered.
- v. The SEC staff's position is generally, if a BDC or other investment company acquires (or knowingly will acquire shortly after the registration statement is declared effective) a significant portion of a private fund, an entire private fund or multiple private funds, at least 2 years of audited, Regulation S-X and GAAP compliant financial statements of the acquired private fund(s) (or private fund(s) to be acquired shortly after the registration statement is declared effective) should be included in the registration statement (including full SOI as opposed to a condensed SOI). In certain circumstances, the SEC staff may also request an audited special purpose schedule of investments to be acquired and/or unaudited pro forma financial statements. In addition, there may be circumstances when additional narrative information regarding the advisor's decision to select a private fund or private funds to be acquired should be disclosed. The aforementioned narrative disclosure should be similar to what is described below in 5(1)(f)(v). The SEC staff may also request management representations as described below in 5(1)(f)(vi).

- vi. If a BDC or other investment company is going to acquire a small portion of a private fund's assets or small portions of assets of multiple private funds, then the SEC staff generally would not object to the registrant including, in lieu of audited private fund financial statements, an audited special purpose schedule of investments to be acquired which would include only those assets which will be purchased by the registrant. The registrant should also include historical and other information about the assets to be acquired from the private fund(s) that would be pertinent to the users of the financial statements such as:
- (1) Disclosure of any asset that was on partial interest accrual or non-accrual of interest status for the last 3 years
 - (2) Disclosure of any material changes in the creditworthiness of any borrower during the last 3 years
 - (3) Disclosure of any restructuring of an asset in the last 3 years such as changes in interest rate, changes in type of interest (cash to PIK, for example), or changes in maturity date
 - (4) Clear disclosure of the type of income currently being accrued for each asset (cash vs. non-cash such as PIK)
 - (5) Narrative disclosure to address the risk of cherry-picking (e.g., an adviser causes the BDC or other investment company to purchase non-performing assets from a private fund) such as a description of why certain assets are being acquired and others are not, as well as a comparison of performance of the assets which are being acquired to those assets which are not acquired
 - (6) Either management representation in the registration statement that the fair values of the assets to be acquired have not materially changed since the last audit of each private fund's financial statements, or if the fair value did materially change disclosure of the new fair values of the assets.
- vii. If BDCs and other investment companies form by acquiring partial or full loan portfolios of private funds, as described above, the registrant should also consider whether to include in the registration statement more recent audited or unaudited financial statement information if for example (1) significant time has passed between the date of the most recent private fund audited financial statements or audited special purpose schedule of investments to be acquired; (2) there has been significant turnover in any private fund's portfolio since the date of the most recent private fund audited financial statements or the date of the audited special purpose schedule of investments to be acquired (3) investors in the private fund(s) have received more recent audited or unaudited financial information about the private fund(s) that was not filed with the SEC.
- viii. The SEC staff discussed non-traded BDC "fee waiver/expense reimbursement plans" under which the adviser waives fees or pays expenses of the BDC to the extent necessary for distributions not to be sourced from return of capital (some plans are designed to prevent a book return of capital, and others are designed to prevent a tax return of capital). These plans typically support a policy of maintaining a high, fixed distribution rate. For example, a BDC with a 9% distribution rate target may not have income or earnings and profits sufficient to maintain the 9% distribution rate without sourcing part of the distribution from return of capital. Therefore, the adviser waives fees or pays BDC expenses to the extent necessary for the BDC's income or earnings and profits to equal the amount of the distribution. Typically, these plans provide a mechanism for the adviser to recoup in the future from the BDC the amount of the fees waived or expenses paid on behalf of the BDC. The staff's position is that any recoupment payment must be conditioned on (1) an expense ratio (excluding management or incentive fees) that, after giving effect to the recoupment, is lower than the expense ratio (excluding management or incentive fees) at the time of the fee waiver or expense reimbursement, and (2) a distribution rate (exclusive of return of capital, if any) equal to or greater than the rate at the time of the waiver or reimbursement. Recoupment of fees waived or BDC expenses paid must occur within three years of the date of the waiver or payment. The SEC staff has encouraged registrants to provide clearer explanations of how these plans operate.

Finally, the SEC staff has been asking for enhanced disclosure of the terms of the recoupment agreement and a chart explicitly describing the amount of the expenses subject to recoupment, the expense ratio and distribution rates at which the adviser can recoup the waived or reimbursed expenses and the expiration

date of the recoupable amount. Disclosure of these types of arrangements should be included in various documents such as the registration statement, the financial statements and marketing materials, specifically where references to distribution rates/yields and distributions are made.

- ix. The SEC staff discussed incentive fee calculation and disclosure for a BDC holding a total return swap (TRS) referenced to an underlying basket of loans. While Section 15(a)(1) of the Investment Company Act states the advisory contract must precisely describe the fees charged to the BDC, the staff observed that advisory contracts for certain non-traded BDCs did not. The contracts typically stated little more than that the Adviser's Act formula for calculating the maximum fee based on capital gain would apply to the sale or liquidation of portfolio securities. A TRS is a contractual arrangement with a counterparty intended to provide the BDC with exposure to certain specified reference assets. Certain BDCs were calculating capital gain incentive fees on the TRS with certain specified loans as reference securities based on the GAAP requirements for accounting and reporting (i.e., GAAP requires all payments received from the TRS to be reported as realized gains, and therefore, BDCs were including all payments received from the TRS in the capital gains incentive fee calculation). Although this is more of a legal interpretation than accounting, in response to SEC staff comments, BDCs have indicated they will calculate the incentive fees on TRS based on a "look through" approach as if the BDC held the loans directly. Under this fee calculation method, payments received for interest income earned on the TRS reference loans are included in the income incentive fee calculation (but interest payments received would be reported as realized gains under GAAP), and the TRS reference loan realized gains, realized losses and unrealized depreciation are included in the capital gain incentive fee calculation.

The SEC staff noted that advisory contracts must be amended if they do not precisely describe the incentive fee calculation method or if that method does not apply the "look through" approach used by the registrant. Material amendments to advisory contracts must be submitted to shareholders for approval. Since these amendments are material, the amended contracts require shareholder approval.

Registrants that have not used the "look through" fee calculation method with respect to TRS in the past, but are currently using the "look through" method, should calculate past incentive fee amounts using the "look through" method and reimburse the BDC for any excess fees collected from the BDC.

- b. The SEC staff recently issued a letter denying the no-action relief requested by Copley Fund, Inc. ("Copley"), an open-end fund and a C Corporation for tax purposes (i.e., a tax paying entity and not a RIC under Subchapter M). Copley sought relief from recording the full amount of its deferred federal tax liability on unrealized gains which is required to be recorded under GAAP by tax paying entities. Instead, Copley proposed calculating its deferred federal tax liability for unrealized gains based on a management-developed estimate that is a pre-set formula. In its response, the SEC staff declined to provide assurance that it would not recommend enforcement action to the SEC against Copley under rule 22c-1 under the Investment Company Act of 1940 and rule 4-01(a)(1) of Regulation S-X if Copley calculated its deferred tax liability as Copley proposed. For more information, visit <http://www.sec.gov/divisions/investment/noaction/2013/copley-fund-040513-22c1.pdf>.
- c. Form N-1A and XBRL – the SEC staff received questions related to average annual return information that is required under Item 4 of Form N-1A for 1, 5, and 10 years. The questions being asked related to how the 3 year average annual return and how a column for a secondary inception date should be tagged using the elements within the XBRL taxonomy. Through discussions with registrants, the SEC staff identified that some registrants may be using a draft taxonomy document that was posted to the SEC's website for a brief period of time, but which has since been removed, as a guide to what may be included in Form N-1A. This document erroneously included references to both the 3 year average annual return and a column for a secondary inception date (which is not permitted under Form N-1A). The SEC staff reminded these registrants to carefully review the Form N-1A instructions for the requirements of what should be included in Form N-1A, and that the best document to use for XBRL filings is the [Mutual Fund Risk/Return Summary Taxonomy Preparers Guide](#) specific for mutual funds.

- d. The SEC staff discussed disclosures when a fund holds a derivative (e.g., option or total return swap) where the underlying is a custom basket of securities or customized index. The disclosure question arose as to whether certain funds are providing adequate disclosure about underlying holdings in the custom basket or comprising the index. The SEC staff gave an example of a managed futures fund that held a total return swap on a customized basket where the notional value represented approximately 100% of the net assets of the fund and the fund used the total return swap to meet its investment objectives; however, the fund provided no transparency of what securities or other holdings comprise the customized basket. Based on this example, the SEC staff would expect the fund to provide additional transparency as to what is included in the custom basket. While the staff has observed some funds lack adequate disclosure, they have also noticed other funds that provide transparency into the holdings in the customized basket. The SEC staff gave an example of a fund which listed each reference security or other holding in the custom basket including name, shares/par, notional, unrealized appreciation/depreciation and also listed other pertinent information. The SEC staff also noted they are reviewing the transparency being provided on fees associated with custom baskets or customized indices (e.g., the total return on the custom basket may be net of certain management and incentive fees).
- e. The SEC staff noted that some auditors' consent letters are missing the auditor's signature or date. Also, in certain circumstances, the SEC staff noticed the date of the audit opinion disclosed in the consent differs from the actual date of the opinion in the fund's financial statements (e.g., consent references audit opinion dated February 25, 2013, but the audit opinion in the financial statements was actually dated February 26, 2013).

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2013 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the June 18, 2013, 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 company issues.

I. Administrative items/AICPA matters:

1. The January and February 2013 Investment Companies Expert Panel (EP) calls highlights are available on http://www.aicpa.org/interestareas/frc/industryinsights/pages/expert_panel_investment_companies.aspx. May 2013 meeting highlights are being reviewed by EP members.
2. The AICPA publications staff and EP discussed an outline and the planning process for the 2013 AICPA Audit Risk Alert - *Investment Companies Industry Developments* (INV ARA).
3. The AICPA staff informed the EP of the first call held by the AICPA Investment Companies Revenue Recognition Task Force.

II. Accounting/Reporting Issues:

1. In connection with recently issued Accounting Standards Update (ASU) 2013-08 *Financial Services—Investment Companies (Topic 946) - Amendments to the Scope, Measurement, and Disclosure Requirements*, the EP members were asked to express their views about the best financial statement presentation for a fund that was created to hold a single investment in another fund. Some are calling this type of pooled investment vehicle an “Access Fund”, whereby a fund was created by a registered investment adviser (RIA) (the June 30 deadline is important in connection with Custody Rule compliance) so that its clients can gain access to another fund that would otherwise be unobtainable on their own. This type of entity is referred to in the updated 946-10-55-14, item d., which clearly states that this type of single-investment fund would not be precluded from qualifying as an investment company under Topic 946. These Access Funds were clearly designed to be single-investment fund-of-funds and not intended to be feeder funds of the unaffiliated investment.

However, paragraph 5.54 of the AICPA Audit and Accounting Guide *Investment Companies* states that “fund management should consider whether an investment in a single underlying fund is so significant to the fund of funds to make the presentation of financial statements in a manner similar to a master-feeder fund more appropriate.” The problem with using a master-feeder presentation is that the feeder fund not only picks up its proportional share of income and expense items from the master, but also includes the master fund’s financial statements as an attachment to its own. Given the fact that the investor’s pseudo-master fund is unaffiliated and audited by another auditor, the typical master-feeder presentation seems untenable. After such consideration, there is a view that the best presentation would

be that of a typical fund-of-funds utilizing the practical expedient, with full disclosure of the purpose of the Access Fund and details about the investee fund's investment strategy, redemption terms, etc.

One EP member suggested first assessing fundamental and typical characteristics of an investment company in the recently issued ASU 2013-08 to determine whether this fund is an investment company. The EP discussed that since this Access Fund and the fund it is investing into are not affiliated entities, fund-of funds presentation would be appropriate. The EP generally believes that, regardless of presentation used, the financial statements of the fund should contain sufficient information about the Access Fund's investment into another fund, especially if the investee fund's financial statements are not attached. The EP acknowledged challenges with an RIA delivering copies of the investee fund's audited financial statements to its own investors. The EP also discussed a "principal auditor" question (auditing a fund with only investment in another fund that is audited by another auditor) and reemphasized that fund's financial statements need to "stand on their own" and contain ample and understandable disclosures about underlying investment(s).

2. The amendments of ASU 2013-07 *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting* apply to all entities that issue financial statements that are presented in conformity with U.S. GAAP, except investment companies that are regulated under the Investment Company Act of 1940 (the 1940 Act). Other entities shall not apply this scope exception by analogy. Therefore, registered investment companies (such as mutual funds) and business development companies (BDCs) that are regulated under the 1940 Act would not follow amended (through ASU 2013-07) guidance. Basis of Conclusions paragraph 6 states: *"In redeliberations, the Board decided to exempt investment companies that are regulated under the 1940 Act from the scope of the Update because those entities would be legally restricted under the 1940 Act from remeasuring their assets and/or modifying the calculation of net asset value in any way. The Board considered removing from the scope all investment companies to preserve consistency among similar entities... The amendments in this Update fill a void in existing U.S. GAAP, and the Board sought to make the guidance applicable to a broad population of entities (recognizing that investment companies regulated under the 1940 Act would be legally prohibited from applying the guidance)."*

The EP discussed that all entities that are regulated under the 1940 Act, including BDCs, closed-end funds, certain commodity pools, interval (quarterly tender) funds would qualify for this exclusion. The EP will revisit this topic in the future.

3. Foreign Withholding Tax Refund Claims – EP members continued discussion of accounting for potential refunds of European dividend withholding tax. During June EP call, the EP members expressed a view that foreign withholding tax is an income tax and, therefore, would be accounted for under Topic 740 as a tax position (or uncertain tax position). If it is more likely than not (MLTN) that the position would be sustained under the law, the greatest amount that is MLTN of being received should be recorded. However, some EP members expressed a view that if the asset is not realizable, a partial or full reserve may be appropriate.
4. Foreign Withholding Tax on Securities on Loan – the EP discussed accounting for substitute payments (foreign dividends and related withholding tax) on securities on loan under the following scenario:
 - A U.S. domiciled fund that holds a foreign security would normally record, on ex-date, dividend income, withholding tax expense based on the tax withholding rate of the jurisdiction of the foreign security and tax reclaim receivable (reducing the expense) based on the tax treaty rate that the U.S. has with the jurisdiction. In some cases the reclaim may not be recorded until later when it is filed or received if it's uncertain as to whether it is recoverable.
 - There is an arbitrage opportunity for the fund (and borrower) to lend the security (possibly at favorable rates to the fund) over record date to a borrower that has a more beneficial treaty status than the fund (i.e., a borrower with a higher reclaim rate or not subject to the tax). The borrower is able to recover the additional reclaim and the difference in reclaim is shared between the fund and the borrower. The fund is sent a *substitute payment* which is the dividend amount, less the taxes withheld adjusted for the fund's share of the reclaim.
 - Currently, the general accounting practice is to accrue the withholding tax and related reclaims for these lent securities. The question is whether or not legal ownership of the security would take precedence here and thus the

borrower of the security would be subject to any applicable taxes and consequently the lending fund should not be accruing any withholding taxes and related reclaims.

- For tax purposes, shareholders cannot include these amounts in qualified dividend income (QDI) and foreign tax credits; therefore, these tax numbers need to be adjusted for the substitute payments.

Some EP members expressed a view that since foreign withholding tax is an income tax, the guidance in ASC Topic 740 would apply. As such, since it is MLTN the fund would sustain a position that it is not obligated to pay the tax, it should not record this tax. Others expressed a view that operationally, it may be a less burden on preparers to present the gross dividend and income tax and this presentation would only affect parenthetical disclosure of foreign withholding tax.

III. SEC Staff Update

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 staff joined the Expert Panel conference call to discuss the following questions presented by EP members:

1. The SEC staff received a question related to page 380 of the proposed rule “Money Market Fund Reform; Amendments to Form PF” (see proposed rule at <http://www.sec.gov/rules/proposed/2013/33-9408.pdf>). Page 380 discusses a proposed requirement to report on Form N-MFP whether a security is categorized as a level 1, level 2, or level 3 measurement in the fair value hierarchy under U.S. Generally Accepted Accounting Principles (US GAAP). The proposal goes on to define level 1 measurements as quoted prices for identical securities in an active market and indicates examples of level 1 securities are active exchange-traded equity securities and U.S. government and agency securities. A question came up related to the leveling of U.S. government and agency securities and where they should fall in the fair value hierarchy. The SEC staff and the EP members both noted that U.S. government and agency securities are typically categorized as level 2 holdings based on how the securities are typically valued. The SEC staff noted the example given in the proposal was only an example and there are certain limited instances where a U.S. government and agency security may be classified as level 1. The SEC staff also mentioned the proposal did not intend to and should not change current practice regarding the leveling in the fair value hierarchy for these types of securities.
2. The SEC shared the following observations from recent financial statement reviews:
 - a. Certain registrants have debt investments which pay both PIK and cash interest. The staff has noticed certain registrants hold debt instruments that have a provision permitting the issuer to determine a range of PIK interest that will be paid along with a minimum cash percentage to be paid. For example, a bond may have a 15% stated interest rate and the rate could include a minimum cash interest rate of 10% with a PIK interest rate between 0% and 5%. The SEC staff believes that if an issuer has an ability to pay a range of PIK interest, the current PIK and cash interest rates should be disclosed, along with the possible PIK interest rate range or the maximum PIK interest rate that could be paid. For example, if the issuer of the bond referenced above with a 15% stated interest rate is currently paying 12% cash and 3% PIK as of the date of the financial statements, then the SOI would disclose the current 12% cash and 3% PIK interest rates, along with the range of possible PIK interest rates that could be paid (i.e., 0-5%) or the maximum allowable amount of PIK interest (i.e., 5%).
 - b. The SEC staff observed certain BDCs and Funds of Funds do not include required disclosures in connection with Rule 12-14 “Investments in and Advances to Affiliates” of Regulation S-X in their financial statements. This rule requires registrants to disclose certain financial information about affiliated investments.
 - c. Shell merger and change of auditor – the SEC staff discussed a specific fact pattern where a registrant created a new legal entity (shell fund with no operations), and that shell fund acquired assets and liabilities from a third-party registered investment company (RIC), where that acquired RIC then becomes the accounting survivor (shell fund is the legal survivor). In this fact pattern, the shell fund has a different auditor than the RIC accounting survivor, and the SEC staff would expect the required change in auditor notifications and disclosures to be made in accordance with Item 77(k) of Form N-SAR (Item 77(k) of Form N-SAR refers registrants to certain information required by Item 4 of Form 8-K, which in turn refers to certain requirements in Item 304 of Regulation S-K).

3. Liquidation basis of accounting – the EP and SEC staff discussed that investment companies regulated under the 1940 Act are scoped out from the guidance under ASU 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior technical committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2013 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the September 17,
2013 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 company issues.

I. Administrative items/AICPA matters:

1. May and June 2013 Investment Companies Expert Panel (EP) meeting and call highlights are being finalized.
2. The EP chair and staff discussed composition of the EP for next volunteer year.
3. Members of the Expert Panel provided industry-specific views on FASB proposal regarding definition of a public business entity for FinREC consideration and inclusion into the FinREC comment letter draft. Once finalized, the EP staff will share final FinREC letter with the EP.
4. The AICPA staff and EP members considered developing a technical practice aid with new illustrative financial statements for a nonregistered fund. This nonauthoritative technical practice aid, once reviewed by the Expert Panel and approved by FinREC, will then be incorporated into future edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide). The EP formed a task force that will develop a draft and share it with the EP at a future EP meeting. The task force will consider whether these illustrative financial statements for nonregistered fund need to be comprehensive or only focus on those areas that differ from financial statements of registered investment companies.
5. AICPA staff plans to update the 2014 Guide edition for known conforming changes during an “interim” development and EP review period this fall. The EP staff highlighted which known conforming changes will be incorporated during the “interim” development period and the timing of such review.
6. AICPA staff updated the EP on the progress of the 2013/14 Investment Companies Audit Risk Alert publication.
7. AICPA staff provided a brief status update on the progress of the Investment Companies Revenue Recognition Task Force.

8. Several EP members will present at the NYSSCPA Investment Companies Conference on November 5 and provide overview of topics considered by the Expert Panel over the past few months.

II. Accounting/Reporting Issues:

1. Money Market Fund (MMF) Reform

- a. **Classification of MMF shares with floating NAV as “cash equivalents”** - the EP continued discussing the Securities and Exchange Commission (SEC)’s proposed rule *Money Market Fund Reform; Amendments to Form PF* (June 2013, Proposed Rule Release No. 33-9408, IA-3616; IC-30551) and whether a money market fund with a floating NAV would qualify as “cash equivalent” under the SEC proposal. Some EP members expressed a view that when a gate (a temporary suspension on share redemptions) is imposed, the MMF likely would not qualify as cash equivalent.
- b. The AICPA FinREC comment letter on MMF Reform developed by a task force consisting of members of the EP was submitted to the SEC.

2. Liquidation Basis of Accounting:

ASC 205-30-25-7 requires entities to also “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” (emphasis added). Challenges may arise in developing estimates of the future costs that will arise, as certain costs are dependent on how long it will take to liquidate the entity. For example, regulations may require that an annual audit be performed until the final termination of the entity, and administrative costs may arise to maintain books and records, communicate with stakeholders, and perform valuations of the remaining assets. A reporting entity shall undertake efforts to evaluate how long it will take the entity to liquidate, and develop an estimate of future expense. Depending on facts and circumstances, there may be significant uncertainty. Therefore, an entity must use significant judgment to determine if it has a reasonable basis for estimating these costs. Such estimate should be evaluated at each subsequent reporting period.

However, the EP noted that generally hedge funds and funds of funds should make their best effort to develop an estimate of costs and income they expect to incur or earn, in accordance with ASC 205-30-25-7, rather than assert that there is no reasonable basis for estimation. Funds should evaluate such an estimate at each reporting date, as well as consider disclosing the time period over which the accruals were made.

Additionally, the EP discussed that the standard provides a scope exception to entities that are liquidated in accordance with a plan specified in the entity’s governing documents during formation of the entity, which may include certain funds established as limited life entities. The EP also discussed whether or not a liquidation process spanning multiple years would necessarily be considered “imminent” (as defined in ASC 205-30-25-1) in all instances.

3. Syndicated Loan Trade Date

Certain BDCs enter into investments in syndicated loans which are verbally agreed to before the end of a reporting period but have not yet been funded. In these situations, the BDC is contacted by a syndicating bank in order to determine their commitment amount. The BDCs have indicated that once a verbal commitment is made then the company is locked in. If they were to back out, then the syndicating bank would most likely not involve them in future deals. The actual deal documents may not be executed until after the end of the reporting period; however, the final executed documents will indicate a trade date prior to the end of the reporting period. In these cases, the BDC is recording the investment and booking a related payable. Per ASC 946-320-25-1, an investment company should record

security purchases and sales as of the trade date. Because securities transactions are recorded as of the trade date rather than the settlement date, the statement of assets and liabilities of most investment companies at the end of an accounting period includes payables for securities purchased but not received.

Given that investments in syndicated loans are not actively traded deals facilitated by a broker, the EP considered whether the concept of a “trade date” still applies, and if so, what would be used to determine the actual trade date. The EP members acknowledged that this is a legal question and considered whether a verbal commitment implies that an enforceable right to the transaction exists. The EP members noted that Accounting Series Release No. 113 (ASR 113) “[Statement Regarding “Restricted Securities”](#)” (October 21, 1969) includes discussion about private placements and enforceable rights to the transaction:

In those situations where the oral understanding contemplates the execution of a formal contract of purchase and sale, no enforceable right exists until the time the formal contract is signed (the “contract date”). If the formal contract does not require compliance with any conditions by the seller, an enforceable right is then obtained, and the securities should be valued as of that date.

Where the formal contract requires compliance with stated conditions which the investment company believes should not be waived, no enforceable right is obtained until the stated conditions are satisfied. In that situation, the valuation date should be the date upon which they are satisfied (the “closing date”).

4. Portfolio Turnover

The following issue observation was presented to the EP by a member:

Within the instructions to Form N-1A, the SEC states that for the calculation of portfolio turnover, a registered investment company should “exclude from both the numerator and the denominator amounts relating to all securities, including options, whose maturities or expiration dates at the time of acquisition were one year or less.” Many mutual funds, specifically short-term bond funds, will acquire a significant number of positions that have a remaining maturity of less than one year at the acquisition date as part of its normal investment strategy.

Pursuant to Rule 12-12 of Regulation S-X, most registered investment companies will include a “short term investments” classification within a schedule of investments that will contain certain money market funds, repurchase agreements, etc. that typically have a remaining maturity of 60 days or less, as these instruments are permitted to be valued at amortized cost (under certain conditions). However, if a security was purchased with a remaining maturity at the acquisition date (as described in the previous paragraph), the issuer will typically classify the security based on the appropriate category (i.e., government securities, corporate bonds, etc.) as opposed to a “short term investments” classification within the schedule of investments..

In addition, the 1940 Act Section 30(e)(6) requires a “statement of the aggregate dollar amounts of purchases and sales of investment securities, other than government securities, made during the period covered by the report.” As sweeps into money market funds or repurchase agreements will often distort these disclosures, purchases and sales of short-term investments, based on the classification within the schedule of investments, are also typically excluded from this disclosure.

Based on this guidance, the definition of “short-term investments” as disclosed within the schedule of investments and disclosure of aggregate purchases and sales would be inconsistent with the definition of short-term investments for the purposes of the portfolio turnover calculation.

Further, for a fund that, as part of its normal investment strategy, would purchase a security with a remaining maturity of less than one year as of the acquisition date, it may be misleading not to include these transactions as part of the portfolio turnover calculation. Not only are these purchases and sales a core part of the investment strategy, but management

does not always have the intention to hold these instruments to maturity (and these securities are thus subject to normal market fluctuations).

As a higher portfolio turnover rate generally implies greater brokerage fees, many fund families will calculate the portfolio turnover based on the definition of short-term investments as disclosed within the schedule of investments as opposed to also excluding those other securities that have maturities or expiration dates of one year or less at the time of acquisition, despite being in direct violation of the instructions to Form N-1A. The EP member inquired whether this is appropriate.

The following EP discussion ensued after the previous issue was presented:

The EP discussed that mutual funds typically would exclude securities that mature within one year or less at the time of acquisition from the portfolio turnover calculation in accordance with the Form N-1A instructions (and would not use 60 days short-term definition within Regulation S-X).

The EP also discussed that many mutual funds disclose aggregate purchases and sales of investments consistent with the amounts used in the portfolio turnover calculation even though the disclosure of aggregate purchases and sales does not expressly exclude short-term securities, but does exclude U.S. Government securities.

5. Blocker Deferred Tax

The EP had previously discussed the appropriateness of consolidating blocker corporations. At the current meeting, a question was raised related to a situation where the fund does not consolidate the blocker entity. An example fact pattern was described where a fund establishes a blocker entity for tax purposes and does not consolidate the blocker. The underlying investment in the blocker has appreciated so that a deferred tax liability should be measured. Given this fact pattern, should the fund present their investment value in the blocker entity gross, with the deferred tax liability presented separately within that section? The EP expressed a view that the deferred tax liability incurred by a blocker entity that is not consolidated would be recognized by the blocker entity. The fund would then present the net value of the blocker entity investment in the fund's financial statements and, if material or significant, disclosure about the tax liability could be included in the notes to the fund's financial statements.

6. Income Statement Presentation for fund of funds (FOF)

An issue was raised regarding an investment company that invests into other investment companies (fund of funds structure), where the reporting entity wishes to present income statement information that retains the character of the income and expenses at the investee fund(s) where the investee fund is structured as a pass-through entity. One may argue that such income statement presentation provides more detailed information on the classification and true nature of the profit and loss (P&L) for the financial statement user, rather than including P&L from the investment within realized and unrealized gains/losses. In this scenario, the investments would be recorded at fair value, and clear disclosure would be included regarding the nature of the investments and the income statement presentation format. The EP members observed that the investments should be recorded at fair value, in accordance with guidance in FASB Accounting Standards Update 2013-08, *Financial Services - Investment Companies (Topic 946)* (ASU 2013-08) and include disclosures about the nature of the investments.

The EP expressed the view that they have seen this presentation before in practice. It is similar to a master-feeder presentation when the master fund is a partnership. Some views expressed indicated that while it may appear to be similar to equity method accounting, which is specifically prohibited within ASU 2013-08, the presentation is more similar to

partnership accounting presentation because the fund is breaking out its components of unrealized gains/losses to the associated line items on the income statement. The presentation would also be more similar to master-feeder presentation and while it may not be specifically a master-feeder, the presentation is supported in GAAP. Some EP members expressed the view that presenting the more detailed allocation on the income statement could be more useful to users of the financial statements; although, presenting the detailed information in a footnote disclosure may also provide a similar benefit to users of the financial statements.

7. ASU 2013-08 implementation issues:

- a.** An entity regulated under the 1940 Act is automatically an investment company under the provisions of ASU 2013-08. All other entities, except for REITs, must assess whether they are an investment company, or reassess whether they continue to be an investment company, as a result of the amendments to the criteria that define an investment company. Some collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) structures may not have been considered investment companies based on the unit ownership attribute in GAAP. These CDOs and CLOs may or may not have been separate reporting entities. The Expert Panel considered whether the entities with the following fact pattern are required to assess, or reassess, whether they are, or continue to be, an investment company:
 1. An operating company, such as a bank or asset manager, consolidates a CDO/CLO into the financial statements of the parent company. The CDO/CLO does not prepare and distribute standalone financial statements.
 2. The CDO/CLO prepares and distributes standalone financial statements to investors.
 3. An operating company, such as a bank or asset manager, accounts for its investment in a CDO/CLO as an equity method investment of the parent company. The CDO/CLO does not prepare and distribute standalone financial statements.

The EP noted that although entities historically may not have been considered investment companies, according to the ASU 2013-08, all entities need to consider if they are or are not investment companies. Certain EP members also discussed that although all of the criteria should be considered, how the CDO/CLO holds itself out to investors and whether it manages its holdings at fair value may be important or differentiating factors.

- b.** Real estate investment trusts (REITs) are excluded from the scope of ASC Topic 946 under the provisions of ASU 2013-08. Prior to the amendments in the ASU, some private real estate funds that elected a tax status as a REIT under the Internal Revenue Code prepared financial statements using the measurement principles of ASC 946 (Private REITs). The basis of conclusions in the ASU states that “BC 58. The Board decided not to address issues related to the applicability of investment company accounting for real estate entities and the measurement of real estate investments at this time. As such, the Board does not intend to change practice for real estate entities for which it is industry practice to issue financial statements that are consistent with the measurement principles in Topic 946.” The EP members discussed that the scope exception for REITs may preclude Private REITs that have historically applied investment company accounting from continuing to do so. The EP will revisit this topic at future call and will consider developing a TPA.
- 8.** Pursuant to the amendments under Dodd-Frank Act, certain swaps will transition from over-the-counter agreements to being centrally cleared. Once the swaps transition to become centrally cleared, and the credit risk is transferred from the counter-party to the clearing facility, the Expert Panel considered whether a fund will be required to continue to disclose the counterparty for the swap in its financial statements. While the EP will

seek the SEC's views on this question at the October conference call, the EP expressed a view that since the credit risk is no longer with the counterparty, the counterparty would no longer need to be disclosed. However, consideration could be given to disclosing the clearing house or centrally clearing party.

9. Balance sheet offsetting (ASU 2011-11) – A fund enters into an agreement with a counter-party to sell securities short and to invest the proceeds received from the short sales. The proceeds received from the short sales, comprised of investments in long positions or cash, are held as collateral in an account with an affiliate of the counter-party. Under the agreement, in the event of default by the counter-party, the fund has the right to offset the collateral maintained in the account with the short positions. The Expert Panel observed that when a master netting agreement exists, the short positions and collateral maintained in the account should be included in the disclosures pursuant to ASU 2011-11. The EP may revisit this topic and consider different scenarios for private funds during the November EP meeting.

III. Audit and Attest Issues

1. The EP discussed how auditing firms respond to SEC inquiries and requests for access to review and receive copies of audit documentation in conjunction with SEC presence examinations of investment advisers.

IV. SEC Staff Update

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 staff joined the Expert Panel call to discuss the following questions presented by Expert Panel (EP) members:

1. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) modified certain CFTC exemptions, requiring more funds to become registered Commodity Pool Operators (CPOs). Certain filing requirements were harmonized with SEC reporting requirements under the Harmonization Rules, including certain compliance obligations for CPOs of investment companies registered under the Investment Company Act of 1940 (1940 Act). One reporting requirement that does not appear to be harmonized relates to pooled investment vehicles that fall under the CFTC Regulation 4.7 *Exemption from certain part 4 requirements for commodity pool operators with respect to offerings to qualified eligible persons and for commodity trading advisors with respect to advising qualified eligible persons*. If a fund can no longer use the CFTC Regulation 4.13 *Exemption from registration as a commodity pool operator*, which was commonly used prior to the rule amendments, and, therefore, falls under Regulation 4.7, there is a 90-day filing requirement applicable under Regulation 4.7, which differs from the 120 day requirement indicated by the SEC Custody Rule (for registered investment advisers to pooled investment vehicles that are not funds-of-funds (FOFs), which are using the Audit Provision). The EP inquired whether the SEC staff has a view on this difference in timing requirements. The SEC staff had no comment since this is a CFTC decision.
2. The SEC adopted [new rules](#) to amend a broker-dealer reporting rule (Rule 17a-5) and the broker-dealer notification rule (Rule 17a-11) under the Securities Exchange Act of 1934. Included under the rule amendments to Rule 17a-5, it is noted that a broker-dealer that has custody of the customers' assets must file a "compliance report" with the SEC to verify they are adhering to broker-dealer capital requirements, protecting customer assets they hold, and periodically sending account statements to customers. The broker-dealer also must engage a PCAOB-registered independent public accountant to prepare a report based on an examination of certain statements in the compliance report of the broker-dealer. The SEC has determined that the independent public accountant's report based on an examination of the compliance report (the "examination report") will satisfy the internal control report requirement under the Custody Rule for dually registered investment advisers and broker-dealers.

Instances may arise during the transition period of the amendments to Rule 17a-5 where the period covered by the examination report differs from the period covered by the internal control report which is used to satisfy Custody Rule. The SEC staff indicated that all periods should be covered by either the examination report and/or the internal control report (i.e., there should be no gaps).

3. The EP inquired about the SEC staff's views regarding Master Limited Partnerships' (MLPs) distributions when calculating a 30 Day SEC Yield, specifically, how funds should treat partnership distributions from MLPs for the 30 Day SEC Yield calculation. MLPs are similar to REIT securities in that a percentage of the distribution received by the fund is typically characterized as return of capital ("ROC"). The EP asked if the treatment would be akin to the guidance for REIT securities, which excludes from the SEC Yield calculation, the portion of the distribution estimated to be a ROC. For purposes of calculating SEC Yield, the EP is seeing some diversity in practice regarding the exclusion of MLP distributions which could potentially represent a ROC. For example, there are instances where funds investing in MLPs make estimates of the portion of a distribution which will be characterized as a ROC. Certain funds investing in MLPs are including the portion of the distribution which is estimated to be a ROC in

their SEC Yield calculation, while others are excluding it. The SEC staff indicated that funds which receive distributions from MLPs need to estimate the portion of the distribution which may be characterized as ROC. Any portion of the distribution estimated to be ROC should not be included in the SEC Yield calculation.

4. An EP member asked if the SEC staff has recently commented on registrants' disclosures relating to Rule 144A securities. The SEC staff indicated there have been no significant comments related to disclosure of Rule 144A securities.
5. The SEC staff received an inquiry regarding the applicability of Rule 6-09 "Statements of changes in net assets" of Regulation S-X related to business development companies (BDCs). The SEC staff noted the Rule does apply to BDCs and requires separate presentation of distributions to shareholders from: (a) investment income-net; (b) realized gain from investment transactions-net; and (c) other sources (such as, distributions from ROC).
6. The SEC staff has observed that certain BDCs and FOFs were not complying with all required tabular disclosures under Rule 12-14 of Regulation S-X, "Investments in and advances to affiliates," and the SEC staff discussed certain technical aspects of the rule.
7. The SEC staff has observed that certain registrants have failed to include the required auditor consent letters in the registration statements when the registrant files financial statements of majority-owned subsidiaries in accordance with Rule 3-09 of Regulation S-X. The SEC staff reminded the panel when majority-owned subsidiary financial statements are filed pursuant to Rule 3-09 of Regulation S-X, and an auditor has opined on the financial statements, an auditor's consent letter from the opining auditor must be included in the registration statement.
8. The SEC staff discussed the process of filing requests for relief under Rule 19b-1(e) of the 1940 Act.

According to the Rule, if a registered investment company because of unforeseen circumstances in a particular tax year proposes to make a distribution which would be prohibited by the provisions of Rule 19b-1, it may file a request with the Commission for authorization to make such a distribution. The request should set forth the pertinent facts and explain the circumstances which the registrant believes justify such distribution. The request shall be deemed granted unless the Commission within 15 days after receipt thereof shall deny such request as not being necessary or appropriate in the public interest or for the protection of investors and notify the registrant in writing of such denial.

When applying for relief under the Rule, the SEC staff has requested that prior to formally filing the request with the Commission, a registrant should first email a draft request to the Chief Accountant's Office for review at imoca@sec.gov. The SEC staff will review the request and discuss any comments with the registrant. Once comments are cleared, registrants can formally file the request with the Commission.

In addition, the SEC staff gave examples where relief is typically not granted, such as when distributions are not deemed to be "unforeseen" or when relief is requested on past distributions.

9. In August 2013, the SEC staff issued the IM Guidance Update related to "Privately Offered Securities under the Investment Advisers Act Custody Rule" (<http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-04.pdf>). – This Update was issued in response to inquiries regarding whether the Custody Rule requires advisers to audited pooled investment vehicles to maintain with a qualified custodian certain privately issued securities, namely, non-transferable stock certificates or "certificated" LLC interests, that were obtained in a private placement ("private stock certificates"). The focus of the inquiries was whether or not these securities meet the

Custody Rule's definition of "privately offered security" and therefore would not have to be held at a qualified custodian. This IM Guidance Update notes that the Division of Investment Management would not object if an adviser does not maintain private stock certificates with a qualified custodian, provided the following five criteria are met:

- 1) the client is a pooled investment vehicle that is subject to a financial statement audit in accordance with paragraph (b)(4) of the Custody Rule, Rule 206(4)-2, which requires the pooled investment vehicle to be subject to audit at least annually by a PCAOB-registered and subject to inspection independent public accountant, and for the audited financial statements to be distributed annually to all beneficial owners of the pool within 120 days of the end of the pool's fiscal year;
- 2) the private stock certificate can only be used to effect a transfer or to otherwise facilitate a change in beneficial ownership of the security with the prior consent of the issuer or holders of the outstanding securities of the issuer;
- 3) ownership of the security is recorded on the books of the issuer or its transfer agent in the name of the client;
- 4) the private stock certificate contains a legend restricting transfer; and
- 5) the private stock certificate is appropriately safeguarded by the adviser and can be replaced upon loss or destruction.

10. The SEC staff discussed the following items:

- a. Income Statement presentation for funds investing in MLPs – the SEC staff inquired whether or not the EP has seen funds that receive distributions from MLPs present the gross distributions received and, in turn, present a reduction for the estimated ROC distributions received in the investment income section on the statement of operations. Certain EP members have seen this presentation in practice and acknowledged that an alternative to this practice may be to present the distributions from MLPs net of the estimated ROC distributions on the statement of operations and show the reduction (estimated ROC) parenthetically on the statement of operations or in the footnotes to the financial statements. The SEC staff will consider this presentation further before forming a view.
- b. On August 1, 2013, the Treasury Department issued a "Notice of proposed rulemaking and notice of public hearing" related to the application of the controlled group rules under section 851 of subchapter M under the U.S. Tax Code (the "Code"), (REG-114122-12). Full text is available at http://www.irs.gov/irb/2013-35_IRB/ar08.html. The proposal, if adopted, would resolve an issue with how the controlled group rules under section 851(c) of subchapter M of the Code should be applied in connection with the regulated investment company (RIC) asset diversification test. The proposal provides clarification on whether a RIC and its controlled subsidiary are considered a controlled group if the subsidiary does not control at least one other corporation. The document also proposes revisions to examples that illustrate the controlled group rules related to RICs.

The SEC staff noted that under certain RICs' current interpretation of the rule, a RIC and its wholly owned subsidiary may not be considered a controlled group; therefore, the RIC does not "look through" to the securities of the wholly owned subsidiary when calculating the asset diversification test. The proposed regulations clarify that each of the RIC's wholly owned subsidiaries is a member of a controlled group of the RIC. Therefore, if adopted as proposed, and using this same example, the proposed regulations would result in the RIC being required to "look through" to the securities of the wholly owned subsidiary when calculating the asset diversification test. This may result in the RIC failing the asset diversification test and no longer qualifying to be treated as a RIC for tax purposes.

As such, in light of the proposal, the SEC staff is asking registrants to consider the need for additional disclosure related to any risk and uncertainty created by this proposed regulation and to consider the impact of this uncertainty in their FIN 48 analysis for uncertain tax positions.

- c. The SEC staff noted instances where feeder funds which invest in a single master fund did not file the master fund's schedule of investments in their Form N-Q filings. The SEC staff reminded the panel that feeder funds which invest in a single master fund should file the schedule of investments of the master fund in their Form N-Q filings.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2012 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the October 15, 2013, 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 company issues.

I. Administrative items/AICPA matters:

1. September 2013 Investment Companies Expert Panel (EP) meeting highlights are being finalized.
2. The EP subgroup is developing an AICPA technical practice aid (TPA) with new illustrative financial statements for nonregistered funds. Upon EP's final review and AICPA FinREC's approval, this TPA would also be included in future editions of the AICPA Audit and Accounting Guide *Investment Companies* (Guide). The EP briefly discussed a draft outline at the October conference call. The subgroup will be seeking the EP's views on a draft TPA at a future EP meeting.
3. The AICPA staff reminded the EP about the timing of their interim review of the 2014 Guide edition's proposed conforming changes.
4. The AICPA staff briefly updated the EP on the progress of the 2013/14 Investment Companies Audit Risk Alert publication.
5. The AICPA staff provided a brief status update on the progress of the Investment Companies Revenue Recognition Task Force.

II. Accounting/Reporting Issues:

1. Pursuant to the amendments under the Dodd-Frank Wall Street Reform and Consumer Production Act (Dodd-Frank Act), certain swaps have transitioned from over-the-counter agreements to being centrally cleared. The EP held a general discussion on centrally cleared swaps and considered forming a small working group consisting of members of the EP to develop consistent views with respect to accounting, reporting, presentation, tax, and legal considerations for centrally cleared swaps. Examples of items to be addressed include accounting for upfront fees, accounting for the components of daily variation margin movements, and whether the counterparty or

clearing agent should be identified in the description of the swap in the financial statements.

The EP also discussed whether daily variation margin payments represent daily movements of collateral or represent legal settlements of the contract. The EP acknowledged that legal analysis (daily movement of collateral vs. settlement) may determine gross or net presentation of variation margin for centrally cleared swaps in financial statements.

2. The EP previously discussed that AICPA TIS 6910.29 indicates that if a nonregistered investment partnership reports capital by investor class, carried interest would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents. The EP members were asked to share views with regards to separate presentation on the statement of changes in partners' capital of the amount allocated from the limited partners to the general partner (GP) for carried interest. The EP revisited this topic on October conference call. An EP member observed that ASC 946 specifically indicates that the amounts of any payments or allocations for advisory services from the GP should be presented on the statement of changes in partners' capital:

946-20-45-4 The amounts of any payments or allocations for advisory services from the general partner shall be presented in either the statement of operations or the statement of changes in partners' capital.

The EP member believes that on the statement of changes in partners' capital, private funds should present a separate line item with a positive amount in the GP column and negative amount in the LP column that would net to zero, and should not adjust the allocations of net investment income, realized gains/losses and unrealized gains/losses for incentive allocations.

The EP noted that practice varies, and that some are seeing separate line item presentation in the statement of changes in net assets while others are seeing it included with other allocations on the statement of changes and the amount specified in a footnote. The EP expressed a consensus view that the allocation should be presented as a separate line item in the statement of changes in partners' capital consistent with the guidance in TIS 6910.29.

3. In reviewing the Exposure Draft of the Private Company Decision-Making Framework, an EP member noted paragraph 1.12, which seems to suggest that the standards of the FASB Private Company Council (PCC) may apply to private investment companies on a limited basis. The Council has issued several proposals, which do not at this point appear to have any significant effect on private investment companies. The EP will monitor the PCC activities to determine the effect, if any, of PCC proposals and final standards on private investment companies and consider them in future updates of the Guide.
4. In light of approaching debt limit deadline and potential Government default, the EP discussed accounting and financial reporting concerns, including interest accrual, principal return, and valuation (investments and collateral), discussions with pricing vendors on valuations, as well as considerations regarding subsequent event disclosures. The EP emphasized the importance of understanding whether the pricing vendors would be providing the "clean" or "dirty" price with respect to interest to ensure income is not double counted. The EP discussed whether any type of suspension of payment would in fact be characterized as a default, or rather an extension of maturity. The EP acknowledged certain operational systems challenges with respect to recharacterization of maturity dates on government obligations and pointed out the importance of controls regarding how interest payments would be recorded.

5. The EP members are monitoring the following FASB projects (a brief summary was distributed to the EP members after the conference call):
 - a. On October 9, 2013, FASB held an Education Session to discuss:
 - a. [Consolidation: principal versus agent analysis](#) (adviser's consolidation of a mutual fund)
 - b. [Investment companies: disclosures about investments in another investment company](#).
 - b. [Transfers and Servicing: Repurchase Agreements and Similar Transactions](#). See attached summary of Board's decisions from October 2 FASB Board meeting.
6. The EP members were asked to provide their views on the following questions regarding the calculation of weighted average maturity/weighted average life (WAM/WAL) for money market funds subject to Rule 2a-7 of the Investment Company Act of 1940 (1940 Act):
 - c. Certain money market funds currently give a weighting of one day to cash for WAM/WAL purposes. For a money market fund that executes forward settling trade (that is, trades that settle T+2, T+5, etc.), all receivables and payables of the forward settling trades are netted and included as cash in the WAM/WAL calculations. To illustrate: Money Market Fund A holds only one security and the fund sells the security to settle T+3. WAM/WAL on T through settlement date would include the receivable/cash only and would calculate to be one. Then upon settlement, the actual cash would be reflected and weighted as one.
 - d. When a variable rate note resets its rates, certain money market funds use the actual reset date when calculating WAM/WAL, regardless of whether or not that day is a business day. But for a demand note, the demand feature may occur on the 7th day, which may fall on a weekend - in which case the funds would push the date for WAM/WAL calculation purposes to the next business day.

The EP members will consider these questions and provide their feedback. The EP will then consider presenting these questions to SEC at a future meeting to confirm whether they are seeing similar treatments with regards to WAM/WAL calculations.

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.

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 EP members:

1. Portfolio Turnover Rate Calculation:
 - a. Futures – the EP observed that they have not seen futures contracts included in the portfolio turnover rate calculation and expressed a view that futures contracts should not be included in this calculation if they have an expiration of less than one year at the time of acquisition. The EP observed that futures contracts typically are not included in the total value of portfolio securities, have expiration dates less than a year and are not exchanged for an underlying asset, as in the case of options. Instruction 4(d) under Item 13 of Form N-1A would seem to support this. The EP inquired as to whether the SEC staff would object to futures being excluded from the portfolio turnover rate calculation. The SEC staff stated that, consistent with Instruction 4(d)(ii), futures contracts whose maturities or expiration dates at the time

of acquisition were one year or less should be excluded from the portfolio turnover rate calculation.

- b. The EP expressed a view that all long-term U.S. Government Obligations, including long-term securities issued by FNMA, GNMA and FHLMC, should be included in the portfolio turnover rate calculation. The SEC staff agreed with the EP's view which is consistent with Instruction 4(d) under Item 13 of Form N-1A.
2. In response to the EP's question about the status of the XML N-SAR project to modify the filing method for Form N-SAR from a DOS-based application to an XML-based application, the SEC staff commented that they are no longer pursuing that project. Instead, the SEC Division of Investment Management is undertaking a new initiative to enhance the forms used by registered investment companies to disclose information about fund operations and portfolio holdings. This new project is aimed to improve quality and usefulness of information provided to the SEC and investors, eliminate duplicative filings or disclosures, and modernize the method for submitting such filings. For more information, visit <http://www.sec.gov/divisions/investment/imannouncements/nsarmodernization-im.htm>
3. An EP member inquired about the frequency of updating a Business Development Company (BDC) Report posted on the SEC website. Service providers of registered funds that invest in BDCs use this Report to identify the investees that are BDCs. If a registered fund invests in a BDC, the fund should include the fees and expenses incurred indirectly by the fund as a result of investment in shares of the BDC as Acquired Fund Fees and Expenses in the fee table in the prospectus. The SEC staff indicated that the most recent BDC Report is located at <http://www.sec.gov/open/datasets.shtml#bdc>. The BDC Report is updated annually and was last updated in June 2013.
4. Pursuant to the amendments under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), certain swaps will transition from over-the-counter agreements to being centrally cleared. Once these swaps transition to become centrally cleared, and the credit risk is transferred from the counter-party to the clearing facility, the EP believes that a fund will not be required to continue to disclose the counterparty for the swap in its financial statements. The SEC staff will consider addressing this issue at a future EP meeting.
5. In September 2013, the SEC staff issued IM Guidance Update No. 2013-07 "Business Development Companies—Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries". Full text is available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-07.pdf>

This guidance reminds registrants that Regulation S-X Rules 3-09 and 4-08(g) apply to BDCs and provides limited relief from certain technical requirements of Rule 4-08(g). The guidance was issued in response to the SEC staff's observations from registration statement reviews of BDCs. The SEC staff observed that certain BDCs with significant subsidiaries do not provide either separate financial statements or summarized financial information for these subsidiaries as required by Rules 3-09 or 4-08(g), respectively. The guidance states that these rules apply to BDCs because they are general rules and there are no special rules in Regulation S-X Rules 6-01 through 6-10 that differ from the requirements in Rules 3-09 and 4-08(g) related to whether, and for what periods, financial statements and financial information are required to be presented.

Rule 3-09 describes, among other things, the circumstances under which separate financial statements of an unconsolidated majority-owned subsidiary are required to be filed. Rule 4-08(g) describes, among other things, the circumstances under which summarized financial information must be presented in the notes to the registrant's financial statements for subsidiaries that are not consolidated.

Rule 4-08(g) generally requires registrants to present in the notes to their financial statements summarized financial information for all unconsolidated subsidiaries when any unconsolidated subsidiary, or combination of unconsolidated subsidiaries, meets the definition of a “significant subsidiary” in Regulation S-X Rule 1-02(w). As described in the IM Guidance Update, the SEC staff noted, if a BDC is required to present summarized financial information, the Division of Investment Management generally would not object if the BDC presents summarized financial information in the notes to the financial statements only for each unconsolidated subsidiary which individually meets the definition of a “significant subsidiary” in Rule 1-02(w) but does not present summarized financial information in the notes to the financial statements for all unconsolidated subsidiaries.

To illustrate the relief provided with respect to Rule 4-08(g), the SEC staff discussed two hypothetical fact patterns, describing the results of the “investment test”. These fact patterns assume that for any subsidiary, the BDC did not fail either the “asset test” or the “income test” at a 20% significance threshold, which would subject the BDC to Rule 3-09.

Under the first fact pattern, if the fair value of a BDC’s investment in one subsidiary was 11 percent of its total assets and the fair value of the BDC’s investment in five other subsidiaries is 5 percent of its total assets (1 percent each), technically, under Rule 4-08(g) based on the results of the “investment test” in Rule 1-02(w), the BDC would be required to present summarized financial information for all six subsidiaries. However, pursuant to the IM Guidance Update, the SEC staff would not object if the BDC only presents summarized financial information for the subsidiary whose fair value represents 11 percent of the BDC’s total assets and does not include summarized financial information for the five other subsidiaries that each had a fair value representing 1 percent of the BDC’s total assets.

Under the second fact pattern, if a BDC invests in eleven different subsidiaries each having a fair value representing 1 percent of the BDC’s total assets, pursuant to the IM Guidance Update, the SEC staff would not object if the BDC did not present summarized financial information for any of the eleven subsidiaries, since none of the subsidiaries individually meets the definition of a “significant subsidiary” under Rule 1-02(w).

In response to some questions the SEC staff received subsequent to issuing the guidance, the SEC staff highlighted the following: (1) this guidance applies regardless of whether a BDC’s subsidiary is an investment company, an entity that functions similarly to an investment company, or a non-investment company (e.g., a portfolio company); (2) all 3 tests under Rule 1-02(w) must be performed to determine whether the BDC must either file separate financial statements or present summarized financial information in the notes to its financial statements as required by Rules 3-09 or 4-08(g), respectively; (3) for purposes of Rules 3-09 and 4-08(g), the definition of “control” which is used in the Regulation S-X Rule 1-02(x) definition of “subsidiary” is based on the 1940 Act definition, which includes the presumption that a person who owns more than 25% of the voting securities of the company has control.

The SEC staff cautioned that structuring transactions to avoid presenting summarized financial information for the subsidiaries might raise issues under Section 48(a) of the 1940 Act.

The SEC staff encouraged registrants to contact them with questions regarding specific fact patterns.

6. With respect to the EP’s inquiry regarding the status of the SEC staff’s TIPS yield project, the SEC staff noted that the project is still ongoing but could not provide anticipated timing of completion.
7. The SEC staff has received a recurring Custody Rule question in relation to the surprise examination. Specifically, a question has been raised regarding the 120 day filing requirement for a certificate of accounting (surprise examination report) on Form ADV-E

to be filed by an independent public accountant when such deadline falls on a weekend. The Investment Adviser Registration Depository (IARD) is available Monday through Friday from 7 a.m. to 11 p.m. Eastern Time, and also on most Saturdays from 8 a.m. until 6 p.m. Eastern Time, but is not available on Sundays. Therefore, when the surprise examination report filing deadline falls on Saturday and the IARD is available on that Saturday, the filing of a surprise examination report is due on such day. An IARD Availability Schedule for Saturdays and holidays is available at <http://www.iard.com/availability.asp>

8. The SEC staff shared that the SEC Division of Enforcement created the Financial Reporting and Audit Task Force. This Task Force consists of 12 staffers, both accountants and lawyers, and focuses on accounting and auditing fraud.

This Task Force will pursue several initiatives that include, among others, using data analytics to identify outliers in terms of performance that may suggest potential fraud, analyzing trends by industry, monitoring high-risk companies to identify potential misconduct, leveraging the work of other divisions and working closely with the SEC Office of the Chief Accountant and the PCAOB, tapping into the academic work on accounting and auditing fraud, and performing sweeps in particular industries and accounting areas. This Task Force will utilize a recently developed Accounting Quality Model and related tools which use data analytics to assess the degree to which a company's financial statements appear anomalous. This will allow for better comparability of the performance across industries and detect outliers that suggest possible fraud.

Additional areas of focus include, but are not limited to, revenue recognition, audit committees, auditors, and investigating independence violations. With respect to auditors, if there is a significant restatement or if Enforcement learns about improper accounting (e.g., from a whistleblower, Enforcement's proactive efforts, or the media), the Task Force will (1) scrutinize not only the CEO, CFO and Controller, but the engagement partner, engagement quality reviewer, and the auditing firm as a whole and (2) probe the quality of the audit and determine whether the auditors missed or ignored red flags, have proper documentation, and followed professional standards.

For more information, refer to the speech made by Andrew Ceresney, Co-Director of the Division of Enforcement, at the American Law Institute Continuing Legal Education in Washington, D.C. on September 19, 2013 <http://www.sec.gov/News/Speech/Detail/Speech/1370539845772#.UI2w6NLks3Q> and the July 2, 2013 press release <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975>

9. The EP sought the SEC staff's view under the following scenario regarding the implementation of ASU 2013-01, *Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*, which is effective for fiscal years beginning on or after January 1, 2013 and interim periods within those annual periods: A new fund with a fiscal year-end prior to December 31, 2013 commences operations in 2013 (e.g., a fund with an April 30, 2013 fiscal year-end commenced operations on January 31, 2013). Pre-existing funds with the same fiscal year-end have not yet had to adopt ASU 2013-01. However, technically, ASU 2013-01 would be effective for the new fund that started in 2013 because its fiscal year began after January 1, 2013. Can the new fund defer implementation of ASU 2013-01 until the effective date for the other funds with the same year-end (e.g., can a fund with an April 30, 2013 fiscal year-end, that commenced operations on January 31, 2013, implement ASU 2013-01 beginning May 1, 2013)? The EP asked the SEC staff whether, similar to the SEC staff's previous position regarding implementation of FAS 157 and FAS 161, the SEC staff would not object if the new fund defers implementation of ASU 2013-01 until other existing funds with the same year-end adopt it.

The SEC staff indicated that their position has not changed, and a new fund should look at other funds with the same year-end to determine when to adopt ASU 2013-01. For example, a new fund that commenced operations on January 31, 2013 and has a fiscal year end of April 30, 2013, could adopt ASU 2013-01 on May 1, 2013, since that is the date other existing funds with the same year-end (April 30, 2013) would adopt ASU 2013-01.

10. The EP inquired if the SEC staff had considered income recognition and valuation issues should there not be a debt ceiling agreement and the US Treasury begins defaulting on debt. The EP also asked what the SEC staff would expect to see in registrants' financial statement disclosures.

The SEC staff noted that they are actively monitoring the situation, and that registrants should continue to consider whether disclosures of risks and uncertainties are appropriate, whether fair values of the securities need to be evaluated for impairment, and, as it relates to income accrual, whether a determination would need to be made regarding collectability of income consistent with the ongoing requirements to do so under current rules and regulations. Registered investment companies should discuss the effect of these current events on the companies' performance, if material, in Management's Discussion of Fund Performance (MDFP).

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2014 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the November 20, 2013, 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 company issues.

I. AICPA/Administrative:

1. The AICPA Investment Companies Expert Panel (EP) welcomed its new members and recognized outgoing EP chair Rob Fabio for his contributions.
2. The September 2013 EP meeting highlights and October 2013 EP conference call highlights are being finalized.
3. The EP was informed about timing of 2014 EP meetings and calls.
4. The EP considered forming a group of volunteers that will develop and present the next Expert Panel webinar. Potential topics may include implementation issues on balance sheet offsetting; overview, including major provisions, of ASU 2013-08 and implementation issues; update on FASB project on disclosures about investments in other investment companies; and others.
5. During the September EP meeting, the EP members supported an idea of developing new illustrative financial statements for a nonregistered fund and formed a task force to lead this project. During the November EP meeting, the EP members considered certain enhancements to the AICPA Audit and Accounting Guide *Investment Companies* (Guide) in lieu of developing a separate AICPA technical practice aid. These enhancements may include reorganizing components of Chapter 7 of the Guide and further clarifying in the Guide financial reporting considerations that apply to both registered and nonregistered investment companies and those that are specific to only registered or nonregistered funds.
6. AICPA Publications staff informed the EP of the status of 2014 Guide edition's conforming changes' interim review and anticipated timing of 2014 conforming changes review (spring 2014).

7. The AICPA Audit Risk Alert “Investment Companies Industry Developments—2013/14” has been issued and is available for purchase in e-book and paperback formats on the [AICPA Store](#) website.
8. AICPA Publications staff provided a status update on the progress of the Investment Companies Revenue Recognition Task Force.
9. During the September EP meeting, the EP discussed that real estate investment trusts (REITs) are excluded from the scope of ASC Topic 946 under current GAAP and will continue to be excluded under the provisions of ASU 2013-08. Some private real estate funds that elected tax status as a REIT under the Internal Revenue Code (private REITs) prepare financial statements using the measurement principles of ASC 946. Paragraph 58 of the basis of conclusions in ASU 2013-08 states:

The Board decided not to address issues related to the applicability of investment company accounting for real estate entities and the measurement of real estate investments at this time. As such, the Board does not intend to change practice for real estate entities for which it is industry practice to issue financial statements that are consistent with the measurement principles in Topic 946.

The EP members discussed the scope exception for REITs and initially considered developing a nonauthoritative TPA. During the November 2013 EP meeting, the EP acknowledged that generally, the population of real estate funds is very diverse. Most large operating REITs undertake significant development and/or management activities (which is a key factor in assessing whether substantially all the entity’s activities are investing activities). Different types of real estate entities measure their investments in real estate differently, and public REITs generally do not carry their investments in real estate at fair value. These are the examples of one fundamental (substantive activities) and one typical (fair value measurement of investments) characteristics of an investment company that many REITs would not meet. Due to the explicit scope exception for REITs, the diversity in practice, and the resulting complexity of addressing this topic, the EP decided not to proceed with developing a TPA at this time.

II. Accounting/Reporting Issues:

1. The Panel heard a brief recap of recent FASB discussions related to the *Investment Companies: Disclosures about Investments in Another Investment Company* project. As indicated on the FASB website, during the October 23, 2013 meeting, the FASB discussed the components of, and the threshold for, disclosures about investments in another investment company. The Board considered requiring disclosures for investments in unconsolidated investment companies and only for the first level of investments in another investment company (that is, not for the investments of the investment company’s investee fund). However, the Board decided that the guidance would include language to discourage a reporting investment company from creating additional levels of investments to circumvent the proposed disclosures.

A reporting investment company would disclose the following about each investment in another investment company (that is, an investee fund) that has a carrying value that equals or exceeds 5 percent of the reporting investment company’s net assets as of the date of its statement of financial position:

- a. The reporting investment company’s share of the dollar amounts of management fees and incentive fees associated with the investee fund. If the reporting investment company cannot obtain information about the dollar amount of its share of the fees, it would disclose instead the percentage amounts and computational basis for each such fee.
- b. The reporting investment company’s fair value of, and its share of income/loss from, its investment in an investee fund.

- c. For investments in which the reporting investment company owns more than 20 percent of an investee fund, the reporting investment company would disclose whether its ownership percentage is between 20 to 50 percent of the net assets of the investee fund or whether its ownership percentage is greater than 50 percent of the net assets of the investee fund.

The Board decided that a reporting investment company would not be required to disclose information about leverage within an investee fund.

An investment company would provide the disclosures for any financial statements that include a schedule of investments (regardless of whether those financial statements are for an annual or interim period). The disclosures would be applied prospectively and early adoption would be permitted. The comment period end date would be the later of 90 days from the date of issuance of the Exposure Draft or May 15, 2014.

The EP noted that the FASB's current proposal would have the most significant impact on nonregistered funds of funds and discussed a variety of implementation issues. Specific implementation issues discussed by EP members included:

- 1) complexities that arise when the reporting fund and the investee fund(s) have different reporting year-end dates,
- 2) potential difficulty in obtaining investee financial information, and
- 3) difficulty providing a sufficient audit trail behind disclosed investee financial information.

The EP also discussed the reasoning behind the use of a 5 percent threshold in the FASB's current proposal. EP members noted that 5 percent is already established in FASB ASC 946 for other additional portfolio investment disclosures.

The EP will form a task force that will draft the AICPA FinREC comment letter on this FASB proposal.

2. The EP continued discussions pertaining to balance sheet offsetting and the disclosures required by ASU 2011-11 and ASU 2013-01. At the September EP meeting, the EP observed that when a master netting agreement (MNA) exists, the short positions and collateral maintained in the account may be subject to the disclosure requirements pursuant to ASU 2011-11. The EP continued discussing this topic and considered the following scenario:

B (or the "Fund"), an investment company, enters into various financial instrument transactions including short sales.

Short Sale

A short sale is a transaction in which B sells a security it does not own in anticipation of a decline in the market value of that security. To complete such a transaction, B must enter into a securities borrowing transaction in which B will borrow the security from a third party to make delivery under the short sale with an obligation to replace such borrowed security at a later date. Until the security is replaced, B is required to repay the lender any dividends or interest that accrue during the period of the securities loan.

The proceeds received from a short sale are recorded as a liability and B records an unrealized gain or loss to the extent of the difference between the proceeds received and the value of the unsettled short position. A gain, limited to the price at which B sold the security short, or a loss, potentially unlimited as there is no upward limit on the price of a security, is recorded when the short position is settled.

If the Fund has borrowed securities from a counterparty in order to sell them short, would this effectively be a secured borrowing, and therefore in scope of ASU 2011-11 and ASU 2013-01? If so, would the secured borrowing be presented in the disclosure table required by ASU 2011-11 and ASU 2013-01 (i.e. are they offset in the financial statements or subject to an enforceable MNA or similar agreement?)

The EP discussed the different operational ways a fund could borrow a security in order to sell it short, including borrowing from a counterparty or a broker (through a prime broker agreement). The EP expressed a view that the securities borrowing discussed in the above fact pattern did represent a borrowing for the fund, regardless of the operational way in which the borrowing is executed; therefore, the short sales meet the criteria of a secured borrowing under the scope criteria for ASU 2011-11 and ASU 2013-01. However, the EP observed that a fund would need to consider the unique facts and circumstances and conduct further analysis of the underlying arrangements with the broker or counterparty to determine if the short sales are subject to an enforceable master netting arrangement or similar agreement. Often times the arrangement may only be a one-way master netting arrangement, and therefore, would not meet the required criteria for inclusion in the offsetting disclosure table.

3. The EP discussed various topics associated with the centrally cleared swap mandate for eligible over the counter (OTC) derivatives (including most swap agreements):
 - a) As discussed during the October 15, 2013 EP conference call, the EP formed a subgroup to develop consistent views with respect to accounting, reporting, presentation, tax, and legal considerations for centrally cleared swaps. During the November meeting, the EP subgroup provided an update to the EP on its discussions on centrally cleared swaps.
 - b) The EP discussed the current trend to convert bilateral OTC swap contracts to centrally cleared contracts through novation, and whether a contract that has been novated has changed its form in such a way that it would constitute a “sale and a repurchase”.

An EP member provided an overview of an SEC letter issued May 11, 2012, to the Chairman of the Accounting Policy Committee of ISDA regarding the accounting impacts under U.S. GAAP of the novation of bilateral OTC derivative contracts to a central counterparty. The letter focused on whether the novation of a hedge designated derivative contract would result in a termination of the original derivative contract and associated hedging relationship. The letter explained that the SEC Office of the Chief Accountant would not object to the view that for accounting purposes the original contract has not been terminated and replaced with a new contract.

Discussion by the EP ensued. An EP member commented that counterparty risk may change significantly through novation, and therefore questioned whether an identical contract exists before and after novation. However, another EP member commented that the economic substance of the underlying contract does not change upon novation, and therefore the contract does remain identical before and after novation, despite the fact that the counterparty credit risk may change.

The May 2012 SEC letter seems to provide a reasonable basis for an investment company to conclude that a sale and repurchase (recognition of the unrealized gain or loss) has not occurred, although a technical view of Topic 860 may result in a different conclusion. An EP member also observed that the issue may not be significant in many cases since the accounting result would be a classification between realized and unrealized gain/loss.

- c) The EP discussed a practice observation whereby clearing agents may be netting certain offsetting positions in centrally cleared swap contracts (that originated from novated OTC contracts). In such instances, a reconciliation break is created when the fund accounting group or administrator is recording the positions gross. The EP discussed this operational issue and considered how the clearing agent determines whether to net certain positions. The EP noted that a legal analysis of the set-off rights is required, and observed that the answer could differ based on legal interpretation of the contractual terms.

4. An EP member presented an issue pertaining to the treatment of To-Be-Announced (TBA) sale commitments, in the portfolio turnover rate (PTO) calculation. The EP member noted that the portfolio turnover calculation in Forms N-1A/N-2 does not provide specific guidance as to how to treat TBA transactions, including TBA sale commitments, in the portfolio turnover. ASC 815-10-15-17 indicates that commitments that require delivery of securities and are accounted for on a trade date basis are exempt from derivative treatment. Therefore, TBA transactions are accounted for as purchases and sales as regular-way transactions using trade date accounting. There are instances when the portfolio manager will enter into a TBA sale commitment, which can be interpreted as a short sale. Per N-1A/N-2 (Item 13.4(d)(iv)), short sales with an intent to remain open for less than a year should be excluded from the PTO calculation. The EP considered whether the TBA sale commitments should be included in the PTO by discussing two optional viewpoints:

- Option 1 – TBA commitments are considered to be akin to short sales and, because of the short term nature of these transactions, follow the N-1A guidance for short sales. As a result, the TBA sale commitments would be excluded (or disregarded) from the PTO calculation.
- Option 2 – The only way to get new issuance of the underlying securities is by entering into the TBA transaction rather than purchasing them on a secondary market, and hence, TBA transactions are akin to purchases and sales of actual securities, although with extended settlement. As a result, the TBA sales commitments are included in the numerator and the value of these commitments is also included in the denominator (as a reduction of the market value). In this option, consider TBA sale commitments to be akin to sales similar to the sales of the actual securities and reduce the denominator by that amount and increase the sales number by the same amount as what would be done with regular securities.

The EP expressed a view that these two and other options (including disclosing multiple computations) would be acceptable and suggested that it may be appropriate to include disclosure that clearly describes what was being included and excluded from the PTO calculation. The EP noted that the second option would inflate PTO and would be more conservative, but was not necessarily more technically correct or more informative to the user of the financial statements.

5. The EP discussed margining requirements for agency mortgage-backed securities (MBS). An EP member provided background information by explaining that most purchases of agency MBS are forward transactions that settle about one month after the trade is agreed upon, and some can also settle further in the future. Parties to forward-settling transactions bear counterparty credit risk—the risk that a counterparty is unable or unwilling to meet its contractual obligations. If one party to a forward transaction does not meet its obligations, the other party may experience a loss. One common means of mitigating the counterparty credit risk of forward transactions is for the counterparties to agree to post collateral, or margin, as the market value of the securities fluctuates. The posting of margin is a common practice in the trading of agency MBS between members of the Mortgage-Backed Securities Division (MBSD) of the Fixed-Income Clearing Corporation, which became a central counterparty (CCP) in April 2012. However, margining is less common in bilateral agency MBS trading between dealers and customers that are not MBSD members.

The Treasury Market Practice Group (TMPG) recommends that the margining practice, at a minimum, apply to four broad categories of agency MBS transactions: TBA transactions, specified pool transactions, adjustable-rate mortgage (ARM) transactions, and collateralized mortgage obligation (CMO) transactions. The TMPG recommends a risk-based approach whereby market participants should continue to implement the practice recommendation on a rolling basis and prioritize their most material counterparty exposures. Recognizing the operational challenges and legal resources required, the TMPG modified the implementation timeline in March 2013 and recommends that market participants make significant progress towards margining forward-settling agency MBS exposures by early June 2013 and substantially complete the process by December 31, 2013.

The EP noted that such margining requirements are currently in the early stages of adoption and evaluation by practitioners and auditors. The EP discussed that financial statement implications related to the new margining requirements will be monitored and discussed during future EP meetings, as appropriate.

6. The EP members were asked to provide their views on the following questions regarding the calculation of weighted average maturity/weighted average life (WAM/WAL) for money market funds subject to Rule 2a-7 of the 1940 Act:
 - a. Certain money market funds currently give a weighting of one day to cash for WAM/WAL purposes. For a money market fund that executes forward settling trade (that is, trades that settle T+2, T+5, etc.), all receivables and payables of the forward settling trades are netted and included as cash in the WAM/WAL calculations. To illustrate: Money Market Fund A holds only one security and the fund sells the security to settle T+3. WAM/WAL on T through settlement date would include the receivable/cash only and would calculate to be one. Then upon settlement, the actual cash would be reflected and weighted as one.
 - b. When a variable rate note resets its rates, certain money market funds use the actual reset date when calculating WAM/WAL, regardless of whether or not that day is a business day. However, for a demand note, the demand feature may occur on the 7th day, which may fall on a weekend - in which case the funds would push the date for WAM/WAL calculation purposes to the next business day.

At the November EP meeting, with respect to question (a), the EP expressed a view that generally, receivables and payables of the forward settling trades would not be included in the WAM/WAL calculation. The EP also discussed question (b) and agreed that, for the purposes of the WAM/WAL calculation, predominant practice is to treat the dates that fall on weekend as occurring on the next business day.

7. There are several commodity exchange-traded funds (ETFs) that invest in “hard” commodities that are currently filing under the 1934 Act (because registered investment companies are limited to 10% of “bad” income, which includes income related to commodities). They do not account for the commodities inventory at fair value, but rather follow inventory accounting, which shows the commodities at “lower of cost or market” and requires quarterly impairment analyses. As a result of ASU 2013-08, investments of an investment company may now include commodities (ASC 946-10-55-12). The question arises whether these funds would now qualify as investment companies, though still not registered under the 1940 Act.

An EP member expressed a view that these commodity ETFs would likely qualify as investment companies since they meet the fundamental characteristics and would also meet most of the typical characteristics of an investment company. One small nuance still exists, which may not change the answer, as to whether one looks at it from the authorized participant’s perspective or the investor who purchases shares on the exchange.

EP members previously stated, as evidenced in the September 1, 2005, EP meeting highlights, that they thought commodity pools would qualify as investment companies under the SOP 07-1, now indefinitely deferred, in which the definition of an investment company was similar to the finalized version contained in the recently issued ASU 2013-08.

At the November EP meeting, the EP members generally agreed that the commodity ETFs would qualify as investment companies under ASU 2013-08. Several EP members are seeing certain 1934 Act registrants following investment company accounting under current GAAP; however, the members thought that may be because the registrants invested in futures contracts where the underlying was the commodity, not commodities directly. The EP also acknowledged that the FASB previously attempted to address accounting for trading inventory, including a potential requirement for fair value of inventory included in the entity’s trading activities, through the EITF Issue No. 06-12, “Accounting for Physical

Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*, and the proposed FSP, *Amendment of the Inventory Provisions of Chapter 4 of ARB No. 43*. However, the project was eventually removed from the FASB project list due to mixed reviews. The EP may raise this issue with the SEC in the future to obtain their view.

III. Audit and Attest Issues

1. In August 2013, the PCAOB proposed two new auditing standards to enhance the auditor's reporting model. The two proposed standards are: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (the "proposed auditor reporting standard")* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (the "proposed other information standard")*. The proposed auditor reporting standard would retain the pass/fail model in the existing auditor's report, but would provide additional information to investors and other financial statement users about the audit and the auditor. The EP shared views and raised questions regarding these proposed standards and their potential impact on investment company audits.
 - The proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" (CAMs) that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.
 - o An EP member noted that the proposed standard requires an auditor to explain why a particular matter is a CAM, rather than explain what the auditor did to gain assurance around the CAM.
 - o The EP then discussed whether all CAMs would already be disclosed within the financial statements and/or related footnotes in accordance with GAAP, and if so, whether the information contained in the financial statement disclosures would overlap with the proposed CAM required communications. For example, for registered investment companies, the EP noted that most CAMs would be centered around valuation of securities, which is already disclosed in extensive detail within the financial statements.
 - o An EP member noted that the proposed standard designates the severity of deficiencies in internal control, if any, as a factor to consider when determining whether a matter is a CAM or not. Furthermore, the proposed standard requires that for each CAM the auditor describe the considerations that led the auditor to determine that the matter was a CAM, which may include the deficiency in internal control over financial reporting. Since current reporting requirements only require disclosure of material weaknesses, the EP discussed whether the proposed standard is an alternative way to increase internal control reporting requirements to the public (due to the potential necessity to disclose all factors that contributed to the auditor determining that a matter is a CAM, including the existence of control deficiencies related to the matter).
 - An EP member reminded the panel that the proposed standard would require disclosure of the auditor's tenure and an expected PCAOB proposal will require disclosure of the partner's name. The EP discussed potential complications around this proposed requirement when an auditor is engaged to perform and issues a report for a fund family that includes multiple individual funds. During this discussion, an EP member questioned whether the requirement would have to be applied at the individual fund level, the fund family level, or the legal entity registrant level.

- The proposed other information standard requires the auditor to “read and evaluate” other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor’s report, rather than the existing requirement to “read and consider” such information.
 - o The EP discussed this change and generally observed that the change may result in a more rigorous requirement for the auditor, and that the more rigorous auditor coverage within a Management’s Discussion and Analysis (MD&A) section of a Form 10-K may add value. However, the EP noted that this same value does not seem to translate over to much of the “other information” in reports and filings containing registered investment company financial statements.
 - o The EP discussed whether the scope of the other information should be narrowed to specific types of other information (for example, the Management’s Discussion of Fund Performance [MDFP]).
 - o The EP also discussed potential audit cost increases associated with the proposed standard.
2. Many mutual fund sponsors seek assurance regarding their financial intermediaries’ compliance with the terms of fund prospectuses, contractual obligations, and securities laws and regulations. The EP was made aware that the Investment Company Institute (ICI) is developing illustrative examples of a management assertion and updating an illustrative auditor’s opinion for an attest engagement around a financial intermediary’s control and compliance environment. In this engagement, performed under attestation standards issued by the American Institute of Certified Public Accountants (AICPA), the auditor issues a report on the design and operating effectiveness of the intermediary’s compliance controls. When originally developed, this attest engagement used a framework consistent with AICPA SOP 07-2, *Attestation Engagements That Address Specified Compliance Control Objectives and Related Controls at Entities That Provide Services to Investment Companies, Investment Advisers, or Other Service Providers*. As a result of new authoritative guidance issued in recent years for attestation engagements (e.g., SSAE 16), the form and content of this report is being reconsidered by the ICI. For more information, visit http://www.ici.org/ops/fund_dist/12_news_comp_review.

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 Expert Panel meeting via conference call to discuss the following questions presented by EP members:

1. The EP is seeing varying levels of descriptions of collateral for repurchase agreements by registered investment companies. Paragraph 7.31 of the Guide, which in part summarizes certain disclosure requirements in Rule 12-12 of Regulation S-X, indicates that “for public registrants, disclosure relating to repurchase agreements should include the parties to the agreement, the date of the agreement, the total amount to be received upon repurchase, the repurchase date, and a brief description of the nature and terms of the collateral” (Rule 12-12 uses the phrase “description of securities subject to repurchase agreements”). Rule 12-12C of Regulation S-X indicates that for “fully collateralized repurchase agreements (indicate in a footnote the range of dates of the repurchase agreements, the total purchase

price of the securities, the total amount to be received upon repurchase, the range of repurchase dates, and description of securities subject to the repurchase agreements)". The EP inquired whether such description of the nature and terms of the collateral for the repurchase agreements should include par value of collateral, since neither Rule 12-12 nor Rule 12-12C of Regulation S-X provides such explicit requirement. The SEC staff believes that, generally, a description of collateral for the repurchase transactions should include par value and market value of the collateral. Registrants are encouraged to consult with the SEC staff on specific facts and circumstances.

2. On November 5, 2013, the SEC staff extended no-action relief for certain engagements under Section 206(4) of the Advisers Act of 1940 and Rule 206(4)-2 thereunder (the "Custody Rule") and will continue to allow an auditor to be considered subject to regular inspection by the PCAOB for purposes of the Custody Rule if the auditor is engaged to audit the financial statements of a broker or a dealer as of the commencement of the professional engagement period of the respective Custody Rule engagement and as of each calendar-year end. The previous no-action relief provided on July 21, 2011 (see below) was set to expire on December 31, 2013. The November 2013 letter extended the July 2011 no-action relief until December 31, 2016, or a date earlier when the SEC approves a PCAOB-adopted permanent program for the inspection of broker and dealer auditors. The PCAOB indicated in its "Second Progress Report on the Interim Inspection Program for Broker and Dealer Auditors" that it anticipates presenting a rule proposal for a permanent inspection program of broker and dealer auditors in 2014 or later. Full text of the November 2013 no-action letter is available at <https://www.sec.gov/divisions/investment/noaction/2013/vangrover-seward-kissel110513.htm>

On July 21, 2011, the SEC staff issued a no-action relief letter stating that the staff of the Division of Investment Management would not recommend enforcement action to the Commission under Section 206(4) of the Advisers Act of 1940 and the Custody Rule thereunder "against an investment adviser who, for purposes of compliance with the Custody Rule, engages an auditor to (1) perform a surprise examination of an investment adviser who maintains, or who has custody because a related person maintains, client funds or securities as qualified custodian in connection with advisory services provided to clients, (2) prepare an internal control report, or (3) audit the financial statements of a pooled investment vehicle in connection with the annual audit provision, as long as such auditor was registered with the PCAOB and was engaged to audit the financial statements of a broker or a dealer as of the commencement of the professional engagement period of the respective Engagement and as of each calendar-year end."

3. The SEC staff stated that they received several written consultations from Business Development Companies (BDCs) regarding relief when the application of Rules 3-09 and 4-08(g) of Regulation S-X results in the presentation of either financial statements or summarized financial information of an unconsolidated significant subsidiary that the BDC believes is not necessary to reasonably inform investors. Rule 3-09 of Regulation S-X describes, among other things, the circumstances under which separate financial statements of an unconsolidated majority-owned subsidiary are required to be filed. Rule 4-08(g) of Regulation S-X describes, among other things, the circumstances under which summarized financial information must be presented in the notes to the financial statements for subsidiaries not consolidated. Rules 3-09 and 4-08(g) refer to the three tests described in Rule 1-02(w) of Regulation S-X, to determine whether the investee is a significant subsidiary for purposes of Rules 3-09 and 4-08(g). The tests described in Rule 1-02(w) to determine a significant subsidiary are performed at a 10% threshold for purposes of Rule 4-08(g) and a 20% threshold for Rule 3-09.

The SEC staff shared the following observations from their consultations with BDCs seeking relief regarding the application of Rules 3-09 and 4-08(g) of Regulation S-X:

- a. If a BDC is asking for relief from the full disclosure requirements stated in the aforementioned Rules, the SEC staff requests that a BDC include in writing:

- 1) the calculated results of the three tests described in Rule 1-02(w) of Regulation S-X (significant subsidiary tests for purposes of Rules 3-09 and 4-08(g)) for each of the last 3 years;
 - 2) the factors the registrant would like the SEC staff to consider in making its determination (i.e., why the strict application of the rules results in the presentation of either the financial statements or summarized financial information of an unconsolidated subsidiary is not necessary to reasonably inform investors); and
 - 3) a proposal regarding what financial information of the subsidiary would be included in the filing in lieu of what is required (e.g., summarized financial information pursuant to Rule 4-08(g) instead of financial statements required under Rule 3-09, etc.).
- b. The SEC staff will not consider blanket prospective relief from Rules 3-09 and 4-08(g) of Regulation S-X requirements for either the registrant as a whole or for specific subsidiaries.
4. The staff of the SEC Division of Investment Management recently issued IM Guidance Update No. 2013-11 “Shareholder Notices of the Sources of Fund Distributions - Electronic Delivery.” This Update discusses that Section 19(a) of the Investment Company Act of 1940 (“1940 Act”) generally prohibits management investment companies (“funds”) from making a distributions from any source other than the fund’s net investment income, unless that payment is accompanied by a written statement that adequately discloses the source or sources of the payment. Rule 19a-1 under the 1940 Act specifies the information is required to be disclosed in the written statement (“Rule 19a-1 Notice”). Rule 19a-1(a) also states that every written statement “shall be made on a separate paper”. Rule 19a-1 was originally adopted and last amended before electronic delivery was available. Therefore, notwithstanding the rule’s provision referencing “a separate paper,” the staff of the Division of Investment Management believes that electronic delivery of a Rule 19a-1 Notice would satisfy the purposes and policies underlying Rule 19a-1. The staff’s position is predicated on compliance with all applicable Commission guidance on electronic delivery. IM Guidance Update No. 2013-11 is available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2013-11.pdf>
 5. The staff of the SEC’s Division of Investment Management has noted in the past that recommending proposed valuation guidance to the Commission was a priority of the Division. The EP asked the SEC staff if they could comment on the timing of the potential valuation guidance and if it was still a priority. The SEC staff noted valuation guidance is a focus area for the Division, however, the Commission is currently focused on rulemaking mandated by the Dodd-Frank Act. The SEC staff noted the Division of Investment Management is analyzing whether there is certain guidance that can be issued by the staff.
 6. The EP shared their observations with the SEC staff regarding the PCAOB proposal on the auditor’s report and requirement to identify CAMs. Refer to Audit and Attest section (Item 1) of these meeting highlights for detailed EP observations.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2014 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the December 10, 2013, 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 company issues.

I. AICPA/Administrative:

1. The October 2013 Expert Panel (EP) conference call and November meeting highlights are being finalized.
2. AICPA staff provided a brief status update on the progress of the Investment Companies Revenue Recognition Task Force.

II. Accounting/Reporting Issues:

1. The EP continued discussing FASB project Investment Companies: Disclosures about Investments in Another Investment Company.
2. The EP subgroup updated the EP on its discussions on centrally cleared swaps.

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.

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

1. EP members noted, there are several commodity exchange-traded funds (ETFs) that invest in “hard” commodities that are currently registering their shares solely under the Securities Act of 1933 (due to the fact that Section 3 paragraph (a)(1)(C) of the Investment Company Act of 1940 (“1940 Act”) states, among other things, that an investment company must be engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40% of the value of such issuer’s total assets (exclusive of Government securities and cash items) on an unconsolidated basis). Generally, these commodity ETFs do not account for the commodities inventory at fair value, but rather follow inventory accounting, which shows the commodities at “lower of cost or market” and requires quarterly impairment analyses. As a result of ASU 2013-08, Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements, investments of an investment company may now include commodities (ASC 946-10-55-12). An EP member questioned whether these funds would now qualify as investment companies for accounting purposes, though still not be registered under the 1940 Act.

An EP member expressed a view that these commodity ETFs would likely qualify as investment companies as defined under GAAP since they meet the fundamental characteristics and would also meet most of the typical characteristics of an investment company as defined under GAAP. The EP noted that one minor consideration, which may not change the answer, is whether one performs the analysis from the authorized participant’s perspective or the perspective of the investor who purchases shares on the exchange.

EP members previously stated, as evidenced in the September 1, 2005, EP meeting highlights, that they thought commodity pools would qualify as investment companies under the SOP 07-1, Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies, now superseded by the recently issued ASU 2013-08, in which the definition of an investment company was similar.

At the November EP meeting, EP members generally agreed that the commodity ETFs would qualify as investment companies for accounting purposes under ASU 2013-08. Several EP members are seeing certain 1934 Act registrants follow investment company accounting under current GAAP; however, the members thought that may be because the registrants invested in futures contracts where the underlying was the commodity, not commodities directly. The EP also acknowledged that the FASB previously attempted to address accounting for trading inventory, including a potential requirement for fair value of inventory included in the entity’s trading activities, through the EITF Issue No. 06-12, “Accounting for Physical Commodity Inventories for Entities within the Scope of the AICPA Audit and Accounting Guide, Brokers and Dealers in Securities”, and the proposed FSP, Amendment of the Inventory Provisions of Chapter 4 of ARB No. 43. However, the project was eventually removed from the FASB project list due to mixed views.

The SEC staff noted that filings made by commodity ETFs which are not registered under the 1940 Act are reviewed by staff in the Division of Corporation Finance (“Corp Fin”). If a commodity ETF registrant believes it should be considered an investment company under GAAP, the registrant should consult with Corp Fin staff.

2. The SEC staff noted that during BDC financial statement reviews, they have generally observed that BDCs disclose information about their commitments and contingent liabilities in the notes to the financial statements. However, certain BDCs do not comply with Rule 6-04.15 of Regulation S-X, which requires the balance sheet to include a line item for “Commitments and contingent liabilities” between the total liabilities and net assets sections. Therefore, at the minimum, registrants should include a commitments and contingent liabilities line item on the balance sheet with a parenthetical reference to the note that discloses information about any commitments and contingent liabilities. For example:

Total liabilities \$XXXX

Commitments and contingent liabilities (Note X)

Net Assets:

Common Stock¹ \$XXXX

Further, the SEC staff indicated that if a commitment and contingent liability is material to a seed capital balance sheet, a registrant should consider including a footnote on the face of the balance sheet describing the nature and amount of the commitment and contingent liability. The SEC staff gave an example of a registration statement, which included a seed capital balance sheet and notes to the financial statements, where the BDC did not accrue a liability on the balance sheet for organizational and offering costs which were subject to reimbursement by the BDC to the adviser, because management and the auditors determined the reimbursement was not probable as of the seed capital balance sheet date. The BDC included the details of the reimbursement agreement in the notes to the seed capital financial statements. However, given the materiality of the contingent liability to the BDC's seed capital balance sheet, the SEC staff requested that the registrant include a footnote on the face of the seed capital balance sheet describing the nature and amount of the contingent liability.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2014 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

¹ In accordance with Regulation S-X, line item would also include the title of each class of shares, number of shares authorized, and number of shares outstanding, in addition to the dollar amount.

Investment Companies Expert Panel

Highlights of the January 15,
2014, 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 depository institutions industry to deliberate and come to agreement on key depository institutions issues.

The following are brief highlights of the conference call:

I. AICPA/Administrative:

1. The Expert Panel (EP) October conference call highlights have been submitted for posting and November meeting and December call highlights are currently being finalized.
2. The AICPA staff briefly updated the EP on the status of development of the Audit and Accounting Guide Investment Companies (2014 edition) and timing of future reviews.

II. Accounting/Reporting Issues:

1. The EP subgroup covering centrally cleared swaps is currently drafting a white paper on accounting, reporting, presentation, tax, and legal considerations for centrally cleared swaps from a fund (end-user) perspective. The task force is researching various issues, including how 1) centrally cleared swaps are different from OTC swaps, and 2) arrangements that exist between a fund and the Futures Commission Merchant (FCM). The EP continued discussing whether movements of daily variation margin represent a movement of a collateral or settlement.
2. An EP member inquired whether other EP members have experience with the guidance under Regulation S-X Rule 1-02(w) whereby for the purposes of determining the amounts to include in the income test under Rule 1-02(w)(3), if the income of the registrant for the most recent fiscal year is at least 10% lower than the average of the income for the last five fiscal years, such average income should be substituted for purposes of the computation, with any loss years omitted for purposes of computing the average income. Specifically, the EP member discussed whether in calculating the income test for interim periods for disclosure under Rule 10-01(b)(1), an investment company can utilize the five year average of the last five corresponding year-to-date interim periods similar to averaging allowable for annual periods.

The EP noted that the SEC Division of Corporation Finance Financial Reporting Manual indicates that the average income should not be used for interim periods. The EP observed that this may result in inconsistent presentation for annual and interim periods.

Please refer to the SEC Staff Update section of these call highlights for the full text of the background/question and further discussion of the issue.

3. MLP Funds - Deferred Tax Liabilities and the Appearance of Leverage

The EP discussed the following question. Among registered investment companies, there are certain funds that invest, as a limited partner, the majority of their assets in Master Limited Partnerships (MLP Funds). These MLP Funds do not qualify as regulated investment companies pursuant to Subchapter M of the Internal Revenue Code and are, therefore, taxed as corporations. Generally, the footnote disclosures of the MLP Funds discuss their respective tax considerations as prescribed by GAAP. A nuance of corporate taxation is the possibility of generating deferred taxes, which does occur in the MLP Funds and is discussed in their respective footnote disclosures. A tangential result of generating deferred taxes, specifically, deferred tax liabilities (and the daily adjustment that is made to this liability), is the appearance of a leveraging effect. A deferred tax liability (and the resulting appearance of leverage) can be, and frequently is, significant to the respective MLP Fund. Based on a review of several MLP Funds' SEC filings, such deferred tax liabilities ranged from ~1% to ~8% of net assets. Does this or should this appearance of leverage have footnote disclosure implications?

During the January 2014 call, EP members generally observed that a deferred tax liability discussed above would not be considered "leverage"/borrowings for accounting purposes, but understand that it may create the appearance of leverage. EP members also noted that they have not seen MLP Funds include disclosure in the notes to the financial statements addressing this "appearance of leverage" or whether the fund considers the deferred tax liability to be leverage for regulatory or other purposes. The EP acknowledged that although not required, disclosure regarding this matter may be informative to users of the financial statements and nothing prevents MLP Funds from providing such disclosure.

4. An EP member inquired whether a nonregistered fund emerging from bankruptcy would apply a "fresh-start" accounting. EP members responded that they have not seen this issue in practice.
5. The EP discussed recording of interest income on convertible debt securities. The question was raised regarding treatment of the amortization of discount/premium and whether the conversion option should be bifurcated from the debt host instrument. One approach may be to bifurcate a conversion option from the debt host instrument and accrue interest on a host instrument only. An EP member noted that ASC 815 suggests bifurcation of an embedded equity derivative from the debt host instrument in this case. Another view discussed was that when hybrid instruments are marked to market, with changes in fair value reflected through net income, such bifurcation would not occur.

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.

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

1. As previously discussed during the October 2013 EP conference call, pursuant to the amendments under the Dodd-Frank Wall Street Reform and Consumer Protection Act

(Dodd-Frank Act), certain swaps have transitioned from over-the-counter agreements to being centrally cleared, and the credit risk has been transferred from the counter-party to the clearing facility. The EP believes that a fund is not required to disclose the counterparty for the centrally cleared swap in its financial statements. The SEC staff is still considering this issue.

2. Rule 4-08(g) of Regulation S-X requires an investment company to provide summarized financial information of subsidiaries not consolidated if a subsidiary meets the definition of a significant subsidiary pursuant to Rule 1-02(w) of Regulation S-X. Under Computational Note 2 to Rule 1-02(w), for the purposes of determining the amounts to include in the income test under Rule 1-02(w)(3), if the income of the registrant and its subsidiaries consolidated exclusive of amounts attributable to any noncontrolling interests for the most recent fiscal year is at least 10% lower than the average of the income for the last five fiscal years, such average income should be utilized for purposes of the computation, with any loss years omitted for purposes of computing the average income. The application of the significance test thresholds under Rule 1-02(w) for determining if disclosure of summarized financial information for subsidiaries not consolidated also applies to interim financial statements is prescribed under Rule 10-01(b)(1) of Regulation S-X, but at a 20% threshold (as opposed to a 10% threshold for annual financial statements).

An EP member asked if in calculating the income test for interim periods for disclosure under Rule 10-01(b)(1), can an investment company use the five-year average of the last five corresponding year-to-date interim periods similar to the averaging allowable for annual periods? For example, if an investment company's net income for the six-month interim period was 10% lower than the average of the income for the corresponding six-month periods in the previous five years, can an investment company use the interim five year average? The EP member noted, if not, disclosure of summarized financial information under Rule 10-01(b)(1) for a particular subsidiary not consolidated may be required for interim periods where disclosure may not be required to be included had use of an average been permitted.

A discussion ensued where it was noted the SEC's Division of Corporation Finance (CorpFin) Financial Reporting Manual paragraph 2420.7 indicates, income averaging should be omitted for purposes of calculating the income test for interim periods. In addition, CorpFin had previously discussed the application of the income test for interim periods at the [SEC Regs committee meeting on July 8, 2008](#) and decided the use of averaging should not be permitted for interim periods.

The SEC staff inquired whether there might be a compelling reason for investment companies to use income averaging for interim financial statements. An EP member noted that using consistent computational methodologies (consistent with the Computational Note 2 to Rule 1-02(w)) could be desirable for investment companies, because it would result in better consistency in the results of the test and therefore better consistency in disclosure between interim and annual periods. The SEC staff noted registrants could contact the staff with specific fact patterns.

3. The SEC staff discussed a question relating to a business development company's (BDC's) disclosure of an end-of-term payment by a debt issuer in the BDC's schedule of investments (SOI). The question relates to whether a BDC should disclose both the stated interest rate of the debt as well as the end-of-term cash payment rate or disclose solely the effective yield of the debt as part of the debt investment's description pursuant to Rule 12-12 of Regulation S-X. For example, if a bond had a stated interest rate of 10%, and at the maturity date, there was an end-of-term payment of 5% of the principal balance, for the purposes of the description of the investment on the SOI, can the BDC disclose only the effective yield (blended rate of the stated rate and the end of term payment) or should the BDC instead separately present each the stated interest rate and end-of term payment rate? Based on discussion with the BDC, management indicated the end-of-term payment was a contractual right in which the issuer had the obligation to pay the BDC a cash payment, based on a predetermined interest rate, upon either maturity of the loan or restructuring of the investment. The SEC staff indicated they would object to the SOI disclosure if the BDC only presented the effective yield as part of the description. The BDC should separately disclose the stated rate and end-of-term payment rate in the description of the investment and may also include the effective yield as a supplemental disclosure.

4. The SEC staff discussed a recent enforcement case, described in an Order, against two principals and one partner of a public accounting firm for causing a registered investment adviser to violate the Custody Rule by failing to complete surprise examinations (i.e., failing to complete fieldwork, prepare and issue surprise exam reports, and file Forms ADV-E with the SEC). Alternatively, they failed to withdraw from the engagements and notify the client on a timely basis. The accounting firm was engaged by Freedom One Investment Advisers, Inc. (Freedom One) to perform 2006 and 2008 surprise examinations for purposes of Freedom One's compliance with the Custody Rule (prior to the 2009 amendments). Examples of the accounting firm's violations in this case are as follows:
 - 1) Noncompliance with procedures for conducting surprise examinations identified in Accounting Series Release No. 103 (which was in effect until it was superseded effective March 12, 2010 by IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*), including
 - a. Failure to obtain confirmation of securities or funds held by the qualified custodians
 - b. Failure to send confirmation requests to Freedom One's clients
 - c. Improper testing of reconciliations
 - 2) Failure to issue surprise examination reports or withdraw from the engagements; and
 - 3) Due professional care violations based on standards set forth in AT 101The Order denies the principals and the partner from practicing before the SEC as accountants and may allow their reinstatement after two to three years, under certain conditions identified in the Order. For more information, visit <http://www.sec.gov/litigation/admin/2013/34-71070.pdf>.
5. The SEC's Office of Compliance Inspections and Examinations (OCIE) has announced its National Exam Program's (NEP's) [2014 examination priorities](#). These priorities cover (1) market-wide priorities and (2) those priorities specific to investment advisers and investment companies, broker-dealers, exchanges and self-regulatory organizations, and clearing and transfer agents. OCIE, in addition to risks specific to each registrant, will consider these areas in conducting their exams. The list of the 2014 priorities is not exhaustive and OCIE will conduct additional examinations in 2014 that may result from market developments, new information learned from exams and other sources, and coordination with other regulators.
6. On January 30, 2014, the SEC will conduct a national seminar for investment companies and investment advisers, as part of its compliance outreach program. This seminar, intended to help these firms' Chief Compliance Officers (CCOs) and other senior personnel, will cover program priorities for 2014, topics of interest for private fund advisers (including presence exam observations, private fund initiatives/guidance, and private equity issues) and registered investment companies (including alternative mutual funds and exchange traded products), valuation (valuation techniques and practices and difficult-to-value investments, and the role of persons other than the investment adviser such as the Board and pricing services), and the role of the CCO (including staff observations and recent enforcement actions). This event will feature staff from OCIE, the Enforcement Division's Asset Management Unit, and the Division of Investment Management. For more information, see the press release at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540495022> and the agenda at <http://www.sec.gov/info/cco/ccons2014agenda.pdf>. A replay of the seminar is located at <http://www.sec.gov/news/otherwebcasts/2014/complianceoutreachns013014.shtml>.
7. In late December 2013, pursuant to the provisions of the Dodd-Frank Act, [the SEC adopted amendments to Rule 5b-3 of the Investment Company Act of 1940 and amended Forms N-1, N-2, and N-3](#) to remove required references to credit ratings by nationally recognized statistical ratings organizations (NRSROs). The amendments to Forms N-1, N-2, and N-3 remove the required use of credit ratings by NRSROs when the fund chooses to depict its portfolio holdings by credit quality. Forms N-1A, N-2 and N-3 contain the requirements for shareholder reports of mutual funds, closed-end funds and certain insurance company separate accounts that offer variable annuities, respectively. The Forms have been amended to permit a fund to depict the

credit quality of portfolio holdings in different ways, including, for example (1) alternative categorizations not based on NRSRO credit ratings; (2) the ratings assigned by different NRSROs (for split-rated securities); or (3) ratings provided by credit rating agencies that are not NRSROs.

If a fund chooses to depict its portfolio holdings by credit quality, it would need to include additional disclosure regarding how the credit quality has been determined.

If the fund continues to use credit ratings provided by a credit rating agency, the fund would also need to provide additional disclosures on how the ratings are identified and selected. The effective date of this rule is February 7, 2014, and the compliance date is July 7, 2014.

8. In late December 2013, the staff issued "[Report on Review of Disclosure Requirements in Regulation S-K](#)." As part of this report, the staff is recommending, among other things, development of a plan to systematically review SEC forms and regulations, including Regulations S-K and S-X.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2014 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the March 12,
2014, 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 depository institutions industry to deliberate and come to agreement on key depository institutions issues.

The following are brief highlights of the conference call:

I. AICPA/Administrative:

1. The Expert Panel (EP) January 2014 conference call highlights are being finalized. All previous meetings and calls highlights are available at http://www.aicpa.org/InterestAreas/FRC/IndustryInsights/Pages/Expert_Panel_Investment_Companies.aspx. 2012 and prior highlights are now included in a master pdf file that allows easy searching.
2. The AICPA is revising the Alternative Investments Practice Aid and is seeking reviewer comments from several EPs, including the Investment Companies EP.
3. The EP was informed about a change in the EP composition and thanked Amy Edwards for her contributions to the EP and AICPA Asset Management Revenue Recognition Task Force.
4. Applications for the new volunteer year (2014-15) are currently being accepted. Interested applicants should apply on [AICPA Volunteer Central](#). The deadline for applications to be considered is May 15, 2014.
5. The AICPA publications staff provided the EP with a brief status update on development of the Audit and Accounting Guide *Investment Companies* (Guide) and informed the EP about potentially discontinuing of the Investment Companies Industry Audit Risk Alert.
6. The AICPA staff solicited the EP's views whether a detailed schedule of investments included in a Form N-CSR filing (while the report to shareholders only included a summary schedule of investments) would be considered supplemental information, as defined in PCAOB Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*.

II. Accounting/Reporting Issues:

1. **Origination of Loans**
Certain entities that are currently considered investment companies may be established to either originate loans or "season" loans. Seasoning occurs initially after a loan has been originated, where an entity may hold the loan for a period of 30-180 days until it establishes a track record and can be rated by a credit rating agency.

The amendments in Financial Accounting Standards Board (FASB) *Accounting Standards Update* (ASU) No. 2013-08, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements* (ASU 2013-08), allow for an investment company to provide activities other than investing activities as long as the activity is not substantive.

During March 12, 2014, the EP members were asked to share their views on what constitutes a substantial business activity or substantial source of income that would prohibit an entity from qualifying as an investment company. The EP discussed whether originating or seasoning loans may be considered a separate substantial business activity, even though the ultimate purpose of the entity is to provide returns from capital appreciation and investment income. The EP also considered a scenario when a reporting entity has an interest in another entity that originates loans on the reporting entity's behalf and if the reporting entity's ownership level impacts whether the reporting entity is an investment company.

The EP noted that the determination of a substantial business activity or substantial source of income requires careful analysis of the specific facts and circumstances including an analysis of both quantitative and qualitative factors. The EP will consider identifying certain quantitative (for example, life of the loan; origination fees as compared to the yield earned over the life of the loan; percent of loan origination fees in relation to the reporting entity's overall income) and qualitative (for example, nature of activity, such as originating loans, seasoning loans or securitizing loans) factors practitioners could be considered in determining what constitutes substantial business activity or a substantial source of income that would affect the determination of whether a reporting entity that originates loans (or acquires loans from an affiliated entity that originates loans) qualifies as an investment company. The EP will discuss this topic at future EP meetings and will determine whether to develop a nonauthoritative TPA.

2. The EP discussed the calculation and presentation of the net investment income and expense ratios required as part of the financial highlights disclosure for a hedge fund, or similar entity, in liquidation. ASU No. 2013-07, *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting* (ASU 2013-07), applies to nonregistered investment companies (investment companies regulated under the Investment Company Act of 1940 are excluded from the scope of ASU 2013-07). EP members observed that financial highlights ratios are generally most relevant for a going concern entity.

An EP member highlighted the following two requirements of ASU 2013-07 which would affect the calculation of the net investment income and expense ratios:

- a. All expenses of the liquidation (and income) are to be accrued at the time of adoption of the liquidation basis;
- b. Assets are to be carried at the estimated cash (or other) proceeds from disposal, which may or may not equal fair value.

An EP member further observed that at the time of adoption of the liquidation basis, other items which the entity had not previously recognized under GAAP (e.g., internally developed intangibles), that are expected to be realized are recorded. However, the EP member noted that these items are not expected to be material to investment companies.

EP members were asked to express their views on how to calculate and present the net investment income and expense ratios for a fund in liquidation once ASU 2013-07 is adopted.

ASU 2013-07 requires, at a minimum, an entity that applies the liquidation basis of accounting to present a statement of net assets in liquidation and a statement of changes in net assets in liquidation. In addition an entity that has adopted the liquidation basis of accounting is required to make all other disclosures required by other GAAP that are relevant to understanding the entity's statement of net assets in liquidation and statement of changes in net assets in liquidation.

An EP member noted that while the net investment income and expense ratios may be meaningful in the initial period to an investor, in later fiscal periods the ratios may become

less meaningful. The EP member noted that in subsequent periods the expenses will be revisions to estimates of the previously accrued amounts and assets will decline as the fund liquidates the remaining investments.

Although ASU 2013-07 may not explicitly require a nonregistered investment company to present financial highlights for a fund in liquidation, some EP members believe other GAAP would still require disclosures such as financial highlights and schedule of investments. Several EP members recommended presenting ratios while also including a footnote disclosure that the ratios may not be meaningful due to adoption of the liquidation basis of accounting, which includes estimates of future expenses through final liquidation of the entity. Other members of the EP commented that the net investment income and expense ratios may not be required as they are not relevant in understanding the entity's statement of net assets in liquidation or statement of changes in net assets in liquidation.

Another EP member inquired whether a nonregistered investment company would even be considered an investment company once liquidation commenced.

The EP members acknowledged that a TPA on the application of ASU 2013-07 for nonregistered investment company would be helpful.

3. Blocker entities and investment company definition

In accordance with current GAAP and the guidance in ASU 2013-08, an investment company should generally not consolidate a non-investment company investee. Accordingly, in evaluating whether to consolidate a blocker entity, the reporting entity is required to determine whether the blocker entity is an investment company.

Many believe that due to the overall structure of a blocker entity and the investment company complex, a blocker entity may be considered an investment company under ASU 2013-08 and, accordingly, may qualify for consolidation. Those who believe a blocker entity may qualify as an investment company believe that even though the blocker entity may not be considered to be providing investment management services directly, the structure of the investment company complex as a whole is set up to provide investment management services. Accordingly, the blocker entity would meet this characteristic.

However, there is an alternate view that a blocker entity may not qualify as an investment company because the blocker entity does not provide investment management services within the blocker entity (a fundamental characteristic included in paragraph 946-10-15-6).

The EP acknowledged the SEC staff's view generally supporting consolidation of a wholly-owned or substantially-owned nonregistered investment entity, such as blocker entities by a registered investment company or a BDC.

The EP highlighted that paragraph 946-10-55-18 indicates that an investment company with a single investor formed for legal, regulatory, tax, or other business reasons may still be considered an investment company even though it does not possess one of the typical characteristics of an investment company (more than one investor). The EP noted that although the specific question was about one of the fundamental characteristics (providing investing-related services) it would be contradictory to the spirit of ASU 2013-08 to conclude that a blocker entity is not an investment company if it was established in the context of another investment company solely for legal, tax or regulatory purposes. However, the EP noted that determining if a blocker entity met the definition of an investment company required judgment and a careful analysis of the specific facts and circumstances. EP members observed that there could be instances where a blocker entity did not meet the definition of an investment company.

4. Preparing financial statements under IFRS—Master/Feeder structure

The EP members considered whether under IFRS, a feeder fund may attach the financial statements of its master fund, rather than including the full set of disclosures in the feeder fund's financial statements (provided all of the disclosure requirements would be met). IFRS 10 and the Basis for Conclusions in IFRS 10 confirm that there is no requirement for the "parent entity" or feeder fund to attach the financial statements of their investment entity subsidiaries. However, it does not conclude whether this is prohibited.

IFRS 10

BC273 The Board considered whether it should require certain investment entity parents to attach the financial statements of their investment entity subsidiaries to the parent's financial statements. Some respondents argued that it would be essential for users of the financial statements of an investment entity parent to have information about the underlying investments of its investment entity subsidiary, particularly when the investment entity parent has only one investment entity subsidiary (e.g. 'master-feeder funds').

BC274 However, the Board decided against requiring financial statements of an investment entity subsidiary to be attached to the financial statements of an investment entity parent. The Board believed that it would be difficult to define which types of structures should be covered by such a requirement. Moreover, the Board thought that such a requirement would be inconsistent with the proposal that fair value information is always the most relevant information for investment entities.

The EP members acknowledged that they have not seen this issue arising in practice. One EP member shared a situation where a feeder fund included all applicable disclosures in the feeder fund's financial statements and also attached the financial statements of its master fund.

5. The EP was presented a specific scenario regarding accounting for placement fees. In this arrangement, a general partner (GP) agrees to waive the management fee to the extent that placement fees are paid by the fund. The GP also guarantees to the placement agent that the placement fees will be paid, but does not guarantee to the fund that it will be reimbursed for placement agent fees if the fund is liquidated prior to the placement fees being recouped through the management fee waiver.

The EP members agreed that it would be appropriate to record placement fees paid by the fund as a debit to capital. Furthermore, it would be appropriate to record the management fee gross with a corresponding waiver for the amount of the placement fees paid by the fund consistent with the terms of the partnership agreement or management fee agreement. The EP members concluded that it would not be appropriate to record an asset for the amount due from the GP for future management fee waivers as a result of the placement fees paid by the fund unless the GP was obligated to contribute such amount in a hypothetical liquidation as of the reporting date.

6. The EP considered accounting for private equity management fee waiver arrangement where an investment adviser/general partner (GP) waives the management fee and receives a deemed capital contribution for the amount of the waiver. Examples were discussed where a waiver of management fee for a deemed capital contribution can be made:

1. At the discretion of the GP at any time,
2. Upon the fund achieving certain hurdle rates of return, or
3. When the fund has positive income (total results of operations).

The EP member inquired whether others are seeing similar arrangements and whether they are being treated as waivers.

The EP members believe it may be appropriate to record a reduction of the management fee for "deemed" capital contribution as waivers. The management fee would be presented gross and a waiver would be presented as a reduction of total expenses on the statement of operations.

EP members determined that the amount of a waiver presented in the statement of operations should be presented as an allocation of capital in lieu of management fee to the GP in the statement of changes in partners' capital (reallocation of capital from the LPs to the GP) and should be shown as a separate line item from any incentive allocation in the same period.

III. Audit and Attest Issues

1. **CFTC/NFA filings and consideration of a reissuance of the audit report**

Due to recent CFTC and NFA rule changes, which affected many of the exemptions that both non-registered funds and registered investment companies (RICs) previously relied on, more funds have to comply with the additional filing requirements as a Commodity Pool Operator (CPO).

Under certain requirements, a fund's issued financial statements, including the auditor's report, are subsequently provided and filed with the CFTC and NFA. These filings are not made publically available. EP members discussed that they would generally not consider this subsequent filing of the audited financial statements to be a reissuance of the previously issued auditor's report. However, if the financial statements were modified from their previously issued format, for example, for inclusion or exclusion of certain footnotes, the auditor may need to consider performing additional auditing procedures and determine whether there is a need to modify the auditor's opinion as this would constitute a reissuance. An EP member offered a scenario when a shareholder report for a registered investment company is issued and then later included in a N-CSR filing, the N-CSR filing is not considered a reissuance.

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 call to discuss the following general observations:

1. General:

- a. The SEC staff provided observations on the consultation process noting that they have received written consultations from legal counsel representing certain registrants seeking the SEC staff's views on GAAP or Regulation S-X interpretations. The SEC staff highlighted that when a registrant is seeking formal views from the SEC staff regarding accounting, financial reporting, and auditing concerns or questions, especially those involving unusual, complex, or innovative transactions for which no clear authoritative guidance exists as well as on issues regarding auditor independence, a registrant should follow the consultation process as outlined in "Guidance for Consulting with the Office of the Chief Accountant" available at: <http://www.sec.gov/info/accountants/ocasubguidance.htm>. The SEC staff observed that some of the recent requests have not included: a) the name of the registrant seeking consultation with the SEC staff, b) the name of the audit firm, the audit firm's conclusion and whether the submission and the proposed resolution of the issue have been discussed with the audit firm's national office, or c) the audit committee's views on the issue.
- b. The SEC staff informed the EP that information regarding enforcement cases related to valuation issues specific to registered funds and BDCs can be found within the enforcement section of the "Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies — Select Bibliography of the Division of Investment Management" document which is located in the SEC's Division of Investment Management Topical Reference Guide under valuation. See direct link "[Valuation](#)." Information on, and links to, enforcement cases related to private funds are located on the SEC's Division of Investment Management's home page in the Information and Guidance section under "[Litigation](#)".
- c. In January 2014, the staff of the SEC's Division of Investment Management issued IM Guidance Update No. 2014-01, "Risk Management in Changing Fixed Income Market Conditions." This Update outlines steps fund advisers may consider taking regarding risk management and disclosure matters relating to changing fixed

income market conditions, including (1) assess and stress test liquidity; (2) conduct more general stress-tests/scenario analyses; (3) risk management evaluation; (4) communication with Fund Boards; and (5) shareholder communications. IM Guidance Update No. 2014-01 is available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>

2. The SEC staff shared the following comments from recent financial statement and registration statement reviews:

- a. As the SEC staff has pointed out in previous meetings, they have noticed a number of investment companies acquiring private funds prior to or shortly after the investment company's registration statement is declared effective. In these situations, the registration statement of the BDC or registered investment company that is acquiring a private fund or substantially all of the investments of a private fund should include, among other things, at least two years of audited financial statements of the private fund which are compliant with Regulation S-X.

The Regulation S-X compliant financial statements should include, among other things, a full schedule of investments, which illustrates each investment the private fund is holding as of the private fund's most recent year-end. For example, a private fund which includes as part of its financial statements only a condensed schedule of investments in accordance with GAAP, and not a full schedule of investments, will not satisfy the requirement to include a full schedule of investments pursuant to Rule 12-12 of Regulation S-X.

The SEC staff shared that certain attorneys do not believe that a private fund's financial statements need to be included in the registration statement filing, based on footnote 2 of an incoming request for no-action relief submitted by Mass Mutual in 1995, which states, "We are not asking that the respective Funds be treated as the successors of the corresponding [unregistered separate investment accounts] for financial accounting purposes. Thus, any performance figures used in the Trust's financial statements, such as in the Financial Highlights, will reflect the actual performance of the Funds from the date of inception, that is as of the Effective Date of the Trust's Registration Statement."

Full text of the letter is available at

<http://www.sec.gov/divisions/investment/noaction/1995/massmutualinstitutional092895.pdf>

The SEC staff noted that the staff no-action letter permits, among other things, the use of a private fund's performance in an open-end management investment company's prospectus, statement of additional information, advertisements and sales literature based on representations that (1) each Fund is managed in a manner that is in all material respects equivalent to the management of the corresponding [unregistered separate investment account] and (2) the [unregistered separate investment accounts] were created for purposes entirely unrelated to the establishment of a performance record.

The staff no-action letter did not address footnote 2 of the incoming request for no action relief, and the SEC staff does not believe that the footnote in the incoming letter precludes the SEC staff from requesting registrants to include financial statements of the private fund in a registered investment company's or BDC's registration statement.

The staff also noted that based on general instruction 1(a) to Item 13 of Form N-1A, a registered investment company's financial highlights should only be presented for the periods subsequent to the effective date of the fund's registration statement. Therefore, typically, a registrant would not include financial highlights information of the private fund as part of the financial highlights of the registered investment company in the registration statement.

- b. Total return swaps – certain registrants do not include the financing portion of a total return swap as part of the description of the total return swap. The SEC staff described a scenario where a registrant enters into a total return swap where it receives a total return equal to the return of an index and pays a financing fee equal to LIBOR plus a certain spread. Generally, the SEC staff believes that the financing fee portion (LIBOR plus the spread as described above) should be included as part of the description of the swap pursuant to Regulation S-X.

- c. The SEC staff has noted that certain BDCs holding controlling interests in portfolio companies have recapitalized these portfolio companies, causing the portfolio companies to take on more debt and use the cash to make payments back up to the BDCs, which the BDCs characterized as dividend income. The SEC staff expects BDCs to have a process in place to determine the character of payments received from portfolio companies (i.e., whether payments represent income or return of capital). The SEC staff believes such a process is of particular importance to BDCs, since BDCs may earn incentive fees on net investment income separately from incentive fees on realized capital gains (where the realized capital gains incentive fee is computed net of all realized capital losses and unrealized capital depreciation in accordance with Section 205(b)(3) of the Investment Advisers Act of 1940).
- d. The SEC staff recently reviewed a valuation policy for a fund investing entirely in private loans. The registrant's valuation policy indicated private loans are valued at par, unless there is evidence of credit impairment (e.g., delinquency on payments). The SEC staff observed that this valuation policy is not in accordance with GAAP. GAAP requires fair value based on ASC 820 to be an "exit price" (what a willing market participant would pay to buy that loan at the measurement date), regardless of whether a fund intends to hold a loan to its maturity (ASC 820-10-05-1C states, in part, that a reporting entity's intention to hold an asset is not relevant when measuring fair value). The SEC staff reminded registrants that valuing loans at par and only adjusting the fair value if there is a credit impairment is not in accordance with GAAP.
- e. The SEC staff discussed fair value level disclosures for registered funds investing in equity securities where a material portion of the securities are valued using level 1 inputs and a material portion are valued using level 2 inputs within the fair value hierarchy. In one situation, the fund's entire portfolio consisted of equity securities, and the fund grouped its schedule of investments by industry. However, the fund presented only one broad category ("equity securities") in the fair value hierarchy disclosure table. In this situation, where both level 1 and level 2 in the fair value hierarchy are determined to contain material balances, the SEC staff would expect to see a more granular fair value hierarchy disclosure (for example, by industry or geography) rather than in total for all equity securities.
- f. The SEC staff highlighted an ASC 815 disclosure requirement about an entity's volume of derivative activity. Certain registrants include a statement that derivatives as presented in the financial statements as of the reporting date are indicative of the volume of derivative activity during the period. The SEC staff noted that such disclosure may be acceptable, but only if the registrant performs an analysis and determines this is the case. If the volume of derivative activity in the financial statements as of the reporting date is not indicative of the volume of derivative activity during the year, based on ASC 815-10-50-1B, the registrant shall select the format and the specifics of disclosures relating to its volume of derivative activity that are most relevant and practical for its individual facts and circumstances.
- g. The SEC staff commented that from time to time, certain funds which are "regulated investment companies" as defined in section 851 of the Internal Revenue Code of 1986 ("RICs") seek relief from the provisions of Rule 19b-1 under the 1940 Act for additional long-term capital gain distributions that otherwise may be prohibited. Generally, Rule 19b-1 prohibits a RIC from making more than three voluntary long-term capital gain distributions related to a taxable year (a regular distribution, an excise tax distribution, and a supplemental distribution that does not exceed 10% of the aggregate original amount distributed during the taxable year). Paragraph (e) of Rule 19b-1 indicates that if a RIC, because of unforeseen circumstances, proposes to make a distribution which would be prohibited under the provisions of this rule, a registrant may file a request with the Commission for authorization to make such distribution. Rule 19b-1(e) also indicates that such request shall be deemed granted unless the Commission denies such request within 15 days after the receipt. The SEC staff asks registrants to include in the request all relevant facts and explain the circumstances that would justify such distribution, which the SEC staff will use to consider whether relief under Rule 19b-1(e) is warranted. During the March EP conference call, the SEC staff noted that given the 15 day clock, a registrant should submit a draft of the request via email to the SEC staff in advance of an official filing with the Commission, so the draft request can be promptly reviewed by the Chief Accountant's and Chief Counsel's offices in the Division of Investment Management, who then can contact the registrant with questions or

comments, including the SEC staff's views on the merits of the request. Draft requests can be emailed to IMOCA@sec.gov. When filing the official request for relief, the SEC staff has not objected to registrants filing the request on EDGAR electronically as a 40-APP.

3. The SEC staff shared the following observations relating to Rules 3-09 and 4-08(g) of Regulation S-X:
 - a. The first observation relates to the tests performed under Rule 1-02(w) of Regulation S-X to determine the applicability of Rule 3-09 or Rule 4-08(g). The SEC staff reviewed an asset test calculation performed by one BDC, and noted that the total assets of a significant subsidiary were reduced by an amount of debt payable to a bank. Registrants are reminded that when preparing the test calculations, Rule 1-02(w) requires total assets amounts as determined by GAAP (pursuant to the note to paragraph (w)) and it does not provide for any reductions, including for any liabilities, to total assets.
 - b. The SEC staff highlighted recent financial statement review comments provided to certain BDCs that included Rule 4-08(g) disclosures in their 10-K annual report filings. The SEC staff noted that although certain BDCs' notes to the financial statements included the required summarized financial information of their significant subsidiaries, BDCs should also consider including a brief narrative about the business and operations of each significant subsidiary that precedes the summarized financial information required by Rule 4-08(g). The SEC staff indicated that this type of narrative is usually included in a BDC's registration statement, and the SEC staff recommends also including such information in the notes to the financial statements to provide additional context to investors.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

Copyright © 2014 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the May 20, 2014, 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 depository institutions industry to deliberate and come to agreement on key depository institutions issues.

I. **AICPA/Administrative:**

1. The Expert Panel (EP) January and March 2014 conference call highlights are being finalized.
2. AICPA staff and EP chair discussed the EP current and future composition.
3. AICPA staff informed the panel about current status of the 2014 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide). The EP discussed the applicability of the illustrative auditor's reports contained in paragraph 11.27 of the Guide (2013 edition). The language currently included in the fourth paragraph of Example 1-A and in the second paragraph of Example 1-B implies that the detailed schedule of investments (Sol) is supplemental information. The panel discussed that the detailed Sol is not considered to be supplemental information pursuant to PCAOB Auditing Standard No. 17, rather the detailed Sol is audited as part of and is subject to the same auditing procedures as all other components of the financial statements. As a result, the panel concluded that Example 1-A should be revised for clarification and that Example 1-B should be removed from the 2014 edition of the Guide.
4. AICPA staff provided a brief status update on the progress of the Investment Companies Revenue Recognition Task Force.
5. AICPA staff and the EP discussed alternative communication channels available for disseminating information previously contained in the Audit Risk Alert publication. The use of alternative channels will allow the EP to continue informing AICPA members and other practitioners about pertinent industry information in a timely manner.
6. The AICPA is considering revising the Alternative Investments Practice Aid. The responsible AICPA task force will commence its work in June 2014 and will include certain members of the Investment Companies EP.
7. The AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* is discontinued. The majority of the content in this practice aid will be incorporated into other AICPA publications, including the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*. The EP is considering incorporating applicable guidance from Chapter 8 of the practice aid (dedicated to commodity pools, which generally fall within scope of FASB ASC 946) into future editions of the Guide.

8. AICPA is developing a valuation competency framework. The task force responsible for developing the framework will include valuation experts from several industries and audit firms.

II. Accounting/Reporting Issues:

1. The EP is considering developing several TPAs in connection with various topics previously discussed by the EP.
2. Certain Private Equity Funds employ a leveraged buyout (LBO) strategy. At the May EP meeting, the EP discussed the following fact pattern:
A Private Equity fund (PE Fund) invests in an operating company in 20X2 for \$50 million, and at the end of 20X2 the fair value of the investment in the operating company is \$75 million. In 20X3, the operating company's capital is restructured and a loan with a third party of \$40 million is secured. The debt is collateralized by the assets of the underlying operating company, and will be repaid by the cash flows of the underlying operating company. The proceeds from the third party debt are used to distribute cash to the Private Equity Fund and other equity investors of the operating company. The PE Fund's allocation is \$30 million. The operating company's accumulated retained earnings are \$5 million on a GAAP basis and \$10 million on a tax basis at the end of 20X2.

The EP considered the following options to account for the distribution of \$30 million received by the PE Fund in the 20X3 financial statements.

Option 1 – The PE Fund records dividend income to the extent that the operating company has tax basis earnings and profits to support the distribution. Under this option the PE Fund would record \$10 million of dividend income and \$20 million return of capital.

Option 2 – The PE Fund records dividend income to the extent that the operating company has GAAP basis earnings and profits to support the distribution. Under this option the PE Fund would record \$5 million of dividend income and \$25 million return of capital.

Option 3 – Record dividend income to the extent that the PE Fund has unrealized appreciation to support the distribution. Under this option the PE Fund would record dividend income of \$25 million (the amount of unrealized appreciation) and \$5 million of return of capital.

EP members noted that this issue was discussed at the December 1, 2005 EP meeting and the EP expressed a view that the preferable method for recording distributions received by a private fund is using the tax basis earnings and profits of the underlying operating company. During May 2014 meeting, the EP noted that both Option 1 and Option 2 could be acceptable as long as applied consistently.

3. Accounting for discounts on securities subject to underwriter lock-up agreements

The EP discussed accounting for discounts on securities subject to underwriter lock-up agreement.

As amended by ASU 2011-04, ASC 820 now states:

>>> Case A: Restriction on the Sale of an Equity Instrument

820-10-55-52 A reporting entity holds an equity instrument (a financial asset) for which sale is legally **or contractually** restricted for a specified period. (For example, such a restriction could limit sale to qualifying investors, as may be the case in accordance with Rule 144 or similar rules of the Securities and Exchange Commission [SEC].) The restriction is a characteristic of the instrument and, therefore, would be transferred to market participants. In that case, the fair value of the instrument would be measured on the basis of the quoted price for an otherwise identical unrestricted equity instrument of the same issuer that trades in a public market, adjusted to reflect the effect of the restriction. The adjustment would reflect the amount market participants would demand because of the risk relating to the inability to access a public market for the instrument for the specified period. The adjustment will vary depending on all of the following:

- a. The nature and duration of the restriction
- b. The extent to which buyers are limited by the restriction (for example, there might be a large number of qualifying investors)
- c. Qualitative and quantitative factors specific to both the instrument and the issuer.

The EP discussed that one should first determine whether a legal or contractual restriction is specific to the financial instrument itself or the entity. For example, a restriction related to the sale of initial public offering (IPO) shares that is described in the IPO prospectus would likely be limited to the entity's management holding the shares, and not to the shares themselves. In this case, the entity would not consider this restriction in determining fair value of IPO shares. However, in certain situations these restrictions could be security-specific, depending on the nature of the restriction, and therefore can be considered in the measurement of fair value for the securities. For example, if the underwriter lock-up agreement permits the transfer of the IPO shares subject to the remaining lock-up period, it may be appropriate to consider the restriction to be an attribute of the security. Some EP members questioned the interpretation of the need to determine if the restriction is specific to the financial instrument itself or the entity given the language "for which sale is legally or contractually restricted" does not appear to require this analysis.

4. Fee Waivers/Reimbursements in Excess of Total Expenses by Advisers to Fund-of-Funds Investment advisers of registered fund-of-funds (FOF) may enter into an expense limitation arrangement whereby they agree to limit the total expenses of the FOF, inclusive of Acquired Fund Fees and Expenses (AFFE). This may result in the adviser waiving/reimbursing expenses in excess of the total operating expenses at the FOF level, in effect reimbursing a portion of the underlying/acquired fund's expenses. How should this waiver/reimbursement be presented in the statement of operations and financial highlights?

The EP members discussed that payments by the adviser/affiliate to a fund are generally included in the section of the financial statements that gives rise to the payment (NAV error or "as of" dilution is included with capital activity in the statement of changes in net assets, reimbursement of fund expenses is a reduction of total expenses, reimbursement of investment loss is an addition in the realized gain/loss section, etc.).

The EP members discussed five options for recording the waiver/reimbursement of expenses in excess of the operating expenses incurred by the fund.

Option 1 – Record the amount in excess of total operating expenses as a capital contribution by the investment advisor.

Option 2 – Record the amount in excess of total operating expenses as other income to the fund.

Option 3 – Record the amount in excess of total operating expenses as an expense reimbursement/waiver, resulting in negative net expenses.

Option 4 – Record the amount in excess of total operating expenses as a component of realized gain/loss.

Option 5 – Record the amount in excess of total operating expenses as a separate and distinct waiver/reimbursement following net expenses and preceding net investment income (included in net investment income, but not resulting in negative net expenses/negative net expense ratio).

Most EP members did not support option 1 because this would be inconsistent with how other payments from the advisor are recorded and often the advisor does not hold any equity in the Fund. Certain EP members noted that option 2 may be inconsistent with how the AFFE are recognized in the fund's financial statements, specifically when the underlying funds do not have distributions from income. Certain EP members noted that option 4 would provide for a better matching with how the AFFE are recognized in the fund's financial statements than option 2 when the underlying funds do not have distributions from income. Certain EP members noted that the waiver/reimbursement in excess of total expenses should be included in net investment income on the statement of operations, but did not think it was appropriate to present the waiver/reimbursement of an underlying fund's expenses as a reduction of the FOF operating expenses, resulting in negative net expenses and a negative net expense ratio. However, other EP members thought that by showing negative net expenses and a negative net expense ratio, it would give the reader the overall picture of the fee they are paying. As such, certain EP members determined that option 2 or option 5 may be appropriate because it would clearly disclose to users of the financial statements the affect of these waivers without resulting in negative net expenses and a negative net expense ratio. The EP members agreed that it would be important to include meaningful disclosure of the affect of the AFFE waivers on the expense ratio and other financial highlights.

The EP determined that it would be appropriate to discuss this topic with the SEC and further consider the options.

5. With certain requirements of FATCA becoming effective as of July 1, 2014, certain funds may be required to withhold taxes on US sourced income depending on the domicile of their investors. The EP members agreed that these withholdings should be treated as if the fund were acting as an agent on behalf of the taxpayers. As a result such amounts should be recorded as a reduction of capital and would not be recorded on the fund's income statement as an expense.

6. **Accretion of Non-performing Loans**

The EP members discussed the following questions:

1. Is an entity required to accrete non-performing loans purchased at a discount?
2. What if the entity has entered into a forbearance agreement with the borrower that includes 12 monthly payments defined as forbearance fee payments. At the end of the forbearance period the note holder will accept a discounted payoff.

EP members agreed that an entity should consider the expected timing and amount of future cash flows when determining the discount rate that provides a constant yield per ASC 946-320-35-20 and 835-30-35-2. EP members discussed that for debt instruments acquired that were distressed this could be difficult, but would still be appropriate.

III. **Audit and Attest Issues**

1. **Senior loan funds – Confirmation with Custodian and/or Agent Banks**

Certain registered investment companies invest in senior bank loans as part of their investment strategy (Senior Loan Fund). Senior loans, or loan participations, generally are arranged through private negotiations between a borrower and several financial institutions represented by an agent who is usually one of the originating lenders (the Agent Bank). The Agent Bank has responsibility for ongoing administration of a senior loan. Agent Banks are typically paid fees by the borrower for their services. The Agent Bank also is responsible for monitoring collateral and for exercising remedies available to the lenders such as foreclosure upon collateral.

Similar to other registered investment companies, the Senior Loan Fund's securities and cash are maintained under a Custody Agreement with a typical Custodian Bank. However, the Custodian Bank does not service the senior loans, rather all of the legal agreements, books and records are maintained by each of the Agent Banks. The Custodian Bank may have procedures and internal controls in place to reconcile the Senior Loan Fund's positions with each of the Agent Banks, among other typical controls over the safety of assets performed by a Custodian. For example, the Custodian Bank may use the periodic Agent Bank notices to reconcile the senior loan positions with each of the Agent Banks. However, the procedures and controls may not be included within the scope of the SOC II SSAE 16 report of the custody activities of the Custodian Bank.

Under section 30(g) of the Investment Company Act and the Commission's Accounting Series Release No. 118 (Dec. 23, 1970), the audit report included in the financial statements must include a statement "that such independent public accountants have verified securities owned, either by actual examination, or by receipt of a certificate from the custodian." Often the auditor will confirm the existence of the senior loans with each of the respective Agent Banks, which may require a significant number of confirmations, as well as alternative procedures for confirmations not received. The EP discussed if the Custodian Bank is willing to confirm as custodian the senior loan positions held by the Fund, would the auditor still be required to confirm the existence of the senior loan positions with each of the Agent Banks.

EP members highlighted that the auditor should evaluate whether the Custodian Bank, even if it is willing to provide a confirmation, is legally responsible for custody of the securities and has the basis and knowledge to provide a confirmation. EP members did not believe that it was common for the Custodian Bank to have legal responsibility for custody of the senior loan positions and the basis or knowledge to provide a confirmation and therefore it typically would not be appropriate to only send an audit confirmation to the Custodian Bank. EP

members indicated that it would be important to exercise professional skepticism and evaluate any confirmation received by a Custodian Bank for disclaimers or other information that may indicate the Custodian Bank's confirmation of senior loan position does not provide sufficient audit evidence.

2. Treatment of traded bank loans under custody rule.

EP members highlighted that it is not clear who the "issuer" is for bank loans. The EP discussed whether the "issuer" should be considered a) the lending banks or b) the ultimate borrower. If the lending banks are determined to be the issuer, then bank loans may qualify as "privately offered securities" since they could have been bought "directly from the issuer." If the borrower is determined to be the issuer, then bank loans may not qualify as privately offered securities. The EP noted that this was a legal determination that should be evaluated.

EP members indicated that most "qualified custodians" do not claim to have custody of bank loans as the ownership records are usually maintained by agent banks. Unless bank loans are considered to be "privately offered securities", it is not clear how an adviser can comply with the quarterly statement rule, since the only potential sources of statements are the agent banks on a loan-by-loan basis. The EP discussed whether this topic should be submitted as a question to the SEC depending on whether it was determined that bank loans were privately offered securities.

3. PCAOB Auditing Standard No. 16

The EP discussed whether PCAOB Auditing Standard No. 16, *Communications with Audit Committees and Amendments to other PCAOB Standards*, has changed the requirements for the frequency of communication with the audit committee for those working on large fund complexes.

Background from October 2012 EP conference call highlights:

The Expert Panel discussed timing of communication of the audit firm with audit committees in light of the recently issued PCAOB Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to other PCAOB Standards*. Footnote 43 in the Auditing Standard (AS) No. 16 states:

Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

This exception currently enables large fund complexes with individual funds' fiscal year-ends that are spread throughout the year to have quarterly audit committee meetings (rather than monthly audit committee meetings). Some are interpreting the changes to Auditing Standard 16 to require certain communications to take place prior to issuance of the opinion for each individual fund within large fund complex. This interpretation of Auditing Standard No. 16 may cause audit committees to move to a monthly meeting schedule (so that they can receive and discuss the required communications prior to issuance of each opinion). Yet, others believe, from PCAOB's 2010 Proposing Release No. 2010- 001 and the 2012 adopting release (No. 2012-004), that the PCAOB did not intend to change current practice for investment companies.

EP members observed that, unless the PCAOB or the SEC issue clear guidance regarding application of this Standard for mutual fund complexes, some may interpret that communications between the auditor and audit committee must take place before issuing the auditor's opinion; however, the nature of such communication may be flexible (for example, through a conference call or e-mail). Some believe that it is a best practice to have monthly communication between audit committee and audit firm.

The EP members also discussed that, if the frequency of these communication increases for large fund complexes with different reporting periods for individual funds, it may present an additional burden to the registrants, as the funds may incur additional costs in preparing meetings.

Subsequent to the October 2012 meeting, EP members from public accounting firms reached a consensus view that 1) the PCAOB did not intend to change current practice, 2) that quarterly communication (including providing material written communications between the auditor and management, such as the management representation letter) was typically adequate under the standard unless there were significant changes since the most recent communication, 3) that significant changes since the most recent communication with the audit committee (e.g., disagreements with management, significant difficulties in conducting the audit, etc.) should be communicated timely, and 4) that, in certain circumstances, better practices may include more frequent than quarterly communication with the audit committee or audit committee chair.

At the May meeting, EP members reconfirmed their view with respect to Auditing Standard No. 16.

4. COSO 2013

EP members discussed the impact of COSO 2013 on investment companies. EP members noted the following:

- Mutual funds are responsible for establishing and maintaining disclosure controls and procedures (as defined in Rule 30a-3(c) under the Investment Company Act of 1940 (the “Act”)) and internal control over financial reporting (as defined in Rule 30a-3(d) under the Act
- Each principal executive and principal financial officer of the fund must sign a certification regarding these controls for each report filed on Form N-CSR and Form N-Q
- To the EP members knowledge, the only widely available control framework to be used by management is the criteria established in the 1992 Internal Control – Integrated Framework issued by COSO
- Effective December 15, 2014, the 1992 COSO Framework will be superseded and replaced by the 2013 Framework.

EP members observed that registrants were performing an analysis to identify potential implications to their internal control over financial reporting when evaluated against COSO 2013.

5. Rule 17f-2 of the Investment Company 1940 Act

EP members observed that the EP should request that the SEC consider updating Rule 17f-2 guidance to accountants to conform to Rule 206. EP members indicated that they would inquire if the SEC staff would object if the Rule 206 guidance was followed for 17f-2 counts, except that all investment companies would be under scope, not just a sample of accounts.

The EP considered whether the notice reference (that the examination was done without notice to the company) should be relocated to the headnote from the bullets of the auditor’s report. An EP member noted that the 17f-2 auditor’s report should say whether the examination was done without notice to the company (one per year it may be performed with notice). However the EP member observed that the phrase indicating whether the examination was done without notice is located in the first bullet in the example auditor’s report in the Guide which states “count and inspection of all securities located in the vault...” The EP member further noted that it is common for this bullet to be removed as there often are no securities in a vault. In those situations, this phrase is not included in the auditors’ report and with it the notice reference.

An EP member highlighted that the management assertion in the sample report covers both the examination date and the period from the last exam, however the opinion paragraph only covers the examination date. The EP discussed this mismatch between the assertion and the opinion paragraph in the example report 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 meeting in person to provide a brief overview of the Chief Accountant’s Office of the Division of Investment Management (IM-CAO), update the EP on SEC rulemaking and SEC staff projects, and share the SEC staff’s observations in connection with recent financial statement reviews and other consultations.

1. Brief overview of the Office: IM-CAO serves primarily as a consultation office for the SEC on accounting and auditing issues related to the investment management industry. IM-CAO works with various offices in the Division of Investment Management, including IM’s Disclosure Review Office, IM’s Chief Counsel’s Office and IM’s Rulemaking Offices, as well as the Office of Compliance Inspections and Examinations (OCIE) and the Enforcement Division. IM-CAO staff may join the OCIE staff for examinations. IM-CAO also works with the SEC’s Office of Chief Accountant (OCA) on FASB and PCAOB standard-setting activities impacting investment companies and advisers. The SEC staff is available for external consultations with registrants, auditors, and counsel.
2. Update on Division rulemaking and SEC staff projects:
 1. IM rulemaking
 - a. The SEC staff informed the EP that a comprehensive list of rulemakings the SEC is working on is included in the agency rule list published semi-annually by the Office of Information and Regulatory Affairs and the Office of Management and Budget. The Spring 2014 [Agency Rule List](#) is now available.
 - b. Money Market Fund (MMF) Reform – In her recent [speech](#), SEC Chair White indicated that completing MMF reform with a final rule “is a critical priority for the Commission in the relatively near term of 2014.”
 - c. Target Date Retirement Funds – In 2010, the SEC issued a rule [proposal](#) that would require marketing materials for target date funds to include a graphical or tabular depiction of changes in the fund’s asset allocation over time, known as a fund’s “glide path.” On April 3, 2014, the SEC reopened the comment period on the 2010 proposal to request comment on the Investor Advisory Committee’s recommendation that the SEC develop a glide path illustration based on a standardized measure of fund risk, which would replace or supplement what it previously proposed.
 - d. Form N-SAR and Portfolio Holdings Reform – The Division of IM is seeking to improve the quality of information received for non-MMFs (i.e., non-MMF mutual funds, closed-end funds and exchange-traded funds (ETFs)) regarding fund operations and portfolio holdings and reduce unnecessary burdens. As indicated in the [March 7th speech by Norm Champ](#), Director of the Division of Investment Management, the SEC staff is “reviewing the frequency and format of fund portfolio holdings information, including the merits of receiving that information in a tagged format...and is considering making a recommendation to the Commission.”
 - e. Variable Annuity Summary Prospectus – The Division of IM is considering recommending that the Commission propose rules designed to provide variable annuity investors with more user-friendly disclosure and to improve and streamline the delivery of information about variable annuities through increased use of the Internet and other electronic means of delivery.
 - f. ETF rule – the Division of IM is considering recommending that the Commission re-propose new rules and rule amendments to provide exemptive relief for certain index-based and actively-managed ETFs.
 - g. Investment Adviser/Broker-Dealer initiative – Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) gave the SEC broad authority to impose a uniform fiduciary standard for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. In a recent [speech](#), SEC Chair White indicated that to more fully inform the Commission’s decision, she directed the staff to evaluate all of the potential options available to the Commission, including a uniform fiduciary standard for

days at approximately the value ascribed to it by the fund, whereas a Level 2 security could be illiquid if a fund cannot sell or dispose of it in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund).

- c. Broker quotes – The SEC staff expressed concerns that certain registrants are automatically classifying in Level 2 of the fair value hierarchy any investment which is being fair valued using a broker quote, without determining whether the quote was derived from significant unobservable inputs which would warrant a Level 3 classification (e.g., certain registrants classified broker quoted securities in Level 2 without considering the valuation techniques, inputs, and assumptions the broker used to determine the quoted value).
- d. BDCs –The SEC staff recently received a number of consultations relating to disclosures about a joint venture formed by a BDC and a third party, where a BDC has concluded consolidation of the joint venture is not required. Under these circumstances, generally the SEC staff has suggested including, and BDCs have included, in the notes to their interim and annual financial statements: (1) a schedule of investments of the joint venture that complies with Article 12 of Regulation S-X and (2) summarized financial information of the joint venture. The summarized financial information has typically included detailed information related to the assets, liabilities and results of operations of the joint venture (e.g., investments, cash, other assets, total assets, debt, other liabilities, total liabilities, members equity, interest income, dividend income, other income, total income, management fees, incentive fees, interest expense, other expenses, total expenses, net investment income, change in unrealized gain/loss, realized gain/loss, etc.). BDCs should also evaluate whether to file separate financial statements of the joint venture pursuant to rule 3-09 of Regulation S-X.
- e. Balance sheet offsetting – The SEC staff discussed a recent review of balance sheet offsetting disclosures in accordance with ASU 2011-11 and ASU 2013-01. The ASUs were effective for fiscal years beginning on or after January 1, 2013, and interim periods within those fiscal years. The SEC staff indicated that while generally funds are meeting the requirements of the ASUs, the SEC staff observed the following during its reviews:

Some funds' disclosures did not include sufficient qualitative information to satisfy the ASC 210-20-50-5 requirement to provide a description of the rights of setoff associated with recognized assets and liabilities subject to an enforceable master netting arrangement (MNA) or similar agreement disclosed in accordance with ASC 210-20-50-3(d), including the nature of those rights.

The SEC staff noted diversity in practice in relation to the form of the quantitative disclosure required by ASC 210-20-50-3. ASC 210-20-50-4 states that the information required by ASC 210-20-50-3 "shall be presented in a tabular format, separately for assets and liabilities, unless another format is more appropriate." Almost all funds presented the new disclosures in a tabular format, but organization of the tabular disclosure was split between funds that arranged the table by counterparty, those that grouped by financial instrument, and funds that disclosed by counterparty and financial instrument. The staff did not object to any of these presentations.

The SEC staff also reminded the EP that ASC 210-20-50-1d requires disclosures for applicable financial instruments (e.g., derivatives accounted for in accordance with Topic 815, repurchase and reverse repurchase agreements, and securities borrowing and securities lending transactions) subject to an enforceable MNA or similar agreement, irrespective of whether applicable financial instruments are offset in accordance with either ASC 210-20-45 or 815-10-45. The SEC staff noted one fund may have been missing disclosures for derivatives that are typically subject to an enforceable MNA or similar agreement.

The SEC staff noted diversity in practice in whether futures and repurchase agreements were included in the quantitative disclosures required by ASC 210-20-50-3. Funds must make a legal determination as to whether these instruments are subject to an enforceable MNA or similar agreement based on individual facts and circumstances. When repurchase agreements were included, the SEC staff noticed one fund that did not offset the collateral

received against the value of the repurchase agreement asset. As these disclosures apply only to specific financial instruments subject to an enforceable MNA or similar agreement, the SEC staff generally would expect repurchase agreement collateral received by the fund to offset the repurchase agreement asset. For example, a fund invests in a repurchase agreement valued at \$100, which is collateralized by US Treasury Bonds valued at \$102. In the balance sheet offsetting disclosure, the SEC staff would expect to see \$100 in the column for Assets presented on Statement of Assets and Liabilities and \$100 disclosed as collateral, with a net amount of \$0.

ASC 210-20-50-4 limits the tabular disclosure of collateral to the amount shown as the net liability on the Statement of Assets and Liabilities. Many funds disclosed in a note to their tabular disclosure that the net amount column in the tabular disclosure did not include overcollateralization, and thus the net amount column was limited to \$0 in instances of overcollateralization. For example, if a fund had a liability of \$200 and pledged collateral of \$220, the collateral column would disclose \$200 and the net amount after considering collateral would be \$0. The fund included a note to the balance sheet offsetting table, which discussed that the collateral and net amount columns did not include the impact of overcollateralization.

The SEC staff indicated that as additional funds' disclosures are reviewed, additional comments may arise. The SEC staff will communicate additional comments, if any, at a later date.

5. The SEC staff discussed that when a registered investment company changes its fiscal year-end to a new date that is 1 month later than its current fiscal year-end or semi-annual period-end (i.e., 7 months later than its current fiscal year-end), the fund can request relief from the timing and transmittal requirements of Rule 30e-1 under the Investment Company Act of 1940 ("the Act"), *Reports to stockholders of management companies*, which provides that the shareholder report must be transmitted to shareholders within 60 days after the close of the period for which such report is being made.¹

Specifically, when a registrant's fiscal year-end is changed by 1 month, a registrant, upon showing good cause pursuant to Rule 30e-1(e) under the Act, may request relief to include financial statements for both the annual (12 months) and stub (1 month) periods in one combined set of financial statements (with separate columns covering each period), as long as the combined report is distributed to the fund's shareholders within 75 days following the original fiscal year-end. For example, a fund with a 6/30/14 fiscal year-end that changes its fiscal year-end to 7/31/14 and receives relief to distribute to shareholders a combined report by 9/13/14, would not be required to mail or electronically distribute, as applicable, two separate reports to shareholders. The combined report would include, among other things: (i) balance sheets as of 7/31/14 and 6/30/14; (ii) income statements for the 1 month period ended 7/31/14 and for the year ended 6/30/14; (iii) statements of changes in net assets for the 1 month period ended 7/31/14, for the year ended 6/30/14, and for the year ended 6/30/13; (iv) statements of cash flows, if applicable, for the 1 month period ended 7/31/14 and for the year ended 6/30/14; and (vi) financial highlights for the 1 month period ended 7/31/14 and for each of the years ended 6/30/14, 6/30/13, 6/30/12, 6/30/11 and 6/30/10.

Similar relief may be requested for situations when a registrant's fiscal year-end changes by 7 months. For example, a fund with a 12/31/14 fiscal year-end that changes its fiscal year-end to 7/31/14 could request relief to distribute to shareholders an audited annual report for the 7 months ended 7/31/14 by 9/13/14, in lieu of distributing an unaudited semi-annual report for the period ended 6/30/14 and a 7 month audited annual report for the 7 months ending 7/31/14. The combined report would include, among other things: (i) a balance sheet as of

¹ Registrants requesting this relief from Rule 30e-1 also request relief from Rule 30a-2 under the Act which requires that each report filed on Form N-CSR by a registered management investment company include certifications in the exact wording as set forth in Item 12(a)(2) of Form N-CSR (registrants receiving relief modify the certification about changes in internal control over financial reporting in paragraph 4(d) of Item 12(a)(2) of Form N-CSR to cover a period of 4 months instead of the 2nd fiscal quarter of the period covered by Form N-CSR).

7/31/14; (ii) income statements for the 7 month period ended 7/31/14 and for the year ended 12/31/13; (iii) statements of changes in net assets for the 7 month period ended 7/31/14, for the year ended 12/31/13, and for the year ended 12/31/12; (iv) statements of cash flows, if applicable, for the 7 month period ended 7/31/14 and for the year ended 12/31/13; and (v) financial highlights for the 7 month period ended 7/31/14 and for each of the years ended 12/31/13, 12/31/12, 12/31/11, 12/31/10 and 12/31/09.

A registrant receiving relief in either scenario must still comply with Rule 30b2-1 under the Act which requires that the report to shareholders containing the registered investment company's financial statements be filed on Form N-CSR not later than 10 days after the transmission to shareholders.

The SEC staff stated that when registrants change their fiscal year-ends by 1 month or 7 months, there is a standard template for requesting relief, which contains specific representations required for relief to be granted. Registrants may request the template from the SEC staff.

6. The SEC staff discussed consolidation of wholly-owned subsidiaries of registered investment companies (RICs) and BDCs. The SEC staff generally would expect a RIC or BDC to consolidate a wholly-owned or a substantially wholly-owned subsidiary in its financial statements when the design and business purpose of the subsidiary is to act as an extension of the operations of the parent investment company and is used to facilitate the execution of the parent's investment strategy (e.g., blocker, SBIC, certain holding companies, etc.). As part of the registration statement and financial statement review process, the staff has suggested BDCs consolidate such subsidiaries, because in the staff's view, consolidation provides investors with the most meaningful presentation. If a RIC or BDC believes that consolidating a wholly-owned or substantially wholly-owned subsidiary in its financial statements does not provide the most meaningful presentation, the SEC staff encourages the RIC or BDC to consult with the SEC staff.
7. In connection with comments made in a recent [speech](#) by Andrew J. Bowden, Director of OCIE, the SEC staff highlighted examples within the two categories of exam observations highlighted in the speech:
 - a. Expenses: Examples of findings related to expenses charged to private funds include, but are not limited to, expense shifting (such as a private fund adviser shifting expenses from itself to the fund during the middle of a fund's life without disclosing this to limited partners) and charging hidden fees (where fees are not adequately disclosed to investors in the limited partnership agreement, such as administrative fees).
 - b. Marketing and Valuation: Examples of findings related to marketing and valuation include, but are not limited to, the use of valuation methodologies that are different from those disclosed to investors and changing valuation methodologies from period to period, yet, not disclosing such change to investors. Both of these examples could, in turn, impact the information being used during fundraising.

Investment Companies Expert Panel

Highlights of the July 23, 2014, 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 depository institutions industry to deliberate and come to agreement on key depository institutions issues.

I. AICPA/Administrative:

1. The Expert Panel (EP) January call highlights have been posted. March 2014 conference call and May 2014 meeting highlights are being finalized.
2. AICPA staff informed the EP of the current status of the 2014 edition of the AICPA Audit and Accounting Guide *Investment Companies*. The e-book is currently available and hard copy and Online Professional Library version will be available by July 31.
3. AICPA staff provided a brief status update on the progress of the Asset Management Revenue Recognition Task Force.
4. The AICPA task force is being formed to revise the Alternative Investments Practice Aid. The EP representative on that task force will provide an update on the latest efforts to date at the next EP meeting.

II. Accounting/Reporting Issues:

1. The EP continued discussing consolidation of a wholly-owned and majority-owned blocker entities that meet the definition of an investment company under ASC Topic 946 by an investment company and considered situations when it may not be appropriate, such as
 - a. Master-feeder structures where a feeder fund that owns (wholly or substantially) a master fund,
 - b. separate accounts that own (wholly or substantially) underlying mutual funds,
 - c. proprietary fund of funds (FOF) – an investment adviser starts a new fund that initially is substantially or wholly owned by another investment company within the fund complex. Concurrently or subsequently, this new fund will generally be offered to other investors that over time may reduce the FOF’s percentage ownership.

The EP acknowledged that term “blocker entity” is not defined in the ASC Master Glossary; however there is reference to “blocker fund” at paragraph 946-10-55-15 in the context of evaluating the typical characteristics of an investment company.

2. The EP inquired how others interpret “financial support” under ASC 946-10-55-10:

An investment company may provide both of the following services to an investee, either directly or through an investment in an entity that provides those services, only if those services are provided for the purpose of

maximizing returns from capital appreciation, investment income, or both (rather than other benefits) and do not represent a separate substantial business activity or separate substantial source of income for the investment company:

- a. Assistance with day-to-day management of the operations of an investee
- b. **Financial support, such as a loan, capital commitment, or guarantee.**
(Emphasis added)

An EP member noted there is no further clarification in GAAP and suggested to consider discussing this topic with the SEC staff at the next meeting.

During the July conference call, the EP discussed that although each Fund's fact and circumstances may be different, there are two general situations where the interpretation of the term financial support would be required:

1. What type of financial support would be indicative that the entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income (that is, what type of activity would preclude the entity from meeting the definition of an investment company under ASC Topic 946)?
2. What type of financial support should be disclosed in accordance with paragraph 946-20-50-15?

Where additional securities are received for capital provided to an investee, certain EP members believe this may not constitute financial support. For example, additional rounds of financing by a venture capital fund that receives securities in return for its debt or equity investment may not constitute financial support. An EP member commented that in a situation where a distressed debt investment held by a high yield bond fund is being restructured and the fund provides additional financing or other financial support, it may be appropriate to disclose the restructuring. The EP member also observed that if a fund regularly participates in restructuring of debt investments, it may be possible to provide general disclosure regarding the circumstances of such activity and how the fund participates/provides financial support.

The EP members also pointed out it appears that current SEC guidance may be more restrictive regarding the definition of "financial support" than US GAAP and noted that certain comment letters on the SEC Money Market Fund Reform proposal were seeking further clarity regarding the definition and examples of "financial support" in that proposal.

3. The EP considered the meaning of "active and orderly markets" in assessing principal markets under ASC Topic 820. The FSPs (FASB Staff Position FAS 157-3: *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* and FASB Staff Position FAS 157-4: *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*) which were released around active and orderly markets intended to discuss markets which went inactive and disorderly during the financial crisis. The EP discussed that currently, certain markets or securities may have limited activity. The EP observed that a decrease in the frequency and volume of transactions for equity securities may result in classification of fair value of such equity securities as level 2 since the market may not be considered "active". In addition, some investments in foreign equity markets may be orderly but have very infrequent transactions, which may result in the use of level 3 inputs for determining fair value. The EP members acknowledged that these questions may arise more frequently for nonregistered investment companies.
4. One EP member inquired about interest income recognition for entities that measure their investments at fair value. Specifically, the EP member questioned what accounting model is being applied. The EP member noted that EITF 99-20 addresses such entities however it may be unclear if this model should also be applied for deep discounted debt instruments or TIPS which may generate negative income. The EITF 99-20 states, in part, that "the method used for recognizing and measuring the amount of interest income on a beneficial interest should not differ based on whether that beneficial interest is classified as held-to-maturity, available-for-sale, or trading."

During July EP conference call, the EP members observed that consistent with the EP May meeting discussion, an investment company should use an effective interest method which

involves consideration of the expected timing and amount of future cash flows when determining the discount rate that provides a constant yield per ASC 946-320-35-20 and 835-30-35-2. The EP members acknowledged that it may be difficult to estimate the timing and amount of future cash flows for distressed assets.

5. The EP members considered the following scenario:

A business development company (BDC) invests in a non-registered fund that will not be consolidated. The investee fund is a partnership and not a corporate entity or corporate trust. As a result, the investee fund will not be required to make distributions in the normal course as income will be allocated to its various partners. ASU 2013-08 precludes investment companies from using the equity method of accounting for investments in other investment companies. How should the BDC record income from the investee fund and how should it record distributions it receives?

The EP members discussed that, in the absence of equity method accounting, it appears that recognition of income at the investee fund would likely result in an increase in the value of the investee fund. One EP member noted that to the extent the investee fund makes distributions, the investee fund would, as an unincorporated entity, consider the distributions to be deemed withdrawals from the partnership and the BDC would record the transaction as a sale of a portion of its investments with the potential recognition of capital gain or possibly a return of capital.

Some EP members noted that the BDC should consider the character of the distribution received by the BDC. One EP member's understanding is that historical practice, especially for private equity funds, is for the distributions to be recorded by the BDC based on the underlying character of income being distributed (often capital gains or return of capital for a private equity fund). One EP member shared that certain investee funds provide an investor fund with information about components of distributions (capital gain, ordinary income, or return of capital), which the investor fund would, in turn, use to record the investor's fund's realized or unrealized gains.

The EP generally does not anticipate significant changes in accounting for distributions received from an underlying fund.

6. Real Estate Investment Trust (REIT) Investments that Participate in Security Lending Programs

For REITs, dividend distributions for tax purposes are allocated to ordinary income, capital gains and return of capital, each of which may be taxed at a different rate. All public companies, including REITs, are required early in the calendar year to provide their shareholders with information clarifying how the previous calendar year dividends should be characterized for tax purposes. This information is distributed by each company to its list of shareholders on IRS Form 1099-DIV. An [historical record](#) of the allocation of REIT distributions between ordinary income, return of capital and capital gains can be found in the [Industry Data](#) section of REIT.com.

Certain registrants treat the character and/or timing of distributions on REITS differently for tax and GAAP purposes.

The EP considered a scenario where a REIT pays a distribution while it is on loan pursuant to a security lending program. For tax purposes, the payment is a substitute payment and is entirely ordinary income.

For US GAAP purposes, there is differing practice:

- Some registrants treat the dividend on a REIT on loan the same as what is done for US tax purposes.
- Others do not differentiate on the payments, given that a Fund does not "sell" the security under FASB ASC 860*. Therefore, a payment on a REIT on loan will retain its character as income, capital gains and/or return of capital based on the character of the payment.

*FASB ASC 860-30-25-7 continues to explain that those transactions should be accounted for as secured borrowings, in which (a) cash (or other securities that the holder is permitted by contract or custom to sell or repledge) received as collateral is considered the amount borrowed, (b) the securities loaned are considered pledged as collateral against the cash borrowed and reclassified Chapter 7 - Financial Statements of Investment Companies Page

as set forth in FASB ASC 860-30-25-5(a), and (c) any rebate paid to the transferee of securities is interest on the cash that the transferor is considered to have borrowed.

The EP members noted discussions held in 2013 in connection with recording of substitute payments (dividend income less foreign withholding tax) on foreign equity securities that have been lent by a fund over the ex-dividend date. During the June 2013 call, some EP members expressed a view that since foreign withholding tax is an income tax, the guidance in ASC Topic 740 would apply. Under the scenario presented to the EP in July 2014, one view is that the fund should record the distribution as ordinary income consistent with the tax treatment since the fund will not obtain the character reported by the REIT on the annual Form 1099-DIV. Another view is that since the fund does not “sell” the security and there is no precedence for another ASC Topic to apply, this REIT distribution would be treated as if the fund still owns the REIT security and an allocation to investment income, capital gain and return of capital would be made for GAAP purposes based on reporting by the REIT. The EP will revisit this topic at a future meeting.

7. The EP will revisit current drafts of TPAs at the September EP meeting to determine whether to move forward with them.

III. Audit and Attest Issues

1. The Expert Panel previously discussed timing of communication of the audit firm with audit committees in light of the recently issued PCAOB Auditing Standard No. 16, *Communications with Audit Committees, and Amendments to other PCAOB Standards*. Footnote 43 in the Auditing Standard (AS) No. 16 states:

Consistent with Rule 2-07 of Regulation S-X, 17 C.F.R. § 210.2-07, in the case of a registered investment company, audit committee communication should occur annually, and if the annual communication is not within 90 days prior to the filing of the auditor's report, the auditor should provide an update in the 90-day period prior to the filing of the auditor's report, of any changes to the previously reported information.

This exception currently enables fund complexes to have quarterly audit committee meetings (rather than monthly audit committee meetings). Certain members of the EP concluded, from PCAOB's 2010 Proposing Release No. 2010- 001 and the 2012 adopting release (No. 2012-004), that the PCAOB did not intend to change current practice for investment companies.

Example: Audit Committee has quarterly meetings on 1/15, 4/15, 7/15, and 10/15. For a 12/31/13 fiscal year end registered investment company, financial statements are issued by 2/28/14. As there is an audit committee meeting on 1/15/14, the meeting and communication is within 90 days prior to filing.

As a registered investment company's financial statements have to be filed with the SEC within 60 days after year-end, the quarterly meetings would suffice to meet the requirements under Rule 2-07 of Regulation S-X and all communication standards under AS 16. However, without any other oral or written communication, the final signed management representation letter in connection with the 12/31 audits may not be reported to the audit committee until the following quarterly meeting on 4/15 (which is approximately 45 days after issuance of financial statements on 2/28).

Paragraphs 25 and 26 of AS 16 states:

Form and Documentation of Communications

25. The auditor should communicate to the audit committee the matters in this standard, either orally or in writing,^{in 41} unless otherwise specified in this standard. The auditor must document the communications in the work papers, whether such communications took place orally or in writing.^{in 42}

Note: If, as part of its communications to the audit committee, management communicated some or all of the matters identified in [paragraphs 12](#) or [18](#) and, as a result, the auditor did not communicate these matters at the same level of detail as management, the auditor must include a copy of or a summary of management's communications provided to the audit committee in the audit documentation.

Timing

26. All audit committee communications required by this standard should be made in a timely manner and prior to the issuance of the auditor's report.^{in 43} The appropriate timing of a particular communication to the audit committee depends

on factors such as the significance of the matters to be communicated and corrective or follow-up action needed, unless other timing requirements are specified by PCAOB rules or standards or the securities laws.

Note: An auditor may communicate to only the audit committee chair if done in order to communicate matters in a timely manner during the audit. The auditor, however, should communicate such matters to the audit committee prior to the issuance of the auditor's report.

Reporting all final signed management representation letters to the audit committee before issuance of the opinion would place an undue burden on both the auditor and audit committee for fund complexes that have numerous management representation letters issued for funds throughout the year. Historical practice has been to either include the final signed management representation letters in the following quarterly audit committee meeting and/or include a standard management representation letter that is used as a template for all funds across the investment company fund complex within each quarterly communication. If there were any significant modifications to the standard management representation letter for an individual fund, such as an appendix for uncorrected or corrected misstatements above a clearly trivial amount, they would be communicated to the audit committee prior to issuance the opinion if significant based on the judgment of the auditor and management. This communication would either occur through management or directly by the auditor in accordance with paragraph 25 of AS16.

Subsequent to the October 2012 meeting, as documented in May 20 2014 EP meeting highlights, EP members from public accounting firms generally agreed that 1) the PCAOB did not intend to change current practice, 2) that quarterly communication (including the management representation letter) was typically adequate under the standard unless there were significant changes since the most recent communication, 3) that significant changes since the most recent communication with the audit committee (e.g., disagreements with management, significant difficulties in conducting the audit, etc.) should be communicated timely, and 4) that, in certain circumstances, better practices may include more frequent than quarterly communication with the audit committee or audit committee chair.

At the May meeting, EP members reconfirmed their view with respect to Auditing Standard No. 16.

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 call to discuss the following questions presented by the EP members and also share additional observations:

1. On July 23, 2014, the SEC adopted amendments to the rules that govern [Money Market Funds](#) (MMF rules) that, among other things, will require institutional prime money market funds, for purposes of sales and redemptions, to move from transacting at a stable net asset value (NAV) per share rounded to the nearest penny (e.g., \$1.00) to a floating NAV based on the current market value of the securities in their portfolios rounded to the nearest basis point (e.g., \$1.0000). Government and retail money market funds will be allowed to continue using the amortized cost method of valuation and/or penny rounding method of pricing to seek to maintain a stable share price.

The MMF rules define a government money market fund as a money market fund that invests 99.5% or more of its total assets in cash, government securities, and/or repurchase agreements that are collateralized solely by government securities or cash. A retail money market fund is a money market fund that has policies and procedures reasonably designed to limit all beneficial owners of the money market fund to natural persons. A municipal (or tax-exempt) money market fund will be required to transact at a floating NAV unless the fund meets the definition of a retail money market fund, in which case it would be allowed to

use the amortized cost method of valuation and/or penny rounding method of pricing to seek to maintain a stable share price.

The MMF rules will allow fund boards discretion to impose liquidity fees and redemption gates in times of market stress if a money market fund's level of "weekly liquid assets" falls below certain thresholds, as follows:

- a. Liquidity fees:
 - If a money market fund's level of "weekly liquid assets" falls below 30% of its total assets, the board will be allowed to impose a liquidity fee of up to 2% on all redemptions but only if the board (including a majority of independent directors) determines that such a fee is in the best interests of the fund.
 - If a money market fund's level of "weekly liquid assets" falls below 10% of its total assets, the fund will be required to impose a liquidity fee of 1% on all redemptions. The fee would not be imposed if the board (including a majority of independent directors) determines that it would not be in the best interests of the fund or that a lower or higher (up to 2%) liquidity fee is in the best interests of the fund.
- b. Redemption gates – if a money market fund's level of "weekly liquid assets" falls below 30% of its total assets, its board (including a majority of independent directors) can, if it determines that it is in the best interests of the fund, temporarily suspend redemptions (gate). If a gate is imposed, a money market fund would be required to lift that gate within 10 business days, although the board could determine to lift the gate earlier. Money market funds would not be able to impose a gate for more than 10 business days within any 90-day period.

The amendments to MMF rules change certain diversification requirements for money market funds' portfolios, enhance stress testing requirements, enhance disclosure requirements (e.g., (1) website disclosure, such as daily disclosure of: (a) level of daily and weekly liquid assets; (b) net shareholder inflows or outflows; (c) market-based NAV/share; (d) imposition of fees and gates; and (e) any use of affiliate sponsor support; (2) new material event disclosure on Form N-CR including: (a) imposition or removal of fees or gates and the primary considerations or factors taken into account by a board in its decisions related to fees and gates; (b) default or event of insolvency of a portfolio security that accounts for at least ½ of 1% of the fund's assets; (c) sponsor or fund affiliate support including the amount of support and a brief description and the reason for support; and (d) for retail and government money market funds – a fall in the fund's market based NAV/share below ¼ of 1% of its intended stable share price (e.g., if market based NAV/share falls below \$0.9975 for a fund that seeks to maintain a \$1.00 stable NAV/share); and (3) disclosure of sponsor support), and also amend:

- Form N-MFP to require additional information that will assist in assessing money market fund risk and eliminate the current 60-day delay on the public availability of the information filed on the form and make it public immediately upon filing, and
- Form PF to require an adviser to a large liquidity fund (a liquidity fund is a private fund that seeks to maintain a stable NAV (or minimize fluctuations in its NAV) similar to a registered money market fund) to report substantially the same portfolio information as registered money market funds are required to report on Form N-MFP.

In connection with the adoption of MMF rules, the U.S. Department of the Treasury and the Internal Revenue Service released two types of [tax guidance](#) ((1) proposed regulations to allow floating NAV money market fund investors to use a simplified tax accounting method to track gains and losses, which will eliminate the need to track individual purchase and sale transactions for tax reporting purposes and could be used beginning July 23, 2014 and (2) a new revenue procedure providing relief from the "wash sale" rules for any losses on shares of a floating NAV money market fund).

The adopting release includes valuation guidance and accounting guidance which have been codified into the Commission's Codification of Financial Reporting Policies. The valuation guidance (beginning on pg. 277) pertains to the use of amortized cost, fair value for thinly-traded securities and the use of pricing services. The accounting guidance pertains to the determination of whether an investment in a floating NAV money market fund or a money market fund which has the ability to impose liquidity fees or gates meets the definition of a "cash equivalent" for purposes of U.S. GAAP. The Commission indicated in

the adopting release that under normal circumstances, an investment in a money market fund with a floating NAV or a money market fund that has the ability to impose a fee or gate qualifies as a “cash equivalent” for purposes of U.S. GAAP. However, as is currently the case, events may occur that give rise to credit and liquidity issues where shareholders would need to reassess their investments in money market funds to determine whether they continue to meet the definition of a “cash equivalent.” If events occur that cause shareholders to determine that their money market fund shares are not cash equivalents, the shares would need to be classified as investments, and shareholders would have to treat them as trading securities or available-for-sale securities in accordance with ASC 320. The Commission also indicated in the adopting release that a more formal pronouncement to confirm this position is not required because the federal securities laws provide the Commission with plenary authority to set accounting standards.

The compliance dates for the MMF rules are as follows:

- Floating NAV and Fees and Gates Amendments – October 14, 2016 (2 years)
- New Form N-CR – July 14, 2015 (9 months)
- Diversification, Stress Testing, Disclosure, Form PF, Form N-MFP and clarifying amendments – April 14, 2016 (1.5 years)

2. As originally communicated during the May 2013 EP meeting, the SEC staff issued a letter, in April 2013, denying the no-action relief requested by Copley Fund, Inc. (“Copley”), an open-end fund that is a C Corporation for tax purposes (i.e., a tax paying entity and not a RIC under Subchapter M). Copley sought relief from recording the full amount of its deferred federal tax liability on unrealized gains which is required to be recorded under GAAP. Instead, Copley proposed calculating its deferred federal tax liability for unrealized gains using a management-developed estimate based on a pre-set formula. In its response, the SEC staff declined to provide assurance that it would not recommend enforcement action to the SEC against Copley under rule 22c-1 under the Investment Company Act of 1940 (1940 Act) or rule 4-01(a)(1) of Regulation S-X if Copley calculated its deferred tax liability as Copley proposed.

During the July 2014 conference call, the SEC staff communicated that in September 2013, Copley applied to the Commission for an Order for Exemptive Relief to account for its deferred tax liability on unrealized gains by establishing a tax reserve based on a pre-set formula. In May 2014, the Commission issued a [Notice of Application](#) (Notice) to Copley indicating its preliminary views that an exemption from rule 22c-1 under the 1940 Act and rule 4-01(a)(1) of Regulation S-X is not necessary or appropriate in the public interest and is not consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the 1940 Act. In the Notice, the Commission explained the rationale for its preliminary views. On June 20 2014, the Commission issued a final [Order](#) denying the requested exemptions. The SEC staff also noted that Copley has sued the SEC for declining to grant the requested exemptive relief.

3. The SEC staff provided the following comments in connection with recent financial statement and registration statement reviews:
 - a. During the December 2013 EP conference call, the SEC staff described a scenario where a registered investment adviser (RIA) to a business development company (BDC) incurred all of the organizational and offering costs on behalf of the BDC, which were subject to immediate reimbursement by the BDC to the RIA upon the successful completion of the initial public offering of the BDC. In addition to including the commitments and contingent liabilities line item on the balance sheet with a reference to the footnotes, the BDC also included a footnote on the face of the balance sheet describing the amount and details of the potential reimbursement. Most recently, another BDC had a similar fact pattern where the RIA incurred the majority of the organizational and offering costs and the BDC was required to reimburse the RIA under the terms of the agreement in place with the RIA (which was reimbursement upon the successful completion of the BDC’s IPO). In this case, the BDC included the dollar amount of the potential reimbursement on the face of the balance sheet and provided the full description of the commitment and contingent liability in the footnotes to the financial statements instead of on the face of the balance sheet. If a BDC with this type of fact pattern does not record the liability in the financial statements under ASC 450 *Contingencies*, the SEC staff indicated that they would not object to such presentation on the balance sheet:

Commitments and contingent liabilities (\$xxx, Note X)

- b. The SEC staff has recently considered various wholly owned or substantially wholly owned holding company structures that may be used by BDCs and RICs and provided the following hypothetical scenario that could be of particular concern if the holding company is not consolidated:

A BDC invests in a holding company, which was set up to invest in the equity of an operating company. The BDC owns all the debt and all the equity of the holding company, and there is no 3rd party debt or equity investor in the holding company. The BDC invested \$100 in the holding company (\$85 debt and \$15 equity). The holding company invested that \$100 in the equity of an operating company. For its most recent fiscal year, the operating company paid a \$10 distribution to the holding company comprised of \$7 of dividend income (based on the operating company's earnings and profits ("E&P")) and \$3 of return of capital, and the holding company paid \$10 of coupon payments to the BDC to satisfy interest owed on the BDC's debt investment. At year-end, assume for simplicity for purposes of this hypothetical example, fair value of each of the BDC's and holding company's investments is equal to cost.

In this hypothetical scenario, if the BDC does not consolidate the holding company:

- i. The BDC's schedule of investments would show an \$85 debt investment and a \$15 equity investment in the holding company.
- ii. The BDC's statement of operations would show all \$10 of coupon payments received from the holding company as interest income, therefore increasing net investment income by \$10.

If the BDC consolidates the holding company:

- i. The BDC's schedule of investments would show a \$100 equity investment in the operating company.
- ii. The BDC's statement of operations would show \$7 of dividend income, therefore increasing net investment income by \$7.

The SEC staff expressed concern that not consolidating the holding company in this hypothetical scenario might confuse investors about the actual risks of the BDC's investment, as investors may perceive debt investments to be less risky than equity investments. The SEC staff also expressed concern that not consolidating the holding company in this hypothetical scenario results in the recharacterization of \$3 of return of capital to net investment income, which results in an increased yield advertised to investors (yield is calculated based on net investment income) and increased income incentive fees earned by the adviser (whereas if the BDC consolidated the holding company, interest income recorded by the BDC would be eliminated in consolidation with the interest expense recorded by the holding company and dividend income would only be recognized to the extent of the operating company's E&P).

The SEC staff also indicated they would be concerned if a BDC, in a similar hypothetical scenario, contributed cash to an unconsolidated wholly owned or substantially wholly owned holding company and immediately received the cash back from the holding company as satisfaction of interest owed and recorded as interest income (whereas if the BDC consolidated the holding company, even if the BDC recorded the amount received from the holding company as interest income, it would be eliminated in consolidation with the interest expense recorded by the holding company, and the BDC could only record investment income to the extent the operating company made a distribution from E&P).

The SEC staff reiterated their view expressed during the May meeting that they generally would expect a RIC or BDC to consolidate a wholly-owned or substantially wholly-owned subsidiary when the design and business purpose of the subsidiary is to act as an extension of the operations of the parent investment company and is used to facilitate the execution of the parent's investment strategy (e.g., blocker, SBIC, certain holding companies, etc.). RICs and BDCs are encouraged to consult with the SEC staff if they believe that consolidating a wholly owned or substantially wholly owned subsidiary does not provide the most meaningful presentation.

- c. Related party transactions – during a review of a filing by a BDC, the SEC staff questioned a material balance on the balance sheet presented as a “Due from Adviser.” The amount had been outstanding for more than one year, with only minimal payments made by the adviser to the BDC to satisfy amounts owed. The SEC staff questioned the collectability of the amount due from the adviser to the BDC and also inquired of the BDC’s auditor about how the auditor determined that this amount was collectible. After internal consultation, the SEC staff made a legal determination that the “Due from Adviser” is considered a loan and is a violation of Section 57 of the 1940 Act. Further, until full payment of the loan was made, the BDC could not sell shares. Afterwards, the adviser fully repaid the obligation, with interest. The SEC staff also reminded the EP of an [enforcement case](#) (finalized in 2004) against an auditor who engaged in improper professional conduct when he failed to, among other things, obtain sufficient competent evidence regarding the probable collectability of a receivable and was denied the privilege of appearing or practicing before the Commission as an accountant for 1 year.
- d. The SEC staff informed the EP about three IM Guidance Updates that were recently issued:
- [2014-07](#) - Private Funds and the Application of the Custody Rule to Special Purpose Vehicles and Escrows
 - [2014-08](#) - Guidance Regarding Mutual Fund Enhanced Disclosure
 - [2014-09](#) - Business Development Companies with Wholly-Owned SBIC Subsidiaries-Asset Coverage Requirements
- e. Performance Fee Arrangements — A performance fee arrangement commonly referred to as a “fulcrum fee arrangement” varies the adviser’s compensation proportionately with the fund’s performance relative to an index of securities prices over a specified period. The fulcrum fee arrangement has two components, the performance adjustment amount and the base fee amount (the base fee amount is referred to as a “fulcrum fee” in Rule 205-2).

The SEC staff noted that certain registered funds entering into fulcrum fee arrangements with their advisers incorrectly structure and/or incorrectly describe how these fees are calculated in proxy statements and other filings. These registrants are incorrectly calculating the performance fee by multiplying the performance adjustment percentage by the average net assets over the most recent subperiod, instead of multiplying the performance adjustment percentage by the average net assets over the performance measurement period. For example, certain registered funds had disclosed that the performance adjustment would be calculated using the most recent subperiod of the performance measurement period (e.g., monthly average net assets) instead of the average net assets over the entire performance measurement period (e.g., a rolling 36-month period).

The staff reminded the EP how section 205(b)(2) of the Advisers Act and rules 205-1 and 205-2 thereunder require a fund to calculate a fulcrum fee paid to a fund’s adviser.

The performance adjustment amount is a percentage, e.g., 0.5%, multiplied by average net assets over a performance measurement period specified in the advisory contract, e.g., a rolling 36-month period. The performance adjustment percentage increases proportionately as the difference between the fund’s performance and the index increases. The performance adjustment amount is added to the base fee amount if the fund outperforms the index; that amount is subtracted from the base fee amount if the fund underperforms the index. If the fund’s performance is within a specified number of percentage points of the index’s performance, the base fee amount is not adjusted. The base fee amount is a percentage, e.g., 1.0%, multiplied by average net assets during either (a) the performance measurement period; or (b) the most recent subperiod or subperiods of the performance measurement period, provided that the performance measurement period is a rolling period. Whichever option the fund elects should be specified in the fund’s advisory contract and applied consistently.

Funds that choose to calculate the base fee using average net assets for the most recent subperiod sometimes incorrectly state or imply that the performance adjustment is calculated using the same asset base. The performance adjustment

amount, however, always is calculated using average net assets for the performance measurement period (i.e., the performance adjustment amount cannot be calculated using average net assets over the most recent subperiod or subperiods of the performance measurement period). A fund might incorrectly state, for example, that an adviser's fee will be no less than 0.5% of current net assets and no more than 1.5% of current net assets where the base fee percentage is 1.0% and the maximum performance adjustment percentage is 0.5%. This statement is incorrect because the base fee amount and the performance adjustment amount must be calculated using average net assets over different time periods.

Under certain circumstances, the advisory fee might be negative, *i.e.*, the adviser pays the fund, when the performance adjustment is calculated using average net assets over a rolling performance measurement period and the base fee is calculated using the average net assets over the most recent subperiod. This situation can occur where the fund underperforms the index, and fund assets decline significantly as a consequence of performance or net redemptions. Average net assets over the performance measurement period, used to calculate the performance adjustment amount, is a larger number than average net assets over the current subperiod, used to calculate the base fee. As a result, the negative performance adjustment can be greater than the base fee amount. The SEC staff is reviewing the disclosure describing the terms of the advisory fee agreement and looking for specific disclosure stating that the adviser will reimburse the fund when the negative incentive adjustment exceeds the base fee.

The SEC staff also recommends that advisory contracts include examples of fee calculations as an exhibit and include similar examples where appropriate in descriptions of the performance fee included in other Commission filings.

Investment Companies Expert Panel

Highlights of the September 16, 2014 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 depository institutions industry to deliberate and come to agreement on key depository institutions issues.

The following are brief highlights of the meeting:

I. AICPA/Administrative:

1. The Expert Panel (EP) chair thanked outgoing EP members for their contributions to the EP over the past years.
2. The March EP call highlights have been posted to the EP webpage on aicpa.org. July 2014 conference call and May 2014 meeting highlights are being finalized.
3. Asset Management Revenue Recognition Task Force (AM RRTF) chair provided a status update on the progress of the AM RRTF to date and highlighted implementation issues identified by the task force.
4. The new AICPA Technical Manager responsible for developing annual proposed conforming changes to the AICPA Audit and Accounting Guide *Investment Companies* joined the meeting and discussed anticipated timing of review process.

II. Accounting/Reporting Issues:

1. The EP discussed accounting implications for entities that hold shares in entities that effect corporate inversions. In an inversion, typically the acquiring company adopts the foreign legal jurisdiction of the acquired company. One of the tax results is that the reincorporation of the acquiring domestic company abroad triggers realization of capital gains on the stock of the acquiring company based on its stock price at the acquisition date. This is unlike a typical merger where no change in tax basis occurs in the stock of the acquiring company, regardless of how the acquisition of the acquired company is treated for tax purposes. Shareholders of the acquiring company have to approve the reincorporation, which is consummated by trading shares of the domestic company for the foreign company. In essence this is a legal form transaction only.

The EP considered whether these transactions should result in recognition of realized gain/loss for US GAAP, as well as tax. One EP member expressed a view that although there is a tax step-up (realized gain/loss) for shareholders of the acquiring company, since the substance of the ownership interest has not changed, a corporate inversion would not constitute a realization event for GAAP purposes. Another EP member analogized corporate inversions to an exchange of a financial instrument. Specifically, whether a sale

has occurred if “substantially the same” securities are received as those given up, which may not be a realization event. However, certain EP members noted that an exchange of shares for the acquired company has occurred and the acquired entity is foreign domiciled, which may carry certain legal and other implications. Therefore the securities received in exchange for those previously held may not constitute substantially the same securities.

The EP generally agreed that a difference between classification of unrealized and realized capital gain/loss is generally not significant to the users of the financial statements for most funds. The EP further acknowledged that if a corporate inversion was not considered a realization event for GAAP then this would result in a permanent book/tax difference that may be difficult to track operationally.

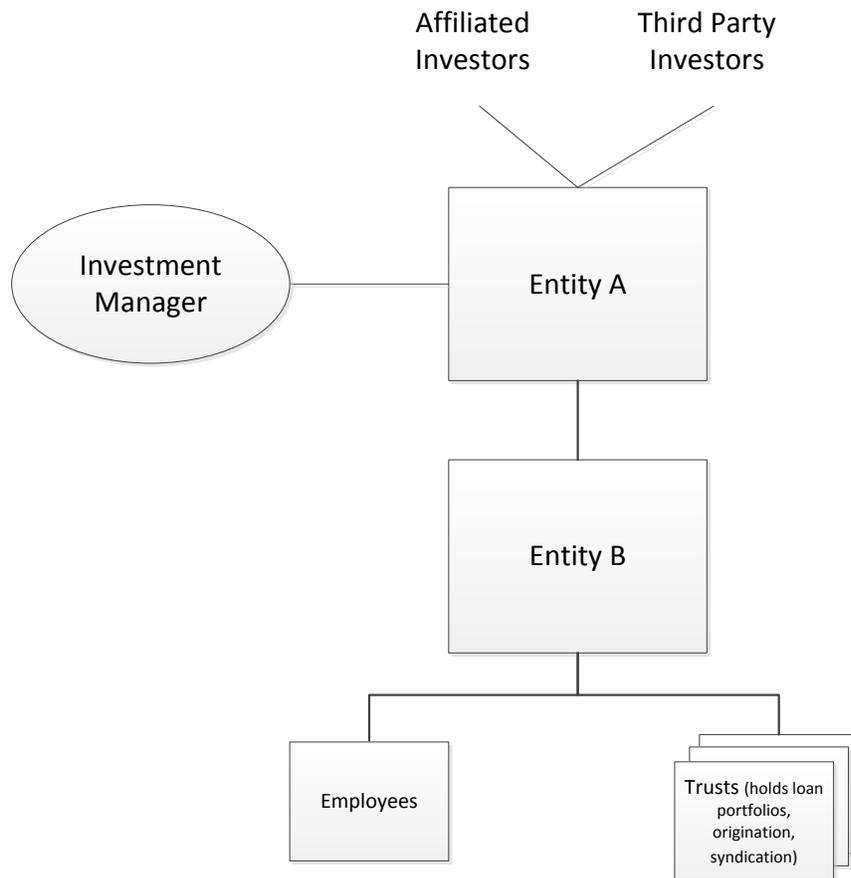
The EP noted that there may be basis for both interpretations depending on the facts and circumstances of the transaction and judgment should be used. As a result the basis should be properly supported and documented.

2. The EP considered the disclosure impact of the recently passed amendments to the rules that govern money market funds. One EP member highlighted that for some funds the business impact might constitute a "significant risk and uncertainty" under ASC Topic 275 *Risks and Uncertainties* (formerly AICPA SOP 94-6). The business impact might be more significant for funds with retail and institutional classes and funds that have a large group of institutional shareholders. ASC Topic 275 requires disclosure of certain risks and uncertainties for items with a "near term" impact which is defined as a period of time not to exceed one year from the financial statement date. The significant provisions of the reform do not take effect until 2016 (that is, two years) and therefore the effective date is not within the scope of near term, as defined. However, if the “impact” (redemption of institutional shareholders, changes in fund structure to separate institutional and retail money market products, etc.) is expected to occur upon passage of time without any other intervening events, a practitioner might conclude that the event should be disclosed. A fund's decision to disclose the potential impact of the rule amendments in the fund's prospectus may provide an indication as to the potential significance of any potential impact on the fund and may be considered in determining whether financial statement disclosure is appropriate.

Certain EP members indicated that they had seen brief financial statement disclosure similar to those required by ASC Topic 250-10-S99-5 (Staff Accounting Bulletin No. 74) and had not seen risk and uncertainty disclosure required by ASC Topic 275. Those EP members that supported this disclosure noted that although the money market reform rules are not a new accounting standard, the rules could affect the use of amortized cost. Still other EP members shared that they have included a statement that management is evaluating the provision of the rule in the fund's prospectus and Management's Discussion of Fund Performance (MDFP). The EP members generally agreed that footnote disclosure describing that the new rule has been issued and the management is considering its impact would be appropriate. The EP also highlighted the additional guidance on valuation and use of amortized cost included in the SEC money market fund rules. The EP will revisit this topic at the November EP meeting.

3. During the March 12, 2014, EP conference call, the EP members were asked to share their views on what constitutes a substantial business activity or substantial source of income that would prohibit an entity from qualifying as an investment company. Specifically, the EP discussed whether originating or seasoning loans may be considered a separate substantial business activity, even though the ultimate purpose of the entity is to provide returns from capital appreciation and investment income. At the September 16, 2014 EP meeting, the EP discussed the following example.

Entity A is raising capital in a private placement from various investors to invest in Entity B. Entity A has delegated management of the activities of Entity A to an investment manager (“IM”). Entity B is a portfolio company with 50+ employees and >\$1b in assets (primarily consisting of loans that are held in multiple underlying vehicles). Entity B's activities are primarily comprised of investing in loan portfolios but also includes the origination and syndication of loans. Entity B's substantial source of income (>93%) is generated mainly from investments in loans (an investing activity that is more passive in nature). A portion of income (<7%) is generated from fees for the origination and syndication of loans. The EP members were asked to share their views whether the loan origination activities in this example would be considered a separate substantial business activity and if Entity A would meet the fundamental characteristic of an investment company included in ASC 946-10-15-6(b).



The EP members acknowledged that the investment company standard is principles-based, and that one has to analyze the facts and circumstances in order to make a determination. For this specific scenario, more information was needed to make any determination.

However, the EP members considered the following factors which could help determine whether or not the entity was or was not an investment company: the substance of both entities and structure (is the structure and purpose more similar to a bank or an investment company), whether entity B is regulated by a banking regulator, who the investors are, whether Entity B is viewed as a bank or an investment company, whether Entity B is making distributions to Entity A, whether the origination services are offered to the lenders, as opposed to the fund, what employees of Entity B do as compared to the Investment Manager (IM), how much of the investment in Entity A is from third parties, how the IM is compensated, whether entity A is being consolidated into another entity and whether that would have any ramifications on the accounting for Entity B, etc.

Acknowledging that more information was needed, certain EP members thought that if Entity B could be an investment company, then it would lead to a conclusion that an Entity A could be an investment company, as these EP members noted that the relationship of Entity A and Entity B may be similar to a master-feeder structure. These EP members also recommended looking at both entities to determine investment company status, as determination for Entity B will impact the determination for another (Entity A).

Some EP members viewed Entity B more as an extension of the investment company. These EP members believe that if the loan origination and syndication activities or income was less than 10%, they would not be considered substantial.

The EP expressed a general view that diversity in practice for other similar structures currently exists and determination of investment company status should be based on facts and circumstances, using some of the considerations above.

4. The FASB Private Company Council (“PCC”) issued the Private Company Decision-Making Framework: *A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (the “Guide”). “Business entities that are within the scope of this Guide are

those for which the Board and the PCC would consider potential alternatives within U.S. GAAP. However, the Board acknowledges that decisions about whether an entity may apply permitted alternatives within U.S. GAAP ultimately may be determined by regulators, lenders and other creditors, or other financial statement users that require U.S. GAAP financial statements. The Board decided that a business entity is not within the scope of this Guide if it meets any one of the following criteria:

- a. It is required by the U.S. Securities and Exchange Commission (SEC) **to file or furnish** financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion. (*emphasis added*)”

The EP considered whether this definition would exclude private equity funds, hedge funds, and other private funds that may be asked to provide financial statements to the SEC upon a custody rule exam. The EP members expressed a view that “file or furnish” does not encompass providing financial statements to the SEC staff upon request as part of SEC examination. The EP recommended this is clarified in future editions of AICPA Audit and Accounting Guide *Investment Companies*.

5. The EP discussed prepayment fees on bonds. Certain bonds, especially middle market private deals, may have a call premium or pre-payment fee above and beyond the stated par amount payable to the holder of the bond if the bond was prepaid. The EP members generally see these prepayment fees on bonds categorized as investment income, especially for business development companies, but noted that diversity in practice exists. Due to the lack of guidance in this area, some EP members observed that the treatment of the prepayment fee for tax purposes may be a consideration in determining the book accounting treatment.
6. The EP continued discussing draft TPAs. The AICPA staff will seek additional comments from the EP. The EP will revisit draft TPAs at the November EP meeting.
7. The EP discussed EITF Issue No. 14-B, “Fair Value Hierarchy Levels for Certain Investments Measured at Net Asset Value.” The EP will revisit this topic at the November EP meeting.

III. Audit and Attest Issues

1. The EP discussed that the PCAOB continues to raise independence concerns in connection with their interim inspections of broker-dealer audits, including concerns regarding auditors providing financial statement word processing (which may include certain financial statement production activities) assistance to audit clients that are required to follow SEC independence rules (which includes broker dealers and investment companies where the audit is used to satisfy the pooled investment vehicle audit exemption for the custody rule). The EP considered the applicability of these issues to the investment management industry (in particular, registered investment advisers that are subject to the custody rule) and discussed whether accounting firms are significantly changing their current practice in connection with the independence concerns raised. The EP members agreed that audit firms are aware of, and have changed their practices to comply with, the SEC staff’s views regarding word processing to investment companies where the financial statements were being used to satisfy the pooled investment vehicle audit exemption under the custody rule.
2. Under the Investment Company Act of 1940, the auditor’s report on the audit of a registered investment company’s financial statements must state specifically that securities have been confirmed or physically examined to substantiate their existence. The EP members discussed this requirement in context of business development companies that present comparative balance sheets. EP members agreed that the auditor is required to state

specifically that securities have been confirmed or physically examined to substantiate their existence at both balance sheet dates.

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 meeting to discuss the following questions presented by the EP members and also share additional observations:

1. The EP discussed that the FASB issued a proposed ASU that would eliminate "extraordinary items" from GAAP. Currently, the instructions for the operating expense table for investment company registration statements on Form N-1A allow the exclusion of expenses that meet the GAAP "extraordinary item" definition. If the ASU is finalized as proposed, it may affect how practitioners comply with Item 3 of Form N-1A. Further, it may affect expense limitation agreements, since there would be no standard criteria to assess exclusions of "extraordinary" expenses from expense cap agreements. The SEC staff noted they are monitoring the FASB's project.

The SEC staff also noted that compliance with the expense limitation agreement is a legal determination.

2. The SEC staff has previously issued FAQs on Rule 206(4)-2 under the Investment Advisers Act of 1940 ("the Custody Rule"), which state, in part:

Question IV.5

Q: The Guidance for Accountants (<http://www.sec.gov/rules/interp/2009/ia-2969.pdf>) states that the accountant's surprise examination report must include an opinion as to whether the investment adviser had been complying with rule 204-2(b) since the prior examination date. When an investment adviser becomes subject to the surprise examination requirement for the first time, what period should such opinion cover?

A: The accountant should report on the investment adviser's compliance with rule 204-2(b) for a period beginning no later than the date the adviser became subject to the surprise examination requirement through the examination date. (Posted December 2, 2010)

The beginning date of the surprise examination period is either the "prior examination date" or the date the registered investment adviser (RIA) first became subject to the requirement. Considering that the surprise exam is an annual requirement, in a situation where an initial exam is to be performed for a current calendar year and the date the RIA first became subject to the requirement is in an earlier calendar year, the EP sought the SEC staff's views regarding the beginning date for the initial examination and offered the following scenario.

For example, the first exam to be performed for the RIA will be for calendar year 2014, but the RIA first became subject to the requirement in 2012. Would the beginning date for the 2014 exam be January 1, 2014? Or would the RIA first have to have a calendar year 2012 exam performed and then a 2013 calendar year exam performed before the 2014 exam can be performed?

The EP believes that if the RIA did not engage an independent accountant to conduct a surprise examination in prior periods when the RIA was subject to such requirement under the Custody Rule, the independent accountant may consider advising the RIA to discuss such matter with legal counsel and the SEC staff. The EP also believes that the independent accountant should consider the specific facts and circumstances and any discussions with the SEC staff and legal counsel, in determining whether the non-compliance matter constitutes a material non-compliance with the provisions of Rule 206(4)-2. Material non-compliance with the Custody Rule would be considered a material discrepancy that must be reported by the accountant to the SEC within one business day of the finding.

In addition, the EP sought the SEC staff's views regarding 1) whether a surprise examination should be conducted for each year a surprise examination was required under the Custody Rule (and whether it is possible to conduct a surprise examination for prior periods) and 2) if a surprise examination is only required to be conducted in the current year, what would be the beginning date of the surprise examination period.

The SEC staff stated that in this scenario, the RIA was not in compliance with the Custody Rule for the 2012 and 2013 calendar years, and there is no ability to retroactively cure this non-compliance. In this scenario, the first year that the RIA could be in compliance is the 2014 calendar year. As the SEC staff stated in the February 2011 EP minutes, based on facts and circumstances, the auditor may consider performing additional testing for the prior years (not for the purposes of compliance with the Custody Rule for prior years), even though the auditor was not engaged for those periods. The SEC staff emphasized that consultations with the SEC staff in these cases are encouraged, as facts and circumstances may vary.

3. The SEC staff provided the following comments in connection with recent financial statement and registration statement reviews.
 - a. Business Development Companies (BDCs):
 - (a) The SEC staff recently reviewed financial statements of BDCs with unconsolidated portfolio companies controlled directly by the BDCs or indirectly through controlled holding companies that are not consolidated by the BDCs, which did not include related party transactions disclosures in accordance with FASB ASC Topic 850. The FASB ASC 850-10-20 definition of related parties includes, among others, "affiliates of the entity" and "other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests." The SEC staff noted registrants should consider whether each of their unconsolidated controlled portfolio companies or holding companies meets the definition of a related party under FASB ASC 850-10-20, and, if so, registrants should include disclosure of material related party transactions in accordance with FASB ASC 850-10-50. For example, if a BDC invests in an unconsolidated controlled holding company which invests in an unconsolidated controlled portfolio company, the SEC staff would expect the BDC to disclose material related party transactions between each of the entities in accordance with FASB ASC 850-10-50 (e.g., disclosure of material related party transactions between (1) the BDC and the controlled holding company; (2) the BDC and the controlled portfolio company; and (3) the controlled holding company and the controlled portfolio company).¹
 - (b) The SEC staff recently reviewed a BDC which was required to include summarized financial information for a significant subsidiary in its notes to financial statements, in accordance with Rule 4-08(g) of Regulation S-X. While the BDC included the summarized financial information for its significant subsidiary in its notes to audited financial statements filed on Form 10-K, the disclosure was marked "unaudited." The SEC staff would like to remind registrants that when disclosure of summarized financial information for a significant subsidiary is required to be included in the notes to the financial statements, it should not be marked as unaudited.
 - (c) The SEC staff discussed it may be important for BDC shareholders to understand the amount of income generated by BDCs that is non-recurring. The SEC staff noted that BDCs may receive certain non-recurring fees from their borrowers, including up-front fees (e.g., financing fees or structuring fees) and back-end fees (e.g., prepayment fees or unamortized original issue discount (OID)). However, BDCs generally have not disclosed the impact of these non-recurring fees on earnings and/or yield (e.g., in either the financial statements or in Management's Discussion and Analysis). The SEC staff believes disclosure of the impact of non-recurring fees on earnings and/or yield

¹ Subsequent to the July 2014 EP meeting, the SEC staff issued [IM Guidance Update 2014-11](#) IM Guidance Update 2014-11 which, among other things, provides the staff's views that generally, a BDC should consolidate a wholly owned subsidiary or a substantially wholly owned subsidiary if the design and purpose of the subsidiary (e.g., holding company) is to act as an extension of the BDC's investment operations and facilitate the execution of the BDC's investment strategy, because the staff believes that consolidation provides investors with the most meaningful presentation in these circumstances.

- could be important to the users of financial statements to help investors analyze the BDC's potential future cash flows and dividend sustainability.
- (d) The SEC staff revisited the topic of accounting and financial statement presentation for organization and offering costs in seed financial statements, most recently discussed during the December 2013 EP meeting and the July 2014 EP conference call.

The SEC staff offered a recent fact pattern where a BDC filed a registration statement, and the seed financial statements did not include a line item on the seed balance sheet for commitments and contingent liabilities, which would otherwise be required pursuant to Article 6 of Regulation S-X, related to organization and offering costs for which the BDC could potentially reimburse the adviser pursuant to the terms of a reimbursement agreement. The footnotes to the seed financial statements included disclosure describing the amounts paid thus far by the adviser for organization and offering costs as well as the agreement in place between the BDC and its adviser and the terms which would subject the BDC to reimburse those costs. Based on these facts and consistent with views expressed previously, the SEC staff expects registrants to include a commitments and contingent liabilities line item on the balance sheet with a reference to the financial statement footnote that discloses information about any commitments and contingent liabilities. The BDC should also consider including the dollar amount parenthetically within the commitments and contingent liabilities line item.

In addition, the SEC staff noted that in this fact pattern, the terms of the reimbursement agreement described in the footnotes to the financial statements differed from the terms of the actual reimbursement agreement. Upon the SEC's staff's discussion with management of the BDC, management determined it was necessary to restate the financial statements since the organization and offering costs were being accounted for in accordance with the terms described in the footnotes to the financial statements rather than the actual terms of the reimbursement agreement.

The SEC staff expressed that it is important for registrants and their auditors to understand the terms of any reimbursement agreements and ensure that the accounting and disclosure are reflective of the actual terms.

- b. The SEC staff recently reviewed a registration statement where the registrant invested in master limited partnerships and had elected to be treated as a C corporation for tax purposes. Therefore, the registrant recorded income tax expense in the statement of operations. The SEC staff observed this expense was not included in the expense example required by Item 27(d)(1) of Form N-1A. The SEC staff reminded registrants that income tax expense should be included in the example required by Item 27(d)(1).

4. The SEC staff also shared the following observations:

- a. The SEC staff discussed a fact pattern related to examinations being performed in accordance with Rule 17f-2 under the Investment Company Act of 1940 (the rule). The rule requires a registered investment company that maintains custody of its securities and similar investments (either through its own self or through a bank or other company under any arrangement where the directors, officers, employees or agents of such company are authorized or permitted to withdraw such investments upon their mere receipt) to engage an independent public accountant to verify the securities and similar investments at least three times during each fiscal year, with at least two of these times to be chosen by the independent public accountant without prior notice to the registered investment company. A certificate detailing that such examination took place and describing the nature and extent of the examination performed by the independent public accountant must be filed with the SEC on Form N-17f-2 promptly after each examination.

The SEC staff discussed the following fact pattern. A fund was subject to the rule and the independent public accountant was engaged to perform the required asset verifications. Rather than selecting the exam dates during the year and commencing those exams promptly, the independent public accountant performed all of the testing when performing the year-end audit work. For example, the fund's year-end was December 31, 2013 and the independent public accountant selected

surprise verification dates in February and July 2013 and selected the year-end date (December 31, 2013) for the third verification. The independent public accountant commenced and performed all testing for the three verifications when performing the year-end audit. Because the independent public accountant commenced and performed all three verifications at one time, and not “during [the] fiscal year” as required by the rule, the SEC staff determined the fund was not in compliance with the rule.

- b. The SEC staff discussed situations where immaterial errors should be analyzed and documented pursuant to the guidance in SEC Staff Accounting Bulletins Nos. [99](#) and [108](#) (“SAB 99 and 108”). As a matter of practice, if the SEC staff is reviewing financial statements and an error is uncovered that the registrant believes is immaterial, the SEC staff may request a SAB 99 analysis (“analysis”). The SEC staff noted the analysis received from registrants sometimes has indicated that the errors are quantitatively material and qualitatively immaterial but not conclusive overall as to whether or not the error is material to the financial statements as a whole. The registrant should have an overall conclusion regarding whether the error is material based both on quantitative and qualitative factors.² The analysis provided to the SEC staff by the registrant should also include the conclusion reached by the independent accountant.

The SEC also staff noted that one registrant determined it had an immaterial error on Form 10-Q and suggested correcting the error by filing a Form 8-K. The SEC staff indicated that errors should not be corrected by filing a Form 8-K. Rather, immaterial errors may be corrected in the next 10-Q or 10-K filing, and if the error is material, amended Forms 10-Q and/or 10-K should be filed.

- c. The SEC staff noted that the EITF discussed EITF Issue No. 14-B, “Fair Value Hierarchy Levels for Certain Investments Measured at Net Asset Value.” This Issue deals with the fair value hierarchy categorization of an investment in an investment company that calculates net asset value per share or its equivalent and is redeemable at certain intervals. The SEC staff noted diversity in classification of these investments as Level 2 or Level 3 within the fair value hierarchy. EITF Issue No. 14-B will address this topic.

Investment Companies Expert Panel

Highlights of the November 12, 2014 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 depository institutions industry to deliberate and come to agreement on key depository institutions issues.

The following are brief highlights of the meeting:

I. AICPA/Administrative:

1. The Expert Panel (EP) welcomed new EP members.
2. The EP May 2014 highlights have been submitted for posting to aicpa.org, July 2014 conference call and September 2014 meeting highlights are being finalized.
3. The Asset Management Revenue Recognition Task Force (AM RRTF) chair and staff provided a status update on the progress of the AM RRTF to date.
4. The EP was updated on a joint call with representatives of several other AICPA Expert Panels on valuation and financial reporting considerations for entities that hold investments in equity securities of Fannie Mae and Freddie Mac whose values were affected by the Federal Court's September 30, 2014 decision to dismiss claims brought by investors in Fannie Mae and Freddie Mac. The court's decision was released after the close of the NYSE on September 30th. Update: the [summary](#) of issues discussed is posted to EP webpage on aicpa.org.
5. The AICPA Publications staff discussed timing of preliminary and final review for the proposed conforming changes to the 2015 AICPA Audit and Accounting Guide Investment Companies and sought volunteers for chapter reviews. The EP discussed a proposed approach for incorporating information regarding recently adopted Money Market Fund Reform into the 2015 Guide.
6. The EP considered options for making EP-only portions of EP meeting and call highlights available in a timelier manner on the EP webpage on aicpa.org and whether it would be appropriate to aggregate SEC Staff Updates from multiple EP calls and meetings into a separate document posted on the EP webpage.
7. The EP discussed 2015 dates for EP meetings and calls.

II. Accounting/Reporting Issues:

1. The EP considered the following [Money Market Fund Reform](#) (MMF rule) implementation questions:
 - a. A government money market fund is defined in the MMF rule as money market fund that invests at least 99.5% of its total assets in cash, government securities, and/or repurchase agreements that are collateralized by cash or government securities. The EP discussed that if a government money market fund has a large inflow of capital and

records a receivable for shares sold (offset to equity), the receivable would cause total assets to increase, so that investments in U.S. government securities would not meet the 99.5% threshold, and whether that is the intent of the rule. The EP considered that in addition to cash and U.S. government securities, including other “cash-type” assets, such as receivables that will settle within a short time period, may be reasonable. The EP was made aware that an industry group is raising numerous questions, including this issue, with the SEC with the expectation that the SEC will release a FAQ on the MMF rule.

- b. The EP revisited a topic on decimal places and financial highlights presentation described in the 2013 [AICPA comment letter](#) on proposed Money Market Fund Reform:

Instruction 1(b) to Item 13(a) *Financial Highlights Information* of Form N-1A requires funds to “List per share amounts at least to the nearest cent. If the offering price is expressed in tenths of a cent or more, then state the amounts in the table in tenths of a cent. Present the information using a consistent number of decimal places.”

Under the proposing release, a money market fund would be required to transact in its shares at the fourth decimal place in the case of a fund with a \$1.00 target share price (i.e., \$1.0000) or an equivalent level of precision if a fund prices its shares at a different target level (e.g., a fund with a \$10 target share price would price its shares at \$10.000). However, the guidance in Form N-1A would require the money market fund to express the amounts in the financial highlights table in tenths of a cent.

We recommend the Commission amend the Instructions to Item 13(a) *Financial Highlights Information* of Form N-1A to state if the offering price of a money market fund is expressed in tenths of a cent or more, then state the amounts in the table using a consistent number of decimal places of at least one tenth of a cent.

An EP member will develop an approach for SEC staff’s consideration and will share it with the EP for potential discussion with the SEC staff at the future EP conference call.

- c. As a follow up to the September EP meeting, the EP members shared recent experiences with respect to financial disclosures and shared that they continue to believe that general footnote disclosure describing that the new rule has been issued and the management is considering its impact would be appropriate.

2. The EP considered whether FASB Accounting Standards Update (ASU) No. 2014-15 *Presentation of Financial Statements— Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern* would apply to investment companies. The EP observed that the guidance from ASU No. 2013-07, *Liquidation Basis of Accounting*, doesn’t apply to investment companies regulated under the Investment Company Act of 1940 or limited-life entities that follow liquidation plans established at their inception. The EP considered whether investment companies would continue to report on the going concern basis even when liquidation is imminent and if there are certain circumstances in which the disclosures required by ASU 2014-15 would not apply. One EP member offered an example where a 1940 Act fund is in the process of being liquidated and it is probable that the adviser will need to make a contribution to the fund to cover breakage (that is, there is substantial doubt that the fund, on its own, would be able to meet its obligations as they become due over the course of the next 12 months). The EP members discussed this scenario and observed that redeemable shares of the fund (equity securities) generally would not be considered obligations of the fund under US GAAP. The EP members also noted that regardless of whether ASU 2014-15 applies, if material, the fact that the fund is being liquidated and that the adviser would be contributing money into the fund, should be considered for disclosure. EP members noted that most funds have substantially greater equity than they do debt and other obligations and it would be relatively rare that a fund would not be a going concern. Although an EP member observed that going concern issues for some funds did arise during the credit crisis/recession. The EP members also noted that technically, the standard would require an analysis/assessment of the funds ability to continue as a going concern (although it could potentially be documented in a memo that is periodically reviewed).

3. The EP discussed whether tender option bonds (TOBs) or self-deposited inverse floaters that are accounted for as secured borrowings by an investment company may be subject to the disclosure requirements of FASB ASU No. 2014-11 *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. An EP member raised an issue regarding whether the TOBs or self-deposited inverse floaters follow a similar model as reverse repurchase agreements and, therefore, may also be

considered a form of short-term secured borrowing within the scope of ASU 2014-11. One EP member observed that in the Investment Management [Staff Issues of Interest](#), the SEC Staff expressed a view that TOBs involve a borrowing by the fund and the issuance of a senior security under Section 18 of the Investment Company Act of 1940 unless the Fund segregates unencumbered liquid assets. This is similar to the views expressed by the SEC for Reverse Repurchase Agreements included in SEC Release 10666. Other EP members noted that the scope of the standard is intentionally narrow and that TOB transactions don't meet the definition of a repurchase agreement or a repurchase-to-maturity transaction and as such, would not be impacted by the ASU.

4. The EP member presented a scenario in which a fund (a parent fund) with a wholly-owned blocker fund(s) wrote an option and the subsidiary (wholly-owned blocker fund) purchased that option from the parent. The EP member inquired whether under this scenario, an option would be eliminated in consolidation. The EP expressed a view that since this is an intercompany transaction, a consolidation (and elimination of this option in consolidation) would be appropriate. The EP members also suggested that it may be appropriate to include disclosure of the option/guarantee provided by the parent.
5. As fund managers assess the impact of money market reform on their businesses, one of the potential outcomes is realignment of their money market fund offerings. In order to have an effective line-up of money market funds under the revised rules, fund managers may undertake mergers to consolidate certain of their funds. Money market fund shareholders currently transact at a dollar. However, there are three NAVs that may be relevant when considering the merger of money market funds: (1) \$1.00 transactional NAV, (2) amortized cost NAV, and (3) market value NAV.
EP members have seen in past practice registered investment advisers (RIAs) make the fund whole for differences between the market value NAV and \$1.00 to the extent that they deemed those differences would cause dilution to the acquiring fund's shareholders. Based upon the limited number of transactions they have seen, EP members have not observed transactions where dilution was absorbed by the acquiring fund. An EP member noted that if the acquired fund's market value NAV is at premium (greater than \$1.00), the fund could possibly sell some of its securities with values in excess of amortized cost and distribute gains to shareholders to bring the NAVs more in line.
6. The EP was made aware of recently issued IASB Exposure Draft "Measuring Quoted Investments in Subsidiaries, Joint Ventures and Associates at Fair Value."
7. The EP discussed application of liquidation basis of accounting to a fund that is liquidated subsequent to a business combination effected through the purchase of net assets of a fund. The EP members observed that pursuant to the FASB ASU No. 2013-07 *Presentation of Financial Statements (Topic 205): Liquidation Basis of Accounting*, "dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation," therefore, liquidation basis of accounting would not apply. The EP acknowledged, however, that if a fund in liquidation is selling portions of its portfolio to other funds, such scenario would not be considered a complete acquisition or a complete merger.
8. The EP members discussed the impact certain significant liabilities have on the presentation of the condensed schedule of investments and ratios of net investment income and expenses to average net assets. Some offshore funds have recorded liabilities for deferred management fees, incentive fees or both, consistent with AICPA TIS Section 6910.27 *Treatment of Deferred Fees*. The liabilities for the deferred fees are indexed to the performance of the fund. In certain instances, the balances of the deferred fees can be greater than the net assets of the fund. Although the deferred fee shares in the gains and losses in the fund proportionate with the share capital accounts, since the deferred fee is recorded as a liability instead of legal capital, it is deducted from assets to arrive at net assets.

Certain asset backed financing entities (e.g., CDOs or CLOs) may qualify as investment companies in accordance with FASB ASC Topic 946. These entities may be significantly capitalized by beneficial interests classified as liabilities in the financial statements, which would also be deducted from assets to arrive at net assets.

FASB ASC 946 permits nonregistered investment companies to present a condensed schedule of investments as part of the financial statements. Among the disclosure requirements for the condensed schedule of investments is a requirement to present the name, shares or principal amount, value, and type of investments which are greater than 5% of net assets. Since the liabilities in each of these situations are deducted from assets to arrive at net assets, this can have the effect of exaggerating (i) the presentation of investment concentrations in the condensed schedule of investments and (ii) the ratios of net investment income and expenses to average net assets.

At the November EP meeting, the EP observed that under a conservative view approach, it would be appropriate to treat the deferred liability and beneficial interests as debt (liability)

and include them in the determination of net assets for the purposes of preparing the condensed schedule of investments and computing the ratios of net investment income and expenses to average net assets. The EP also noted an alternative view: depending on specific facts and circumstances, a case could be made to consider the economics of the deferred liability and beneficial interests described above similar in substance to the capital of the investment company.

9. The EP briefly discussed that in September 2014, the EITF reached a consensus-for-exposure that a reporting entity that measures an investment using the net asset value (NAV) practical expedient would no longer have to categorize the investment in the fair value hierarchy and would no longer include it in the fair value hierarchy table. On October 30, 2014, FASB issued a proposed Accounting Standards Update, *Fair Value Measurement (Topic 820): Disclosures for Investments in Certain Entities that Calculate Net Asset Value per Share (or Its Equivalent)* (a consensus of the FASB Emerging Issues Task Force). [Click here](#) to download the Exposure Draft.

The EP discussed that one of the potential unintended consequences of the proposal would be that it would require a fund that has more than a small amount of its assets invested in an underlying fund that is carried at fair value using the practical expedient to provide a cash flow statement. This is because one of the criteria for an investment company to not provide a cash flow statement is that substantially all of its assets are carried at fair value and included in Level 1 or 2 of the fair value hierarchy.

10. The EP discussed reviewer comments on draft TPAs.

III. Audit and Attest Issues

1. The EP held a general discussion on new PCAOB Standards, including PCAOB Auditing Standard (AS) No. 16, *Communications with Audit Committees* and AS No. 18, *Related Parties, Amendments to Certain PCAOB Standards Regarding Significant Unusual Transactions and Other Amendments to PCAOB Auditing Standards*. In connection with AS 16, the EP reconfirmed its previous views as most recently discussed in May and July 2014.
2. The EP revisited the topic of the SEC independence rules related to financial statement preparation in light of PCAOB and SEC focus on the auditors' involvement with preparation, finalization, and issuance of audited financial statements for entities subject to the SEC independence rules. The EP members discussed whether and how firms have been changing their practices in this area.

The EP was made aware of a recently issued AICPA/CAQ [joint alert on independence](#) considerations for broker-dealers registered with the SEC and, where the engagement is subject to the requirements of the Custody Rule, SEC-registered and certain state-registered investment advisers (RIAs), related party custodians, or private funds (e.g., pooled investment vehicles).

The EP also discussed a distinction concerning the RIA-managed private investment fund with respect to the printing and binding of financial statements as compared to the same for broker-dealers or public companies. The audited financial statements of broker-dealers and public companies are filed with the SEC directly, and accessible through EDGAR. In this regard, EDGAR serves as a control that the financial statements audited and available to the public are intact, complete, and unaltered from the time the auditor issues their report. With respect to RIA-managed private investment funds, there is no control such as EDGAR, which prevents someone from intentionally or unintentionally changing, omitting portions (such as, the schedule of investments) or other integral components of the financial statements upon their distribution to investors. Historically, the auditor has been part of the quality control that ensures a complete, unaltered set of financial statements are assembled for distribution to investors and other interested parties. This control has been in the process of inserting the auditors' report and printing and binding the client-prepared financial statements and distributing them either bound or in secured PDF file to the client or their agents/administrators. The EP members believe that the regulators views in this area have eliminated the quality control aspect provided by the auditors' involvement in this process.

3. Certain EP members inquired whether there is an industry view surrounding the period that may be covered by an initial financial statement for a non-registered fund where the financial statements are not used to satisfy the SEC Custody Rule. The EP members noted that while certain domestic and foreign regulators, other than SEC, may have allowed financial statements covering no more than 15 months, they do not believe explicit authoritative guidance on this topic exists within US GAAP. The EP expressed concern that the presentation of too long a period on the statement of operations may be misleading or may misrepresent certain items.

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 meeting via conference call to discuss the following questions presented by the EP members and shared additional observations:

Jaime Eichen, Chief Accountant of the Division of Investment Management of the SEC, will be leaving the Commission in December 2014.

1. The EP and the SEC staff discussed BDCs’ application of the “income test” in Rule 1-02(w) of Regulation S-X, which is one of three tests used for purposes of determining whether a registrant needs to file separate financial statements of a majority-owned unconsolidated subsidiary in accordance with Rule 3-09 of Regulation S-X or include summarized financial information of an unconsolidated subsidiary in the notes to the BDC’s financial statements in accordance with Rule 4-08(g). The EP will develop a view regarding the application of the test that can be later presented to the SEC staff for consideration.
2. The SEC staff briefly discussed [IM Guidance Update No. 2014-11](#) on consolidation, which highlights, among other things, the following views of the SEC staff:
 - a. For an investment company registered under the Investment Company Act of 1940 (RIC) that is a feeder fund in a master-feeder structure, unconsolidated financial presentation is generally the most meaningful presentation, provided that, among other things, the feeder fund attaches the financial statements of the master fund to the feeder fund’s financial statements. However, if the design and purpose of the master-feeder structure is for the master fund to be wholly owned by a sole feeder fund, the SEC staff encourages registrants to consult on whether consolidated financial presentation would be the most meaningful.
 - b. For a RIC that is a fund of funds, unconsolidated financial presentation is generally the most meaningful presentation. However, in accordance with GAAP, a fund of funds should consider whether its investment in a single underlying fund is so significant to the fund of funds that its financial statement presentation should be made in a manner similar to a master-feeder fund.
 - c. Generally, a BDC should consolidate a wholly owned or substantially wholly owned subsidiary, whose design and purpose is to act as an extension of the BDC’s investment operations and to facilitate the execution of the BDC’s investment strategy (e.g., a holding company). Under similar circumstances, a RIC should also consolidate a wholly owned or substantially wholly owned subsidiary (e.g., a “blocker”).
 - d. Registrants should ensure they include, in their financial statements, related party disclosures required by FASB ASC 850. For example, for BDCs, this would include, among others, disclosures about related party transactions with certain directly or indirectly held portfolio companies, including holding companies.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought. Copyright © 2015 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the January 20, 2015 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 2014 meeting highlights have been submitted for posting to aicpa.org, and November 2014 meeting highlights are being finalized.
2. The Asset Management Revenue Recognition Task Force (AM RRTF) chair and staff provided a status update on the progress of the AM RRTF to date.
3. The AICPA Publications staff thanked EP members for their feedback on the proposed interim conforming changes review and discussed timing of review of final conforming changes to the 2015 AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. The EP discussed the current draft of the AICPA FinREC comment letter on the [proposed ASU regarding additional disclosures for investment companies with investments in other investment companies](#). The proposed ASU will require:
 - a. feeder funds (regulated and non-regulated) to provide the master fund's financial statements along with the feeder fund's financial statements;
 - b. all investment companies (regulated and non-regulated) to disclose each investment owned by an investee fund that exceeds five percent of the reporting investment company's net assets at the reporting date.
2. At the November 12, 2014, EP meeting, the EP sought the SEC staff's views on the mechanics for the significant thresholds tests under Regulation S-X Rule 1-02(w) (the three tests thereunder) that investment companies should apply to determine whether the financial statements of an unconsolidated subsidiary should be attached to the registrant's filing with the Commission (pursuant to Rule 3-09) or whether summarized financial information of an unconsolidated subsidiary should be presented in the notes of the registrant's financial statements (pursuant to Rule 4-08(g)). The SEC staff requested that the EP develop a view that can be later presented to the SEC staff for consideration. On January 20, 2015, the EP considered various alternative calculation methods that had been formulated by a subgroup of the EP. The subgroup of the EP will schedule a separate conference call with the SEC staff to discuss the EP views and examples.

3. The EP considered implementation issues in connection with FASB ASU 2013-07 *Liquidation Basis of Accounting*. The EP is working on developing nonauthoritative Technical Questions and Answers relating to implementation of ASU 2013-07.
4. The EP discussed accounting for organization costs for seed financial statements of newly formed open-end investment companies – please refer to the SEC Staff Update section of these meeting highlights.
5. In July 2014, the EP sought the SEC staff's views regarding fee waivers/reimbursements in excess of total expense by advisers to fund-of-funds (previously discussed at the May EP meeting). Refer to notes from these prior meetings for additional background.

During the November EP meeting, the SEC staff requested the EP's view regarding reimbursements in excess of total expenses by advisers to fund-of-funds (FOF) – whether such reimbursements would be treated as payments by an affiliate and whether the fund should disclose the impact on total return in the fund's financial highlights. On the January 20, 2015 EP call, the EP discussed that guidance related to "payments by an affiliate" is generally applied when the adviser reimburses the fund for losses on investments (either in connection with an investment restriction violation or as a voluntary reimbursement for investment losses outside of the adviser's control.). The EP acknowledged that the waiver or reimbursement of expenses in excess of expenses at the FOF level (to subsidize acquired fund fees and expenses) is different from the typical "payment by affiliate," with a focus on the expense ratio, and not on total return. The EP highlighted that disclosing the impact on total return would be inconsistent with how other expense waivers and reimbursements are treated. The EP acknowledged that the expense reimbursement in question is in excess of the FOF expenses and therefore is not technically an expense reimbursement at the FOF level. However, the EP also noted that the impact on the expense ratio is generally relatively consistent with the impact on total return. The EP expressed a view that the impact on total return may be disclosed in the FOF's financial statements, but such disclosure would not be required. The EP will provide its view to the SEC staff.

6. ASU 2014-16 *Derivatives and Hedging (Topic 815) Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity*

Overview of the Guidance

Certain classes of shares include features that entitle the holders to preferences and rights (such as conversion rights, redemption rights, voting powers, and liquidation and dividend payment preferences) over the other shareholders. Shares that include embedded derivative features are referred to as hybrid financial instruments. Under Subtopic 815-10, the embedded derivative feature must be separated from the host contract and accounted for as a derivative if certain criteria are met.

Per 815-15-25-1, an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

- a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.
- c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

ASU 2014-16 does not change the current criteria for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The ASU instead clarifies that all relevant terms and features (including the embedded derivative feature) should be considered in the evaluation of the nature of the host contract. The

nature of the host contract would depend upon the economic characteristics and risks of the entire hybrid financial instrument.

Considerations and Preliminary Conclusions

For funds that issue Hybrid Financial Instruments (e.g., Auction Rate Preferred Shares (ARPS) and Variable Rate Municipal Term Preferred Shares (VMTPS)) the ASU is applicable as entities rely on the clearly and closely related analysis of ASC 815-15-25-1(a) when determining whether or not the embedded derivative needs to be separated from the host contract (i.e., the ARPS or VMTPS) and accounted for separately as a derivative pursuant to ASC 815-10. For any outstanding ARPS and VMTPS, clearly and closely related analysis should be updated to ensure that entities have considered all relevant terms and features of the hybrid instrument, not just single terms (i.e., mandatory or contingent conversion features), including the embedded derivative feature in making clearly and closely related determination.

For funds that invest in Hybrid Financial Instruments (e.g., convertible bonds) the ASU is not applicable as they do not rely on the clearly and closely related analysis of ASC 815-15-25-1(a) when determining whether or not the embedded derivative (i.e., the conversion feature) in a convertible bond needs to be separated from the host contract (i.e., the bond). Instead investment companies rely on the guidance in ASC 815-15-25-1(b) which states that an embedded derivative should not be separated from the host contract if the hybrid instrument is remeasured at fair value under GAAP with changes in fair value reported in current period earnings as they occur.

Remaining Questions

How does this guidance relate to the guidance in ASC 480-10-25-4 on Distinguishing Liabilities from Equity which says that a mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity? Would ASU 2014-16's evaluation of the nature of the host contract as debt or equity change determination with regard to debt or equity classification of the ARPS or VMTPS?

The EP will resume discussion of these questions at the next EP conference call.

7. An EP member introduced a topic of accounting for securities received in a spinoff. As noted in FASB ASC 946, an investment company may receive securities in a spinoff wherein the entity in which the investment company has invested spins off a portion of its operations. Under this fact pattern a portion of the cost of the securities held shall be allocated to the securities received in the spinoff (see ASC 946-320-30-2).

Paragraph 2.97 of the 2014 Guide notes that spinoffs are **usually tax-free reorganizations** (emphasis added), and in that case, no gain or loss is recognized for income tax or financial reporting purposes. Since it is not explicit in paragraph 2.97, the Expert Panel considered whether spinoffs treated as taxable transactions for income tax purposes should be accounted for consistent with ASC 946-320-30-2. If these transactions are accounted for consistent with ASC 946-320-30-2 these transactions would not result in a gain or loss or dividend income and would result in a difference between book income and taxable income for the investment company and a difference in the cost basis of the securities between book and tax. The EP will revisit this topic at the next EP conference call.

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.

The SEC 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 also share additional observations:

1. Organization Costs for Seed Financial Statements of Open-End Investment Companies

A newly formed open-end investment company incurs organization costs, such as legal services. Organization costs consist of costs incurred to establish the company and enable it to legally do business. In accordance with FASB ASC 720-15-25-1, organization costs should be charged to expense as they are incurred.

The 1998 Dear CFO Letter states:

As a result of SOP 98-5, we believe that organization costs will be treated in one of the following manners: (1) as a direct expense to the investment company, (2) as an expense to the investment company and a simultaneous reimbursement by the sponsor, in accordance with a reimbursement or excess expense plan, or (3) as an expense of the investment company sponsor, if it intends to incur organization costs on behalf of the investment company. When organization costs are charged as expenses of the investment company as in scenarios "(1)" or "(2)", the financial statements of the investment company that are part of its registration statement should include a statement of operations because the investment company has operating activity.

Therefore, when organization costs are treated in the manner described in scenarios (1) or (2) above, the open-end investment company is required to include a statement of operations with the organization costs recorded as an expense. For situations described in scenario (3), an EP member observed, in addition to the requirements in ASC 720, the SEC's guidance would also require an investment company to record an expense for the cost of transactions paid by a principal shareholder on behalf of the company (see FASB ASC 225-10-S99-4). However, the EP member noted the 1998 Dear CFO letter did not include a requirement to include a statement of operations if the sponsor intends to incur organization costs on behalf of the investment company.

The EP member noted that the seed financial statements of certain newly formed open-end investment companies have historically presented a statement of operations that included an expense for the organization costs paid by the sponsor and a corresponding waiver of the expense because:

- (i) the registrant concluded the organization costs (e.g., legal invoices) were the obligation of the open-end investment company and were expensed pursuant to ASC 720, and
- (ii) to provide transparency of the organization costs paid by the sponsor, a related party, on behalf of the open-end investment company.

If the organization costs had not been paid as of the balance sheet date, these seed financial statements also may have included a liability for the obligation for the organization costs and a corresponding receivable from the sponsor for the waived expenses.

The EP inquired whether, for situations where the sponsor intends to incur organization costs on behalf of the newly formed open-end investment company, the SEC staff would accept seed financial statements that include a statement of operations with an expense for organization costs incurred and a corresponding waiver by the sponsor.

The SEC staff stated that this issue should be considered on a facts and circumstances basis, with consideration given to the terms of any agreements and contracts between the sponsor and the investment company. The SEC staff encouraged registrants to consult if there are specific fact patterns that registrants would like the SEC staff to consider on an individual basis.

2. The EP sought SEC staff's views on the following scenarios for an SEC-registered investment adviser (RIA) (also see SEC FAQ XVI.1 below)
 - a. The RIA manages several pooled investment vehicles and does not file its financial statements with the SEC:
 - The RIA is complying with the Custody Rule through an annual surprise examination (no pooled investment vehicle (PIV) audit). Would an accounting firm that assists in preparation of the *financial statements of the adviser (whose financial statements are not filed with the SEC)* and is also engaged to perform the surprise examination need to be independent under SEC independence rules for the purposes of RIA complying with the Custody Rule?
 - The RIA is complying with the Custody Rule through "annual audit exception" provision performed by an accounting firm that also prepares financial statements of the RIA. The financial statements of the RIA are not

filed with the SEC. Would such an accounting firm need to be independent under SEC independence rules for the purposes of RIA complying with the Custody Rule?

- b. One accounting firm audits several pooled investment vehicles managed by a RIA. A different non-affiliated accounting firm performs surprise exam of the RIA for purposes of complying with the Custody Rule. Assume there is an unrelated (to the RIA) qualified custodian that holds PIVs' LLC agreements. If the US GAAP audit performed by the first accounting firm on PIVs managed by the RIA is not being relied upon in the surprise examination performed by the second accounting firm, nor it is used to satisfy "annual audit exception" provision, does the first accounting firm need to be independent under SEC independence rules in order for the RIA to comply with the Custody Rule?

Question XVI.1

Q. Pursuant to the custody rule, an accountant performing a surprise examination must meet the standards of independence described in rules 2-01(b) and (c) of Regulation S-X. Rule 2-01(b) provides the general standard of independence. Rule 2-01(c) provides a non-exclusive list of circumstances, including specific relationships and services, which would be inconsistent with the general standard. How should an accountant who performs a surprise examination under the custody rule consider the propriety of non-audit services specified in rule 2-01(c)(4)(i)-(v) if such services are not subject to the accountant's procedures during the surprise examination?

A. When engaged to issue an audit or attest report to satisfy a requirement in the custody rule, the accountant should consider the application of the general standard of independence to such engagements. The Commission's 2003 adopting release (Release No. 33-8183 (January 28, 2003), *Strengthening the Commission's Requirements Regarding Auditor Independence*), states that there is a rebuttable presumption that certain prohibited non-audit services (e.g., bookkeeping, financial information systems design and implementation) will be subject to audit procedures during an audit of the audit client's financial statements. Rule 2-01(c)(4) provides that these non-audit services are prohibited unless "it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements." Therefore, it is the staff's position that, subject to Rule 2-01(b) of Regulation S-X, an accountant performing a surprise examination under the custody rule would be able to perform certain non-audit services as long as it is reasonable to conclude that: (1) the results of the non-audit service will not be subject to attest procedures which might be performed during the surprise examination; and (2) the results of the non-audit service would not be subject to audit procedures if the accountant had been engaged to perform a financial statement audit. For example, if a pooled investment vehicle is included in the scope of an adviser's surprise examination under the custody rule, the accountant performing the surprise examination would be prohibited from compiling the pooled investment vehicle's financial statements. (Posted December 13, 2011.) (Emphasis added)

3. The EP followed up on the following question originally discussed with the SEC staff during November EP meeting.

On several occasions, certain accounting firms have encountered a situation where an adviser for a number of years has been subject to the custody rule, but only for pooled investment vehicles. The advisor has satisfied the requirements of the custody rule exclusively through the "audit exception". However, during the most recent year (possibly later in the calendar year) the adviser either has accepted a separately managed account (which would not qualify as a pooled investment vehicle), or has organized a new pooled vehicle which for various reasons is not expected to be audited, thus subjecting that account to a surprise examination.

The surprise examination requirements of Rule 206 "provide for the first [surprise] examination to occur within six months of first becoming subject to this paragraph." As written, this suggests the exception only exists when first becoming subject to the surprise examination requirements *as a whole*. Since audits of pooled investment vehicles are an alternative means of compliance with the surprise examination requirement, the literal words of the rule *do not* appear to allow a six-month "delay" where compliance has been

previously achieved exclusively through financial statement audits. As a result a separate surprise examination report is now required. For example, a new account could be opened in November and a surprise examination may be required before December 31 in order to comply with the rule. This raises practical problems for both the adviser and the auditor in terms of executing an engagement letter and planning and performing the examination.

An EP member asked should the Rule 206 provision for the first surprise examination to occur within six months of becoming subject to the custody rule also be applied to a situation where the custody rule has been complied with exclusively through audits of pooled investment vehicles and, due to the opening of new accounts during a year, a separate surprise examination is now newly required? Would this answer be different if the account giving rise to the surprise examination requirement is a) a separately managed account (a class of account new to the adviser) or b) another pooled vehicle for which no audit is anticipated?

The SEC staff stated that these questions should be considered on an individual facts and circumstances basis. The SEC staff encouraged registrants to consult if there are specific fact patterns that registrants would like the SEC staff to consider on an individual basis.

Investment Companies Expert Panel

Highlights of the March 24, 2015 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 conference call:

I. AICPA/Administrative:

1. The Expert Panel (EP) November 2014 meetings and January 2015 call highlights are being finalized.
2. The AICPA Asset Management Revenue Recognition Task Force (AM RRTF) staff provided a status update on the progress of the AM RRTF to date.
3. The AICPA publications staff and the EP considered certain proposed conforming changes for the 2015 AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
4. The EP participated in drafting the [AICPA FinREC comment letter](#) on the [proposed ASU about additional disclosures for investment companies](#). The AICPA staff thanked the EP for their contributions in developing this comment letter.

II. Accounting/Reporting Issues:

1. The EP is reviewing the following TPA drafts. The EP intends to present them to FinREC in June 2015:
 - a. Liquidation Basis of Accounting.
 - b. Loan Origination.
2. The EP will discuss draft TPAs on (1) accounting for amortization or accretion of premiums or discounts for convertible bonds and (2) the meaning of “financial support” in FASB ASC 946-20-50-15 and 50-16 at its May 2015 EP meeting.
3. At the January EP conference call, an EP member introduced a topic related to accounting for securities received in a spinoff.

As noted in FASB ASC 946, an investment company may receive securities in a spinoff wherein the entity in which the investment company has invested spins off a portion of its operations. The ASC Master Glossary defines a spinoff as the transfer of assets that constitute a business by an entity (the spinor) into a new legal spun-off entity (the spinnee), followed by a distribution of the shares of the spinnee to its shareholders, without the surrender by the shareholders of any stock of the spinor. Under this fact pattern a portion of the cost of the securities held shall be allocated to the securities received in the spinoff based on the relative fair value of the original securities held and those received (see ASC 946-320-30-2 and 3).

Paragraph 2.97 of the 2014 Guide notes that spinoffs are **usually tax-free reorganizations** (emphasis added), and no gain or loss is recognized for income tax or financial reporting purposes. Since it is not explicit in paragraph 2.97, the EP considered whether spinoffs treated as taxable transactions for income tax purposes should be accounted for consistent with ASC paragraphs 946-320-30-2 and 3.

During March EP conference call, the EP revisited this topic. The EP expressed a view that if these transactions are accounted for consistent with ASC paragraphs 946-320-30-2 and 3, they would not result in a realized gain or loss or dividend income and would result in differences between the book and tax dividend income and cost basis of the securities. EP members observed that ASC paragraphs 946-320-30-2 and 3 do not indicate that the tax characteristic of the distribution is a criterion for evaluating if the distribution of a business by an investee should be accounted for as a spinoff. As a result the EP members concluded that taxable and tax-free distributions of a portion of an investee's operations that constitutes a business should be accounted for in accordance with ASC paragraphs 946-320-30-2 and 3.

4. A fund may purchase a security that at the time of original issuance had a maturity date greater than one year, but at the date of acquisition the remaining maturity was less than one year. Also, a fund may purchase a structured note that has an underlying that is an equity security, index, or long-term bond where the term of the structured note is 365 days or less. In such cases, the securities may be classified as long-term in the accounting system due to the nature of the security being long dated or the fact that they are booked as equities (structured note with an underlying equity) and manual workarounds are operationally burdensome. If the security matures within 365 days most funds remove the security from the gross purchases and sales disclosed in the notes to the financial statements and used in the portfolio turnover calculation. The security may continue to be categorized as long-term on the schedule of investments (SOI). The guidance in Regulation S-X seems to define short-term debt instruments as instruments whose maturity or expiration date at the time of acquisition are one year or less. One EP member questioned whether the entities' objective (did the entity intend to hold the security for less than one year regardless of the maturity) should be considered in determining the classification in the SOI and inclusion in the portfolio turnover calculation. However, other EP members indicated that the instructions to Form N-1A did not indicate that a fund should consider its intended holding period when determining the security's classification within the SOI and inclusion in the portfolio turnover calculation. The EP members expressed a general view that funds should classify securities on the SOI as short-term and determine if the purchase should be included in the portfolio turnover calculation based on the remaining maturity from the acquisition date. However, the EP wanted to better understand what occurs in practice due to potential operational challenges. As a result the EP will resume this discussion at the May EP meeting.
5. Certain funds engage in covered call strategies or from time to time enter into covered calls. There is diversity in practice of how information on covered calls is disclosed. Some entities identify the security subject to a covered call while others identify the security and disclose the value of the securities that are subject to covered calls in the notes to the financial statements or in the footnote to the SOI. The Audit and Accounting Guide, *Investment Companies* (2014 edition) includes an example on page 261 that states "As of December 31, 20X8, portfolio securities valued at \$634,500 were held in escrow by the custodian as cover for call options written by the company."

Per Rule 12-13 of Regulation S-X, is a registered investment company required to indicate how much of the portfolio is subject to a call even if not escrowed as shown above?

Rule 12-13 states:

Indicate by an appropriate symbol each investment subject to option. State in a footnote: (a) The quantity subject to option, (b) nature of option contract, (c) option price, and (d) dates within which options may be exercised.

The option written roll forward typically would show number of contracts (but can show number of shares).

Paragraph 7.27 of the Guide states: Public registrants are also required to disclose investments in restricted securities, affiliated companies, securities subject to call options, and when-issued securities in the schedule of investments; disclosure of specific

information in the notes to the financial statements may also be required by other authoritative FASB guidance.

The EP members considered whether a separate disclosure is required under Rule 12-13 that would show the value of the portfolio securities subject to call to satisfy the quantity subject to option or is the information in Rule 12-13 along with identification in the SOI sufficient. The EP will further discuss at May EP meeting.

6. At the November 12, 2014, EP meeting, the EP sought the SEC staff's views on the mechanics for the significant thresholds tests under Regulation S-X Rule 1-02(w) (the three tests thereunder) that investment companies should apply to determine whether the financial statements of an unconsolidated subsidiary should be attached to the registrant's filing with the Commission (pursuant to Rule 3-09) or whether summarized financial information of an unconsolidated subsidiary should be presented in the notes of the registrant's financial statements (pursuant to Rule 4-08(g)). The SEC staff requested that the EP develop a view that can be later presented to the SEC staff for consideration. On January 20, 2015, the EP considered various alternative calculation methods that had been formulated by a subgroup of the EP. The subgroup of the EP will resume its efforts in April 2014, prioritize the views of the subgroup, include numerical examples for each view, and present again to the EP. After EP considers the options, the subgroup of the EP will schedule a separate conference call with the SEC staff to discuss the EP's views and examples.
7. The EP was informed of recently issued FASB Accounting Standards Update No. [2014-18](#), *Accounting for Identifiable Intangible Assets in a Business Combination*, that provides private companies with an alternative to include certain identifiable intangible assets in goodwill when applying purchase accounting in business combinations. Entities other than public business entities, not-for-profit entities, and certain employee benefit plans can elect the alternative. The EP members observed that if separately identifiable intangible assets, such as customer relationships, can be sold separately, under this ASU, private companies would not be able to include them in goodwill. The EP noted that private investment advisers would likely not be able to take advantage of this guidance since investment advisory relationships/contracts are often able to be sold separately.
8. The EP revisited a topic previously discussed during the January EP call on whether the requirement in FASB ASU 2014-16 *Derivatives and Hedging (Topic 815) Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* (ASU 2014-16) to evaluate the nature of the host contract as debt or equity would change the determination with regard to debt or equity classification of Auction Rate Preferred Shares (ARPS) and Variable Rate Municipal Term Preferred Shares (VMTPS). During the March EP conference call, the EP expressed a view that ASU 2014-16 would not change the classification as debt or equity of hybrid instruments in the form of shares issued by funds (e.g., ARPS or VMTPS) nor would it change the existing accounting for the embedded derivatives within those types of host contracts. However, for hybrid financial instruments issued by the funds in the form of a share, management may need to update their documentation and evaluation of the embedded derivative features; consider the nature of the host contract (as either debt or equity-like) inclusive of those embedded derivative features; and conclude whether the associated embedded derivative features are clearly and closely related to the host contract.

III. Audit and Attest Issues

1. In order to satisfy the audited financial statement exception in the Custody Rule, the financial statements must be prepared in accordance with US GAAP. Question 19 of the [AICPA FAQs on the Custody Rule](#) discusses financial statements for a liquidation audit, noting balance sheets, statements of operations, statements of changes in partners' capital, and possibly statements of cash flows. ASU 2013-07 changes the required financial statements for a fund in liquidation.

Question 19. Liquidation Audit – is the requirement for the financial statements at the date the plan is adopted or as of the date the final funds are distributed? What is reasonable timing for distribution? **For the purposes of the liquidation audit, the financial statements should be dated as of or near the final distribution date (generally, financial statements would not be distributed prior to the final fund distribution to investors).**

Note that an audit shall occur once every 12 months, therefore, for a fund with December 31, 2010 fiscal year-end, if the liquidation process started in

October 2010 but was not completed until after year-end, an audit is still needed as of December 31, 2010, followed by a liquidation audit after the distribution has been completed. The rule indicates that the financial statements should be distributed promptly, which may be interpreted “as soon as reasonably possible.”

Question whether a single set of audited financial statements could be issued to cover the period from January 1, 2010 through the date of liquidation (exceeding 12 months) if the audited financial statements for that extended period could still be delivered to investors within the 120-day period required under the rule for the annual financials.

The audited financial statements can cover a period exceeding 12 months if they are delivered to investors within 120 days of the December 31, 2010 fiscal year-end and as long as the financial statements contained the following: 2 balance sheets – 1 balance sheet as of December 31, 2010 and 1 balance sheet as of the 2011 liquidation date and 2 income statements, 2 statements of changes in partners’ capital, and 2 statements of cash flows (if applicable), for the period from January 1, 2010 – December 31, 2010 and for the period from January 1, 2011 – 2011 liquidation date.

The EP observed that the second part of Q&A 19 above would likely need to be updated to reflect amendments in ASU 2013-07 to the required financial statements for a fund in liquidation. The EP noted that they are currently working on a TPA addressing what financial statements a fund may include in its liquidation basis financial statements. The EP will raise this question with the SEC staff in connection with the TPA.

2. The N-SAR example in Chapter 12 of the Guide is addressed to Shareholders and the Board of Directors, however, the report is restricted to management and the Board of Directors:

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors of XYZ Investment Company

This report is intended solely for the information and use of management and the Board of Directors of XYZ Investment Company and the Securities and Exchange Commission and is not intended to be and should not be used by anyone other than these specified parties.

The EP discussed that Form N-SAR instructions explicitly require the report to be addressed to the shareholders. However, GAAS explicitly requires that the users of the report be limited to management and board of directors and regulators. The EP acknowledged inconsistency that the report is addressed to the shareholders but is restricted from access to its contents, but determined not to make changes to the example report at this time because of the conflicting requirements.

3. There are some funds that may start to have exposure to Bitcoins, and even some Funds that are focused solely on investing in the currency, as evidenced by the Bitcoins Investment Trust winning regulatory approval from FINRA. The EP members shared that they have had only limited experiences with auditing holdings in virtual currencies and acknowledged challenges with auditing considerations relating to the existence assertion, specifically, verifying where the entity holds such investments, how the entity processes the transactions, including trading and maintaining custody. The EP also noted regulatory concerns to the extent the fund has significant holdings in Bitcoins.

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 meeting via conference call to discuss the following questions presented by the EP members and shared additional observations:

1. During the November EP meeting, the SEC staff requested the EP's view regarding reimbursements in excess of total expenses by advisers to fund-of-funds (FOF) – whether such reimbursements would be treated as payments by an affiliate and whether the fund should disclose the impact on total return in the fund's financial highlights. The EP provided an overview of their discussions on the January 20, 2015 EP call to the SEC staff. EP members highlighted that the EP discussed that guidance related to “payments by an affiliate” is generally applied when the adviser reimburses the fund for losses on investments (either in connection with an investment restriction violation or as a voluntary reimbursement for investment losses outside of the adviser's control.) The EP acknowledged that the waiver or reimbursement of expenses in excess of expenses at the FOF level (to subsidize acquired fund fees and expenses) is different from the typical “payment by affiliate,” with a focus on the expense ratio, and not on total return. The EP highlighted that disclosing the impact on total return would be inconsistent with how other expense waivers and reimbursements are treated. The EP acknowledged that the expense reimbursement in question is in excess of the FOF expenses and therefore is not technically an expense reimbursement at the FOF level. However, the EP also noted that the impact on the expense ratio is generally relatively consistent with the impact on total return. The EP expressed a view that the impact on total return may be disclosed in the FOF's financial statements, but such disclosure would not be required.
2. The SEC staff shared the following observation on a recent review of fund merger filings on Form N-14. A registrant filed two separate Form N-14s. In each Form N-14, the acquiring fund was the same, but the target fund was different. The Form N-14 for each merger was filed in isolation, with neither of the merging funds' Form N-14 filings reflecting the other merger. In this situation, the SEC staff commented that without additional disclosure discussing the multiple fund mergers and pro forma financial information reflecting the multiple fund mergers, the Form N-14 filings could be considered misleading. The SEC staff reminded the EP of the SEC staff's guidance relating to pro forma financial information for multiple fund mergers in a [November 1995 “Dear CFO Letter”](#), December 2008 EP meeting highlights, and 2009 AICPA Audit Risk Alert “Investment Companies Industry Developments.” In the pro-forma fee table, the SEC staff would not object if registrants disclose a range of possible expense ratios, which would include the highest and lowest expense ratio and the expense ratio that would be incurred if all funds merged. In the pro-forma capitalization table, the SEC staff would not object if registrants disclose the same combinations as disclosed in the pro-forma fee table or the most likely combination. For the pro-forma financial statements, the SEC staff would not object if registrants present one set of pro-forma financial statements reflecting the combination of all funds involved in the proposed merger.
3. In January 2015, the Office of Compliance Inspections and Examinations of the SEC issued [2015 examination priorities](#) for investment advisers, broker-dealers, and transfer agents.

Investment Companies Expert Panel

Highlights of the May 19, 2015 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:

AICPA Investment Companies Expert Panel

May 19, 2015 Meeting Highlights

I. AICPA/Administrative:

1. The Expert Panel (EP) January and March 2015 call highlights are being finalized.
2. The AICPA Asset Management Revenue Recognition Task Force (AM RRTF) members and staff provided a status update on the progress of the AM RRTF to date.
3. Liquidation Basis of Accounting and Loan Origination TPA drafts will be submitted for FinREC's June conference call.
4. The AICPA Publications staff informed the EP about:
 - a. timing of the 2015 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
 - b. [2008-2013 ARA SEC observations](#) excerpts are available on [aicpa.org](#).
5. The AICPA is considering developing (updating) audit guidance for auditing alternative investment funds.

II. Accounting/Reporting Issues:

1. The EP discussed the following draft TPAs and will be providing additional comments in advance of next EP conference call:
 - a. Accounting for Convertible Bonds - A convertible bond is comprised of a debt instrument and an embedded option contract representing the conversion feature. As a result, when a convertible bond is acquired, a portion of the purchase price relates to the conversion option and a portion relates to the underlying debt instrument. The TPA would address how an investment company would account for amortization or accretion of convertible bond premiums or discounts when a portion of the purchase price represents the value of the embedded option.
 - b. The meaning of "financial support" – FASB ASC paragraphs 946-20-50-15 and 50-16 require an investment company to disclose information about any financial support that (1) it has provided to an investee during the period presented,

including whether it was contractually required to provide such financial support; and (2) it is contractually required to provide, but has not yet provided, to an investee. Specifically, an investment company is required to disclose the “type and amount of financial support” provided or to be provided and the primary reasons for providing such support. The TPA would assist investment companies in determining whether transactions with investees would be required to be disclosed in accordance with ASC paragraphs 946-20-50-15 and 50-16.

2. The EP revisited a topic originally discussed during the March EP conference call. A fund may purchase a security that at the time of original issuance had a maturity date greater than one year, but at the date of acquisition the remaining maturity was less than one year. Also, a fund may purchase a structured note that has an underlying that is an equity security, index, or long-term bond where the term of the structured note is 365 days or less. In such cases, the securities may be classified as long-term in the accounting system due to the nature of the security being long dated or the fact that they are recorded as equities (structured note with an underlying equity) and manual workarounds are operationally burdensome. If the security matures within 365 days, most funds remove the security from the gross purchases and sales disclosed in the notes to the financial statements and used in the portfolio turnover calculation. The security may continue to be categorized as long-term on the schedule of investments (SOI). The guidance in Regulation S-X seems to define short-term debt instruments as instruments whose maturity or expiration date at the time of acquisition is one year or less. At the March 2015 meeting EP members generally expressed a view that Regulation S-X and the instructions to Form N-1A did not indicate that a fund should consider its intended holding period when determining the security’s classification within the SOI and inclusion in the portfolio turnover calculation. Therefore EP members expressed a general view that investment companies should determine whether the purchase should be included in the portfolio turnover calculation based on the remaining maturity from the acquisition date, however wanted to better understand what occurs in practice. During the May 2015 meeting, the EP members observed that there is diversity in practice in how investment companies present these types of investments on the SOI and whether they include them in the portfolio turnover calculation. EP members observed that generally investment companies exclude these types of securities from the portfolio turnover calculation, but do not include them in the short-term investment section on the SOI. The EP members reconfirmed their view that investment companies should determine whether investments should be included in the portfolio turnover calculation based on the remaining maturity from acquisition. The EP members believe this is consistent with the instructions to Form N-1A. The EP members did not express strong views on the classification of the investments in the SOI and acknowledged that judgment is generally applied in determining the appropriate classification. The EP recognized potential operational challenges this presents.
3. Certain funds engage in covered call strategies or from time to time enter into covered calls. An EP member observed that there seems to be diversity in practice in how investment companies disclose information about covered calls. Some entities identify the security subject to a covered call in the SOI and others identify the security in the SOI and disclose the value of the securities that are subject to covered calls in the notes to the financial statements or in the footnote to the SOI. There is an example in the Guide (2014 edition), on page 261 that states “As of December 31, 20X8, portfolio securities valued at \$634,500 were held in escrow by the custodian as cover for call options written by the company.” The EP considered, whether, per Rule 12-13 of Regulation S-X, an entity is required to indicate how much of the portfolio is subject to a call even if not escrowed as shown above.

Rule 12-13, Investments Other than Securities, states:

Indicate by an appropriate symbol each investment subject to option. State in a footnote: (a) The quantity subject to option, (b) nature of option contract, (c) option price, and (d) dates within which options may be exercised.

The option written roll forward typically would show number of contracts (but can show number of shares).

Paragraph 7.27 of the Guide states:

Public registrants are also required to disclose investments in restricted securities, affiliated companies, securities subject to call options, and when-issued securities

in the schedule of investments; disclosure of specific information in the notes to the financial statements may also be required by other authoritative FASB guidance.

The EP noted that there is a separate requirement in Rule 4-08 of Regulation S-X:

(b) Assets subject to lien. Assets mortgaged, pledged, or otherwise subject to lien, and the approximate amounts thereof, shall be designated and the obligations collateralized briefly identified.

The EP noted that that Rule 12-13 does not apply to investments in securities of unaffiliated issuers and that Rules 12-12 and 12-12C do not have the same disclosure requirement as Rule 12-13. The EP noted that although not explicitly required by Rule 12-13 or paragraph 7.27 of the Guide, due to the requirement in Rule 4-08(b), disclosure of the value of securities subject to option consistent with the example on page 261 of the Guide (2014 edition) would generally be good practice.

4. Accounting for restructuring tender option bonds (TOBs)

As a result of the implementation of the Volcker rule, some banks and investment companies are “modifying” their tender option bond (“TOB”) trusts. This “modification” will involve the termination of existing trusts and the creation of new trusts. The purpose of the restructuring is to allow banks to comply with the rules that prohibit a banking entity from directly or indirectly acquiring any ownership interests in, sponsoring, or acting as a principal of a “covered fund.” TOB trusts will be restructured by transferring the significant responsibilities from the banking entities to the residual certificate owners (funds) and/or restructuring the liquidity facility to change the manner in which floating rate certificates could be acquired by a banking entity. There are two common structures through which investment companies designed their TOB trusts. The first is a “self-deposited TOB trust” where a fund transfers a municipal bond to a TOB trust, and the fund receives the residual interest bond (inverse floater) from the TOB trust. The second structure is an “externally-deposited TOB trust” where a third party broker deposits a municipal bond in a TOB trust, and the fund purchases the residual interest bond (inverse floater) from the TOB trust. Note, the difference between this structure and the first structure is the fund does not intend to legally or substantively be the transferor to the TOB trust, however, further analysis, including principal-agent analysis would be required to determine proper accounting. For purposes of the EP discussion, it was assumed that the externally-deposited TOB trust was not accounted for as a secured borrowing.

The EP considered the accounting considerations related to the restructuring of the self-deposited and externally-deposited TOBs.

The EP discussed potential accounting issues that may result from restructuring the externally-deposited TOB trusts. Specifically, whether the restructuring resulted in a change to the accounting by the investment company, whether the trust should be consolidated by the investment company, whether or not the restructuring would result in debt modification and how the restructuring costs should be recorded, and whether the investment company had all the relevant facts related to the restructuring to evaluate the accounting impact. EP members observed that these issues were being discussed among certain accounting firms, but that conclusions were still being evaluated and they would likely depend on the facts and circumstances of the TOB trust and restructuring.

5. Accounting for Business Development Company (BDC) Stock Issuance Costs

The EP considered the following example:

Example

The BDC offers its shares through a continuous offering, sold on a “best efforts” basis pursuant to a registration statement on Form N-2 filed with the SEC under the Securities Act of 1933. The Company is using a related-party broker/dealer as its dealer/manager and selling agent.

The BDC’s shares are not issued on an exchange, they are sold through continuous offerings on a bi-weekly basis. The BDC also offers limited buy-back opportunities for shareholders. The shares are registered under certain provisions of SEC Rule 415, which is the shelf registration rule. The shares are not specifically registered under the provisions related to shelf offerings (which would require the shares to be exchange listed, among other things) but, rather the provisions related to continuous offerings.

The BDC entered into an Investment Advisory Agreement with the Adviser under which the Adviser will bear the organization and offering costs as follows:

- in excess of \$100,000 are borne by the Adviser if aggregate gross proceeds from the offering have not exceeded \$10 million or
- in excess of 1.75% of aggregate gross proceeds raised are borne by the Adviser if aggregate gross proceeds from the offering exceed \$10 million.

The BDC's gross proceeds from the offering exceeded \$10 million and significant offering costs were incurred to register its shares, including internal costs of the adviser allocated to the BDC. In addition, continuous offering costs are incurred throughout the offering period, which may last for a period of up to seven years. These costs are paid for and recorded by the Adviser. The BDC accounts for these costs as they become an obligation of the fund, which occurs with each bi-weekly capital raise (i.e., 1.75% of each dollar raised results in a charge to APIC and a reimbursement obligation to the Adviser).

The EP considered the following guidance from the AICPA Audit and Accounting Guide *Investment Companies* (2014), which states, in part:

8.28. Offering costs, as defined by the FASB ASC glossary, include the following:

- Legal fees pertaining to the investment company's shares offered for sale
- SEC and state registration fees
- Underwriting and other similar costs
- Costs of printing prospectuses for sales purposes
- Initial fees paid to be listed on an exchange
- Tax opinion costs related to offering of shares
- Initial agency fees of securing the rating for bonds or preferred stock issued by closed-end funds

8.29...Offering costs of open-end investment companies and of closed-end funds with a continuous offering period should be accounted for as a deferred charge until operations begin and thereafter amortized to expense over 12 months on a straight-line basis.

8.31...Some closed-end funds and business development companies offer stock through shelf registration statements. According to Technical Questions and Answers (TIS) section 4110.10, "Costs Incurred in Shelf Registration" (AICPA, *Technical Practice Aids*), legal and other fees incurred for a stock issue under a shelf registration should be capitalized as a prepaid expense. When securities are taken off the shelf and sold, a portion of the costs attributable to the securities sold should be charged against paid in capital. Any subsequent costs incurred to keep the filing "alive" should be charged to expense as incurred. If the filing is withdrawn, the related capitalized costs should be charged to expense.

8.34 Unit investment trusts (UITs) have characteristics that are similar to both open-end and closed-end investment companies. Some UITs offer shares only at a particular time, but others provide for ongoing sales over a longer offering period.

8.35 As explained in FASB ASC 946-20-35-6 and 946-20-40-1, offering costs of UITs should be treated as follows:

- Offering costs should be charged to paid-in capital on a pro rata basis as the units or shares are issued or sold by the trust...
- Offering costs that have not yet been charged to paid-in capital should be written off when it is no longer probable that the shares to which the offering costs relate will be issued in the future. It is presumed that those costs will not have a future benefit one year from the initial offering.

While the BDC is not an open-end mutual fund, guidance related to distribution expenses of these entities is discussed in paragraph 8.12 of the Guide, which states in part:

As discussed in FASB ASC 946-20-05-4, open-end investment companies, also known as funds, are permitted to finance the distribution of their shares under a plan pursuant to Rule 12b-1, ... Under a traditional 12b-1 plan, a fund's distributor

may be compensated or reimbursed for its distribution costs or efforts through the following methods:

- A 12b-1 fee, payable by the fund, based on an annual percentage of the fund's average net assets (a compensation plan) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting contingent deferred sales loads (CDSLs) received by the distributor (a reimbursement plan). Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.

The EP also considered guidance in SAB Topic 5.A *Expenses and Offering* (ASC 340-10-S99-1) which addresses how an operating company would account for stock issuance costs.

The EP discussed whether it was more appropriate for BDCs whose shares are sold through continuous offerings but not offered on an exchange to analogize to the guidance for 1) closed and open end funds with continuous offering periods, 2) shelf registrations, specifically TIS section 4110.10, or 3) 12b-1 fees. An EP member noted that determining the allocation between offering and other costs may present challenges that would be important to consider. Another EP member highlighted that for some BDCs the net investment income is an input into the determination of the management fee and the accounting alternatives would impact the management fee. EP members determined that each alternative may be acceptable depending on the facts and circumstances of the agreement and provided the BDC clearly disclosed its accounting policy.

6. The EP continued discussing implementation issues in connection with FASB ASU on Liquidation Basis of Accounting:

- a. In one example for EP consideration, a nonregistered fund in liquidation has net assets of zero, but the final distribution has not yet occurred as of year-end. In this fact pattern the investment company could have cash, a small payable for accrued expenses, and a distribution payable. The fund ultimately incurs minor additional costs (in excess of the accrued expenses) within a short time period after the year-end. The EP member inquired whether an additional (final) audit upon liquidation would be required after the final distribution for the registered investment adviser (RIA) managing the fund to comply with the SEC Custody Rule. Generally, the final audit is performed after no assets remain in the fund and all amounts have been distributed.

The EP members discussed that if these additional costs are insignificant and incurred by the fund after year-end but before financial statements are issued, it may be acceptable for the entity to disclose the information in a footnote to financial statements and no separate final audit may be needed. An EP member noted that the RIA may wish to consult with the SEC staff regarding this situation.

- b. An EP member inquired whether the liquidation basis of accounting is applicable to both financial reporting and the NAV that is used for transactions (trading NAV). The EP member shared that in a recent call of collective fund advisors, some expressed concerns regarding the concept of accruing income and expense for purposes of calculating the trading NAV. These industry representatives noted concerns about a Day 1 impact to the trading NAV for the accrued income and expense on the day that liquidation became imminent. The EP member noted that certain industry representatives on the above mentioned call believe that FASB ASU 2013-07 appears to be a financial statement presentation standard and not necessarily applicable to the determination of the trading NAV; as such, it appears that the trading NAV and the financial reporting NAV could be different during the liquidation period.

The EP observed that there have been other situations where the financial reporting NAV and the trading NAV were different. However, one EP member noted that when an investment company enters liquidation it is likely that the adviser will establish redemption restrictions and therefore a trading NAV would be unnecessary. Another EP member highlighted that if an investment company used a different trading NAV and financial reporting NAV that eventually those two NAVs would converge. The EP noted that often the investment company's organizational documents describe how the trading NAV should be calculated and if those

documents require a GAAP NAV for trading then the trading NAV and financial reporting NAV should be the same. However, a different financial reporting NAV and trading NAV may be permitted depending on the investment company's organizational documents.

7. Stable Value Accounting

Background

In late April, the FASB released three new Proposed ASUs for benefit plans, one of which is Proposed FASB ASU *Plan Accounting: Defined Contribution Pension Plans (Topic 962) and Health and Welfare Benefit Plans (Topic 965) -Fully Benefit-Responsive Investment Contracts (File Reference No. EITF-15C – I)*. The proposed ASU represents an effort to the simplify employee benefit plan accounting. Topic 962, Plan Accounting—Defined Contribution Pension Plans, and Topic 965, Plan Accounting—Health and Welfare Benefit Plans, require fully benefit-responsive investment contracts (FBRIC) to be measured at contract value. Those Topics also require an adjustment to reconcile contract value to fair value, when these measures differ, on the face of the plan financial statements. Fair value is measured using the requirements in Topic 820, Fair Value Measurement.

Some stakeholders have suggested that requiring, for purposes of presentation and disclosure, FBRICs to be measured at fair value does not provide decision-useful information when fair value differs from contract value. The AICPA Statement of Position (SOP) 94-4, "Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans" (codified in Topic 962), asserted that contract value is the relevant measurement attribute for those contracts because that is the amount participants normally would receive if they were to initiate permitted transactions (for example, withdrawals) under the terms of the underlying plan. Those contracts also are reported at contract value for regulatory reporting.

The proposed Update would designate contract value as the only required measure for FBRICs, which maintains the relevant information while reducing the cost and complexity of reporting for fully benefit-responsive investment contracts.

One EP member inquired whether new Proposed ASUs on contract value vs. fair value of FBRICs for Defined Contribution and Health and Welfare Plans would also apply to stable value investment companies.

The EP members noted that this specific question had been raised to the EITF and that the EITF did not intend to include investment companies within the scope of the proposed updates. The EP observed that this was likely because investment company financial statements are used by plan sponsors to make investment decisions about those funds, and, therefore, fair value would be relevant for the plan sponsors. This differs from the purpose of the plan's financial statements that is to provide information that is useful in assessing the plan's present and future ability to pay benefits when they become due, and the participants transact only at contract value.

8. The EP considered the following practice issues related to disclosures in accordance with FASB ASC 210-20-50 (Offsetting Assets and Liabilities) presented by an EP member and expressed the following EP views:

- 1) For certain derivative contracts, where a broker may serve as a clearing agent, but the counterparty is unknown (most futures and options contracts traded on an exchange), a netting agreement is usually one-sided allowing the clearing broker the right to offset, but does not give such right to the fund,. The EP believes that where there is no bilateral agreement, these contracts would generally not be subject to offsetting disclosure requirements, however, careful analysis of relevant agreements and legal interpretation may be needed to assist entities in making this determination.
- 2) For futures contracts and certain other derivatives, the variation margin receivable or payable would generally be disclosed.
- 3) For securities lending, there has been diversity in practice in the tabular presentation, for example, presenting the securities on loan as an asset, but the collateral (liability) in column 5 rather than column 2. Also, in certain cases, funds have determined that as a result of the gross presentation of assets and liabilities on the balance sheet in combination with the perspective that the netting arrangement inherent in securities lending is outside of the fund (i.e., it is between the securities lending agent and their borrower), that these disclosures would not be necessary. The EP generally noted that this is a legal interpretation and the reporting entity should look into its security lending master agreement to assist in determining the appropriate disclosures.

The EP also noted that the SEC staff continues to issue financial statement review comments related to the narrative description of the rights to offset for registered funds.

9. The EP briefly discussed recently issued [FASB ASU 2015-07 Fair Value Measurement \(Topic 820\): Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share \(or Its Equivalent\) \(a consensus of the Emerging Issues Task Force\)](#) and noted that many funds chose to early adopt. The EP acknowledged that “near term” is now used in determining whether a cash flow statement is required to be presented by an investment company that uses the practical expedient to fair value investments in investment companies. The EP noted that “near term” is still not defined in FASB guidance, however, noted that a TPA on this topic was issued previously.
10. The EP discussed whether a reporting entity may use the practicability exemption in FASB ASC 946-210-50-10 when there is legal restriction on disclosing information about investments held by an investee fund/underlying fund. The EP members expressed a view that when a reporting entity is subject to a confidentiality agreement, such legal or regulatory restriction may result in information about investments greater than 5% considered “not available.” Certain EP members believe that in these situations the practicability exemption would apply. However, other EP members acknowledged that inability to disclose information about investments held by an investee fund may result in qualified audit opinion. One member noted paragraph 16 of AU Section 9508 “Reports on Audited Financial Statements: Auditing Interpretations of Section 508”, issued in 2002, which addressed situations of inadequate disclosures resulting in issuing of a qualified audit opinion for an investment company.
11. More hybrid types of investments are coming to market, especially by foreign issuers. The complexity of the instruments appears to be increasing as well. For example, structures which initially appear to be debt, may have embedded features that cause the holders of the security to lose their debtor rights [and fall in line with equity holders](#) when capital ratios hit trigger amounts. As these embedded conditions become more prevalent, the EP member inquired whether investors are scrutinizing these instruments more rigorously from an accounting perspective. The EP members shared that they are not seeing an increase in investments into these types of securities of foreign issuers.
12. The EP discussed that recently issued [FASB ASU 2015-02](#) impacts the adviser’s consolidation of the funds it manages.
13. At the November 12, 2014, EP meeting, the EP sought the SEC staff’s views on the mechanics for the significant thresholds tests under Regulation S-X Rule 1-02(w) (the three tests thereunder) that investment companies should apply to determine whether the financial statements of an unconsolidated subsidiary should be attached to the registrant’s filing with the Commission (pursuant to Rule 3-09) or whether summarized financial information of an unconsolidated subsidiary should be presented in the notes of the registrant’s financial statements (pursuant to Rule 4-08(g)). The SEC staff requested that the EP develop a view that can be later presented to the SEC staff for consideration. On January 20, 2015, the EP considered various alternative calculation methods that had been formulated by a subgroup of the EP. The subgroup of the EP will resume its efforts in the future, prioritize the views of the subgroup, include numerical examples for each views, and present again to the EP. After EP weighs in, the subgroup of the EP will schedule a separate conference call with the SEC staff to discuss the EP views and examples.

III. Audit and Attest Issues

1. In order to satisfy the audited financial statement exception in the Custody Rule, the financial statements must be prepared in accordance with US GAAP. Question 19 of the [AICPA FAQs on the Custody Rule](#) discusses financial statements for a liquidation audit, noting balance sheets, statements of operations, statements of changes in partners’ capital, and statements of cash flows (when required). With the adoption of ASU 2013-07, the minimum GAAP financial statements required for a fund in liquidation are a statement of net assets in liquidation and a statement of changes in net assets in liquidation. The EP observed that the second part of Q&A 19 above would likely need to be updated to reflect amendments to the required financial statements for a fund in liquidation by ASU 2013-07. The EP noted that they are currently working on a TPA addressing what financial statements a fund may include in its liquidation basis financial statements. The EP will raise this question with the SEC staff in connection with the TPA.

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 meeting in person to provide a brief overview of the Chief Accountant's Office of the Division of Investment Management (IM-CAO), update the EP on the Division of Investment Management ("IM") rulemaking initiatives and SEC staff projects, and share the SEC staff's observations in connection with recent financial statement reviews and other consultations.

1. Brief overview of the Office: IM-CAO serves primarily as a consultation office for the SEC on accounting and auditing issues related to the investment management industry. IM-CAO works with various offices in IM, including IM's Disclosure and Review Office, IM's Chief Counsel's Office and IM's Rulemaking Offices, and different Offices and Divisions within the Commission such as the Office of Compliance Inspections and Examinations (OCIE), the Division of Enforcement, and Commission's Office of the Chief Accountant. IM's Disclosures and Review Office has a number of accountants who have been restructured and will report directly to IM's Chief Accountant's Office.
2. Division initiatives and rulemaking priorities:
 1. A comprehensive list of rulemakings the SEC staff is working on is included in the agency rule list published semi-annually by the Office of Information and Regulatory Affairs and the Office of Management and Budget. The Spring 2015 [Agency Rule List](#) is now available.
 2. David Grim has been named as Director of the Division of Investment Management. In his [March 5, 2015 Remarks](#) to PLI Investment Management Institute and his [March 6, 2015 Remarks to IAA Compliance Conference](#), Mr. Grim outlined the following IM initiatives (included in the above mentioned agency rule list):
 - 1) Enhanced Data Reporting
 - 2) Portfolio Composition Risks Associated with
 - i. Derivatives (the use of derivatives by investment companies)
 - ii. Liquidity
 - 3) Transition Plans, and
 - 4) Stress Testing.
 3. Rulemaking:
 - 1) Proposed rules for registered investment companies and advisers (issued on May 20, 2015):
 - i. [Investment Company Reporting Modernization](#):
 1. New Form N-PORT would require certain registered investment companies to report information about their monthly portfolio holdings in a structured data format.
 2. Amendments to Regulation S-X would require, among other things, standardized, enhanced disclosure about derivatives in investment company financial statements. There are additional disclosure requirements around securities lending.
 3. New rule 30e-3, which would permit but not require registered investment companies to transmit periodic reports to their shareholders by making the reports accessible on a website and satisfying certain other conditions.
 4. New Form N-CEN - would require registered investment companies, other than face amount certificate companies, to annually report certain census-type information to the Commission in a structured data format.
 5. Rescission of current Forms N-Q and N-SAR.
 - ii. [Amendments to Form ADV and Investment Advisers Act Rules](#)
 - 2) Derivatives project - the SEC received comments on the ["Use of Derivatives by Registered Investment Companies Under the Investment Company Act of 1940, Investment Company Act Release No. 29776"](#) (Aug. 31, 2011) ("2011 Derivatives Concept Release") and is considering recommending the Commission propose a new rule under the Investment Company Act

addressing the use of derivatives by funds and related matters, including disclosure of fund use of derivatives.

- 3) Liquidity Management Programs for Funds- IM is considering recommending that the Commission propose a new rule requiring open-end funds to adopt and implement liquidity management programs and that the Commission provide enhanced guidance relating to required liquid assets in open-end funds.
 - 4) Transition Plans for Investment Advisers- The SEC staff provided an overview of the following other longer-term regulatory initiatives:
 - 5) Target Date Retirement Funds – In 2010, the SEC issued a rule [proposal](#) that would require marketing materials for target date funds to include a graphical or tabular depiction of changes in the fund’s asset allocation over time, known as a fund’s “glide path.” On April 3, 2014, the SEC [reopened](#) the comment period on the 2010 proposal to request comment on the Investor Advisory Committee’s recommendation that the SEC develop a glide path illustration based on a standardized measure of fund risk, which would replace or supplement what it previously proposed. The Division is considering recommending that the Commission re-propose amendments to its advertising rules to require target date retirement funds’ marketing materials to provide investors enhanced information about those funds
 - 6) Variable Annuity Summary Prospectus – The Division of IM is considering recommending that the Commission propose rules designed to provide variable annuity investors with concise and more user-friendly disclosure and to improve and streamline the delivery of information about variable annuities through increased use of the Internet and other electronic means of delivery.
 - 7) ETF rule – the Division of IM is considering recommending that the Commission re-propose new rules and rule amendments to provide exemptive relief for certain plain vanilla index-based and actively-managed ETFs.
3. The SEC staff provided an overview of the following other longer-term regulatory initiatives:
 - a. Valuation guidance - the SEC staff indicated that valuation remains an important focus area for the Division of IM, but mentioned there is no update on timing or form of this project.
 - b. As previously discussed with the EP in 2014, in “[Report on Review of Disclosure Requirements in Regulation S-K](#),” the SEC staff is recommending, among other things, development of a plan to systematically review SEC forms and regulations, including Regulations S-K and S-X and eliminate overlaps, where appropriate.
 4. The SEC staff discussed the recently issued [Money Market Fund Frequently Asked Questions](#)
 5. Cybersecurity remains an important issue to the SEC staff. The SEC staff issued [IM Guidance Update No. 2015-02 “Cybersecurity Guidance”](#), which highlighted the importance of the issue and discusses a number of measures that funds and advisers may wish to consider when addressing cybersecurity risks. Because of the rapidly changing nature of cyber threats, the SEC staff will continue to focus on cybersecurity and monitor events in this area.
 6. The SEC staff discussed [OCIE’s 2015 exam priorities and referenced the dedicated OCIE webpage on sec.gov](#) that includes information about OCIE, its national examination program, current focus areas and other relevant information.
 7. The SEC staff described the financial statement review and comment process. As required by the Sarbanes-Oxley Act, all public companies, including regulated investment companies, are subject to the financial statement review process at least once every three years (SOX Review). In addition to the SOX Reviews, the SEC staff may also perform targeted in-depth reviews of certain types of investment companies. The SEC staff reviews not only financial statements but also accounting information included in other filings with the SEC, such as merger filings to ensure consistency and compliance with securities laws. The SEC staff will also review IC website disclosures. The SEC staff generally provides financial statement review comments verbally, and registrants are generally required to provide written responses within 30 days. In certain circumstances, comments may be given to the registrant in a written letter. Lack of comments does not mean that financial statement reviews have not been performed. Certain investment companies may have been reviewed but the reviewer does not have comments.
 8. In July 2014, the EP sought the SEC staff’s views regarding fee waivers/reimbursements in excess of total expense by advisers to fund-of-funds (previously discussed at the May 2014 EP meeting). Refer to notes from these prior meetings for additional background. During the November EP meeting, the SEC staff requested the EP’s view regarding reimbursements in excess of total expenses by advisers to fund-of-funds (FOF) – whether such reimbursements would be treated as payments by an affiliate and whether the fund

should disclose the impact on total return in the fund's financial highlights. On the January 20, 2015 EP call, the EP discussed that guidance related to "payments by an affiliate" is generally applied when the adviser reimburses the fund for losses on investments (either in connection with an investment restriction violation or as a voluntary reimbursement for investment losses outside of the adviser's control.) The EP acknowledged that the waiver or reimbursement of expenses in excess of expenses at the FOF level (to subsidize acquired fund fees and expenses) is different from the typical "payment by affiliate," with a focus on the expense ratio, and not on total return. The EP highlighted that disclosing the impact on total return would be inconsistent with how other expense waivers and reimbursements are treated. The EP acknowledged that the expense reimbursement in question is in excess of the FOF expenses and therefore is not technically an expense reimbursement at the FOF level. However, the EP also noted that the impact on the expense ratio is generally relatively consistent with the impact on total return. The EP expressed a view that the impact on total return may be disclosed in the FOF's financial statements, but such disclosure would not be required. The SEC staff confirmed that best practice is to include the effect on total return in the financial highlights, but would not be object if presentation is similar to direct expense waiver and does not include impact on total return.

9. The SEC staff provided the following other financial statement and registration statement review comments:
1. To the extent a BDC is required (in accordance with Rule 3-09 of Regulation S-X) to include financial statements of its majority-owned significant subsidiary in its annual 10-K filing, a BDC must include such subsidiary's financial statements in part (B) of a BDC's registration statement (Form N-2), and cannot incorporate the subsidiary's financial statements by reference, in accordance with instruction 2(a) to item 24 of Form N-2.
 2. Form N-SAR – the SEC staff continue seeing incorrect or incomplete reports on the registrant's internal controls over financial reporting (for example, date or signatures are missing, a wrong report is filed, or incorrect name of the firm is included). Auditors and registrants should review these reports before the submission.
 3. Form N-2 – annual expenses in "Fee Table" should be based on net assets attributable to common shares only.
 4. Staff accountants also review registrants' other disclosures, such as websites or Fact Sheets, for consistency. The SEC staff noted comments issued to closed-end funds in connection with disclosures of distributions. Specifically the SEC staff reminded that the return of capital portion of a distribution should be properly disclosed and distributions which are return of capital should not be disclosed as dividends. The SEC staff has not objected to the use of the term distribution where there is a return of capital as long as the return of capital is properly disclosed.
 5. The SEC staff highlighted recent [enforcement case involving Alpha Titans](#) where an improper allocation of fund assets was used to pay undisclosed operating expenses.
 6. The SEC staff highlighted another [recent enforcement case \(Nationwide Life Insurance Company, or Nationwide\)](#) where Nationwide was charged with routinely violating pricing rules in its daily processing of purchase and redemption orders for variable insurance contracts and underlying mutual funds.

Investment Companies Expert Panel

Highlights of the July 21, 2015 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) March 2015 call highlights and May 2015 meeting highlights are being finalized.
2. The EP task force is developing a FinREC comment letter on the [SEC's investment company reporting modernization proposal](#).
3. The AICPA Asset Management Revenue Recognition Task Force (AM RRTF) staff provided a status update on the progress of the AM RRTF to date.
4. The AICPA staff and EP chair updated the EP about the status of Liquidation Basis of Accounting and Loan Origination TQA drafts.
5. The 2015 edition of AICPA Audit and Accounting Guide *Investment Companies* is expected later this month.
6. [2008-2013 ARA SEC observations](#) excerpts are available on aicpa.org.

II. Accounting/Reporting Issues:

1. In late April, the FASB released three new Proposed ASUs for benefit plans, one of which is entitled Proposed FASB ASU *Plan Accounting: Defined Contribution Pension Plans (Topic 962) and Health and Welfare Benefit Plans (Topic 965) -Fully Benefit-Responsive Investment Contracts (File Reference No. EITF-15C – I)*. The proposed Update would designate contract value as the only required measure for fully benefit-responsive investments contracts, which maintains the relevant information while reducing the cost and complexity of reporting for fully benefit-responsive investment contracts. An EP member questioned whether the scope of EITF issue 15C would be expanded to include investment companies. The EP members observed that it was their understanding the EITF's objective was to reduce complexity in employee benefit plan accounting. Therefore, the FASB's research, outreach, and factors considered in deliberating this issue had been limited to employee benefit plans. Furthermore, an EP member indicated that the FASB received comments to expand the scope of EITF issue 15C to include investment companies, however the EITF had determined (for the reasons mentioned above) that they would not expand the scope. An EP member noted that if the EP believed that similar accounting would be appropriate for investment companies that the EP should request the FASB

consider a separate issue to expand the scope. The EP will consider whether to engage in a dialog with the EITF.

2. The EP discussed the following scenario.

Company A owns 65% of a public company which is traded on the NYSE. How can this security be priced?

View A:

Since there is a Level 1 price (i.e., quoted price in an active market), the investment must be priced at the closing price on the NYSE.

View B:

The unit of account can be seen as the controlling interest and hence the market in which this investment would be sold is different than the NYSE. Therefore, an alternative to the closing price on the NYSE could be considered.

An EP member observed that FASB ASC paragraph 820-10-35-36B indicates that in certain cases a reporting entity may select inputs, including a control premium, if those inputs are consistent with the characteristics of the asset or liability that a market participant would take into account. However, paragraph 820-10-35-36B further indicates that in all cases, if there is a quoted price in an active market (that is, a Level 1 input) for an asset or a liability, a reporting entity shall use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C.

Another EP member cited guidance from Section 2(a)(41) of Investment Company Act of 1940 ("1940 Act"), which states, in part, with respect to assets of registered investment companies:

Notwithstanding the fact that market quotations for securities issued by controlled companies are available, the board of directors may in good faith determine the value of such securities: Provided, That the value so determined is not in excess of the higher of market value or asset value of such securities in the case of majority-owned subsidiaries, and is not in excess of market value in the case of other controlled companies.

The majority of EP members believe that under US GAAP, it would be inappropriate to apply a control premium to securities where there is a Level 1 input available. EP members also expressed a consensus view that although allowed under the 1940 Act for purposes of calculating transaction NAV, it would be inappropriate to value a security at an amount other than the Level 1 price for financial statement purposes under US GAAP, which could result in a difference between transaction NAV and GAAP NAV for registered investment companies.

3. FASB ASU 2015-10, *Technical Corrections and Improvements*, in paragraph 30 amends the definition of readily determinable fair value to add limited partnerships and venture capital entities as examples, as long as their NAVs are published and are the basis for current transactions.

A criterion for an investment company to use net asset value as a practical expedient to measure fair value of an investee is that the investee fund not have a readily determinable fair value. An EP member expressed a concern that these amendments may influence the reporting entity's determination as to whether investments in limited partnership or venture capital entity have a readily determinable fair value, and, therefore, preclude the use of NAV as a practical expedient for measuring the fair value of these investments. However, the EP members observed that the FASB's technical corrections are not intended to change current practice. An EP member noted that this concern had been described to the FASB and that additional details may be available at later meetings. The EP also discussed the meaning of "published" and noted that, in practice, "published" is not necessarily interpreted to mean "publicly available".

4. The EP considered timing of recording reverse repurchase agreements. FASB ASC 946-320-25-1 states that an investment company should record security purchases and sales as of the trade date. There is some diversity in practice on whether reverse repurchase agreements are recorded on trade date or settlement date when they are used to finance the purchase of a security.

For example, an entity purchases a bond on 5/30 trade date with a settlement date of 6/1 and on 5/31 enters into a reverse repurchase agreement to finance this purchase, which also settles on 6/1. As of 5/31 (the entity's reporting period end), should the entity record both the bond and the reverse repurchase agreement on its balance sheet (trade date accounting for reverse repo) or only the bond and corresponding due to broker with reverse repurchase agreement being recorded on 6/1 (settlement date accounting for reverse repo)?

Option 1 (trade date basis)

Journal entry on 5/30:

Dr. Bond

Cr. Due to broker

Journal entry on 5/31:

Dr. Due from broker

Cr. Reverse Repo

5/31 balance sheet would have the following accounts:

Assets:

Bond

Due from broker

Liabilities:

Due to broker

Reverse Repo

Option 2 (settlement date basis)

5/31 balance sheet would have the following accounts (only the 5/30 journal entry would be recorded since the reverse repo would not be recorded until the 6/1 settlement date):

Assets:

Bond

Liabilities:

Due to broker

The EP members noted this determination should be based on contractual obligation and acknowledged diversity in practice with Option 1 (trading date accounting) prevailing. The EP acknowledged that in some instances, it may be more appropriate to record the reverse repo on settlement date, because the reverse repurchase agreement is accounted for as a secured borrowing rather than a sale of securities/securities transaction.

5. The EP discussed accounting for foreign tax withholding refunds (from taxes previously withheld on realized gains, interest, or dividends) that mutual funds have started receiving in Sweden and Finland, including the timing of recording the receivable for refunds and payable for any potential settlement with the IRS for credits previously reported to shareholders. The EP indicated that the first step in determining the appropriate accounting is to determine if the tax withholding refunds should be accounted for under FASB ASC Topic 740 for income taxes, FASB ASC Topic 450 specific to gain contingencies, or other GAAP. Consistent with EP's previous views expressed in 2013, EP members believe that, generally, foreign withholding taxes are an income tax and, therefore, would be accounted for under FASB ASC Topic 740. However, this conclusion depends on the facts and circumstances of the tax and the specific taxing jurisdiction. Under the FASB ASC 740 model, an entity should record the positive effect of a tax position when it is more likely than not (MLTN) that the entity will sustain that position upon challenge by the tax authority,

considering, not only current laws and regulations, but also past administrative practices and precedents of the tax authority. Once it is determined that the position is MLTN to be sustained, a fund would record the greatest amount of benefit that is MLTN of being sustained. One EP member questioned if an entity that determined its position was MLTN could also conclude that the corresponding receivable was uncollectable. The EP members also discussed the challenges associated with determining if the MLTN threshold had been met. Specifically, the EP discussed if there were gating items that resulted in the MLTN threshold being met. The EP noted that these determinations required judgment, are based on the specific fund's facts and circumstances, and may require the involvement of tax experts.

6. The EP briefly discussed how recent events in Greece, China, and, to a lesser extent, Puerto Rico impact investment management and investment companies industry. The EP discussed if it would be appropriate to include disclosures related to specific concentrations.
7. The EP discussed progress related to a TPA on accounting for convertible bonds.

III. Audit and Attest Issues

1. The EP discussed applicability of audit procedures around executive compensation to investment company complexes and other similar structures, where executives are being compensated outside of the entity being audited in light of recent issuance of PCAOB Auditing Standard No. 18 *Related Parties* and amendments to other PCAOB Auditing Standards regarding, among other things, financial relationships between issuers and executive officers.

AS 12

10A: To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers. The procedures should be designed to identify risks of material misstatement and should include, but not be limited to (1) reading the employment and compensation contracts between the company and its executive officers and (2) reading the proxy statements and other relevant company filings with the Securities and Exchange Commission and other regulatory agencies that relate to the company's financial relationships and transactions with its executive officers.

Appendix A – A3A: Executive officer—For issuers, the president; any vice president of a company in charge of a principal business unit, division, or function (such as sales, administration or finance); any other officer who performs a policy-making function; or any other person who performs similar policymaking functions for a company. Executive officers of subsidiaries may be deemed executive officers of a company if they perform such policymaking functions for the company. (See Rule 3b-7 under the Exchange Act.) For brokers and dealers, the term "executive officer" includes a broker's or dealer's chief executive officer, chief financial officer, chief operations officer, chief legal officer, chief compliance officer, director, and individuals with similar status or functions. (See Schedule A of Form BD.)

It is unclear how to apply AS 18 to the audit of an investment company, since generally, funds do not have employees and the compensation contracts are between the investment adviser and the executive officers. An EP member observed that often certain members of management at the adviser are compensated in part based on the performance of the funds. EP members agreed that procedures generally should be performed to obtain an understanding of compensation arrangements as these arrangements may affect fraud/audit risk assessment. However, EP members noted that it may be possible to obtain an understanding without specifically reviewing compensation contracts. An EP member indicated that although an investment company may outsource certain responsibilities typically held by an executive officer of an operating company, it may still be appropriate to review compensation contracts or other agreements at the adviser.

2. The EP considered proposed draft revisions to Q&A #19 of the AICPA FAQs on custody rule.
3. The EP discussed whether recent [SEC concept release on audit committee disclosures applies to investment companies](#). Since disclosures are currently made in proxy statements, certain registered investment companies (closed-end funds, etc.) are impacted. An EP member noted that in its release the SEC questioned whether the disclosures should apply to other registrants and whether the disclosures should be made in other documents.

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 Accountant 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. ASU 2015-03 requires that unamortized debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, rather than as an asset. For the purposes of calculating asset coverage, the EP sought the SEC staff's view whether reporting entities should
 - a. follow GAAP presentation and include as senior securities the debt liability net of debt issuance costs, as presented on the entity's balance sheet upon adoption of ASU 2015-03 or
 - b. not follow GAAP presentation and include as senior securities the gross amount of the debt liability without deducting debt issuance costs which would not agree to the balance sheet upon adoption of ASU 2015-03.

SEC staff noted that the gross amount should be considered for purposes of asset coverage, but the net GAAP presentation is appropriate for financial reporting purposes.

Investment Companies Expert Panel

Highlights of the September 8, 2015 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) March and July 2015 calls highlights and May 2015 meeting highlights are being finalized.
2. [FinREC comment letter](#) on the [SEC's investment company reporting modernization proposal](#) developed by members of the EP is available.
3. The AICPA Asset Management Revenue Recognition Task Force (AM RRTF) member and staff provided a status update on the progress of the AM RRTF to date.
4. The EP welcomed new AICPA Technical Manager who will work on the investment companies industry publications.
5. The EP considered potential updates to 2016 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
6. The EP was updated on the efforts of the AICPA task force developing a practice aid on auditing of alternative investments.

II. Accounting/Reporting Issues:

1. The EP chair updated the EP on the status of draft Technical Questions and Answers (TQAs, formerly known as TPAs): Liquidation Basis of Accounting and Loan Origination. The EP members provided their views regarding the alternatives presented in the current draft TQA on accounting for convertible bonds.
2. As a result of the implementation of the Volcker rule, some banks and investment companies are “modifying” their tender option bond (“TOB”) trusts. At the May EP meeting, the EP discussed potential accounting issues that may result from restructuring the TOB trusts. The EP continued this discussion at the September EP meeting. EP members observed that these issues were being discussed among certain accounting firms, but that conclusions were still being evaluated and they would likely depend on the facts and circumstances of the TOB trust and restructuring. The EP members discussed a paper that served as a basis for the discussion among certain accounting firms.

3. The EP members considered whether a nonregistered/private fund that converts to a registered fund can be the financial “accounting survivor.” EP members noted that in their experience, a private fund that has converted into a registered investment company is not considered to be an “accounting survivor” and generally the SEC staff has not objected to this view. In several instances, for example, when a common or collective trust fund (CTF) converted into a registered fund, the CTF was not considered the “accounting survivor.” The EP noted that [the SEC staff previously stated](#) that “the survivor of a business combination for accounting purposes (i.e., the fund whose financial statements are carried forward) typically will be the fund whose historical performance may be used by the new or surviving fund”. However, an EP member noted that with respect to the CTF conversions, the CTF may be considered “performance survivor” but not the “accounting survivor”. An EP member noted that the instructions to Form N-1A, Item 13 - Financial Highlights indicate, “Present the information in comparative columnar form for each of the last 5 fiscal years of the Fund (or for such shorter period as the Fund has been in operation), but only for periods subsequent to the effective date of the Fund’s registration statement.” (emphasis added).

4. The EP discussed the following topic on its July 21 conference call.

FASB ASU 2015-10, *Technical Corrections and Improvements*, in paragraph 30 amends the definition of readily determinable fair value to add limited partnerships and venture capital entities as examples, as long as their NAVs are published and are the basis for current transactions.

A criterion for an investment company to use net asset value as a practical expedient to measure fair value of an investee is that the investee fund not have a readily determinable fair value. The EP members expressed a concern that these amendments may suggest that the use of NAV as the practical expedient for measuring fair value for certain investments is not appropriate. However, the EP members observed that the FASB’s technical corrections are not intended to change current practice. An EP member noted that this concern had been described to the FASB and that additional details may be available at later meetings.

At the September 8, 2015, EP meeting, the EP members shared that an accounting firm submitted a technical inquiry to the FASB regarding the impact of the amendments on the use of the practical expedient for certain investments. The EP is monitoring this issue and will be updated on any new developments at the November EP meeting.

5. As a follow up to the July 21 EP conference call, the EP continued discussing accounting for foreign tax withholding refunds that mutual funds have started receiving in Sweden and Finland, including timing of recording a receivable and payable. Consistent with EP previous views expressed in 2013, EP members believe that, generally, foreign withholding tax is an income tax and, therefore, would be accounted for under Topic 740 as a tax position (or uncertain tax position). If it is more likely than not (MLTN) that the position would be sustained under the law, the greatest amount that is MLTN of being received should be recorded. EP members noted that such determination may vary among different jurisdictions.

The EP discussed the need to consider the tax liability that may arise as a result of the tax refund. The foreign taxes withheld are passed through as tax credits to taxable shareholders. When the investment company recovers the previously withheld tax this can result in a tax liability for the shareholders. An EP member described an approach that has been contemplated by certain mutual fund complexes where a RIC that flowed through foreign taxes to reduce the shareholder tax in the previous years are recovered through an offset of current year tax credits (the “credit-offset approach”). Under this credit-offset approach, the U.S. Government is compensated for the earlier tax credits (that were claimed for foreign taxes withheld but have subsequently been refunded) by lowering/offsetting foreign tax credits claimed in the year the taxes are recovered. An EP member indicated that guidance from the IRS was expected to be released in the near term. Alternatively, if the investment company intends to settle any tax liability with IRS on behalf of its shareholders, a tax liability at the fund level may be needed.

6. The EP considered the accounting for capital gains tax on Argentine ADRs based on a change in Argentine law in September 2013, which removed the exemption for non-

residents from paying the capital gains tax on income derived from the sale of securities of Argentine entities. Although non-residents are required to pay capital gains tax on Argentine source income, there is no mechanism for non-residents to pay this tax. The EP discussed that funds should consider the guidance in Topic 740 to determine whether to record a tax liability.

An EP member noted that it was their understanding that certain law firms have concluded that gains from Argentinian ADRs do not represent Argentina source income. However, the EP highlighted that these conclusions were based on the specific facts of the ADR examined and that a legal analysis would be necessary to reach this conclusion. The EP members expressed a view that the determination of the source of income is a legal determination, however, if an entity concluded that gains from Argentina ADRs are not Argentina source income then it would be appropriate not to accrue the capital gains tax. An EP member noted that other tax positions (not regarding the source of the income) could be taken by reporting entity that would impact its determination as to whether to record a liability. The EP observed that these tax positions would be considered uncertain tax positions under Topic 740.

7. The EP considered disclosure and other issues relating to Bank of New York Mellon's inability to timely calculate NAV for certain registered investment companies. Some of the issues discussed relate to reprocessing and recording August 31 trades, subsequent event evaluation, internal controls, and related financial statement and prospectus disclosures.

III. Audit and Attest Issues

1. The EP discussed removal of the example Report for a Closed-End Fund Security Rating Agency (paragraph 11.33 in the 2012 Guide) from 2013 and future editions of the Guide. One EP member observed that agreed upon procedures (AUP) reports are specific to the AUP engagement and therefore an example report may not be that useful. Another EP member noted that there are other example AUP reports published, but those reports generally relate to AUPs required by a regulator. The Closed-End Fund Security Rating Agency report was intentionally deleted based on the EP's review as often it was difficult for the auditor to obtain a letter from the specified users (rating agencies) and therefore these reports were not being issued. The EP determined that it will not be included in the future editions of the Guide.
2. Recently, an increasing number of directors for Cayman Islands based investment vehicles have requested to sign the management representation letter in connection with the audit being performed. These requests are unsolicited by the audit firm, the directors are not required to sign under GAAS, and the directors' request to sign the representation letter are accompanied by requests to include modifying language in the introductory paragraph and the signature paragraph:

Example modification to the introducing paragraph:

[XXXX] and [YYYY] serve as independent directors (the "Independent Directors") to the Funds. The Funds have no employees. Substantially all of the matters referenced below, so far as they relate to the day to day operations of the Funds, are performed by the Funds' service providers, which include, but may not be limited to the investment manager and administrator and others if applicable. In compliance with our fiduciary duties, the Independent Directors supervise and oversee the service providers to the extent necessary to fulfill the Independent Directors' obligations. The investment manager of the Funds is [ABC MANAGER] (the "Manager"). Collectively, the Funds and the Manager are referred to as "We".

Example modification to the signature block prior to the directors' signatures:

The Independent Directors confirm the above representations are made on the basis of our supervision, oversight, inquiry of service providers and inspection of supporting documentation (amongst other things), sufficient to satisfy ourselves that the above representations are true to the best of our knowledge and belief.

While a director signing the management representation letter does not in and of itself appear to impact the audit firm's ability to rely upon the representations received from management, the modifications requested have raised concerns regarding the implied qualification of the representations, and there appears to be diversity in practice

among the firms in i) allowing directors to sign the representation letter and ii) if they sign, whether any modifications are permitted and if so, what modifications are acceptable. The motivation for the directors to sign the representation letter appears to be grounded in a desire to demonstrate fiduciary oversight of the audit. The EP considered the following questions:

- Should directors be allowed to sign the representation letter?
- Should modifications similar to the above be accepted as requested?
- Are additional modifications of this language necessary to ensure the management representation letter continues to constitute sufficient appropriate audit evidence?
- Should firms require directors to sign a separate representation letter from that obtained from management?

An EP member indicated that they have discouraged directors from signing such letter. Another EP member indicated that his firm required such signature from the directors, however they generally discouraged disclaimers or other caveats. The EP member noted that it was ultimately the audit firm's Cayman office's decision because the Cayman office was issuing the opinion. The EP members acknowledged that it would not be appropriate for Cayman directors to sign the representation letter for US-domiciled funds.

3. The EP discussed practices relating to the evaluation of SOC 1 reports for service organizations that provide accounting and administrative services to investment companies, particularly considerations related to user controls and "dark periods".
4. As a follow up to the July 21 EP conference call discussion, in light of recent PCAOB AS 12/AS 18 amendments, the EP further considered applicability of audit procedures around executive compensation to the audits of registered investment companies since executives typically are not compensated directly by funds.

10A: To assist in obtaining information for identifying and assessing risks of material misstatement of the financial statements associated with a company's financial relationships and transactions with its executive officers (e.g., executive compensation, including perquisites, and any other arrangements), the auditor should perform procedures to obtain an understanding of the company's financial relationships and transactions with its executive officers.

EP members reported that some are still formulating their views. Some EP members from public accounting firms reported that they plan to review compensation agreements between the registered investment adviser (RIA) and certain executives. Other EP members from public accounting firms noted that the fund's compensation arrangement is with the RIA (investment management agreement, or IMA) and indicated that they plan to review the IMA, and plan to obtain an understanding of certain compensation arrangements between the RIA and certain executives, but not necessarily through a review of the related agreements. Information about adviser compensation practices may also be available in the materials provided to the funds' board as part of its approval of IMAs. The EP discussed that the RIA may not grant the fund auditor with an access to compensation agreements, particularly where the auditor does not also audit the RIA. The EP members generally agreed that, at a minimum, the auditor must have an adequate understanding of compensation arrangements to properly assess audit risks, including the risk of fraud.

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 meeting via conference call to discuss the following item presented by the EP members.

1. The EP asked the SEC staff to share any observations or guidance provided to registrants that use Bank of New York Mellon for fund accounting purposes in regards to the issue they had in calculating NAV during the week of August 24. The SEC staff shared that they are discussing issues with affected registrants directly and that the SEC staff's main concern is around ensuring each fund's NAVs was processed correctly and shareholders were not harmed. The SEC staff would expect shareholders that were affected to be made whole when appropriate.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought. Copyright © 2016 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the November 17, 2015 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) May, July, and September 2015 meetings and calls highlights are being finalized.
2. The AICPA Asset Management Revenue Recognition Task Force (AM RRTF) staff provided a status update on the progress of the AM RRTF to date and informed the EP that AM RRTF Issue 10-5A, on whether incentive-based capital allocations, such as carried interest, are within the scope of FASB ASC Topic 606, was submitted to the FASB TRG.
3. The EP identified reviewers for proposed conforming changes to 2016 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).
4. The EP briefly discussed the Institutional Limited Partners Association's (ILPA) recently issued fee reporting template.
5. The EP discussed dates for 2016 EP meetings and calls.

II. Accounting/Reporting Issues:

1. The EP originally discussed the amendments to the definition of readily determinable fair value included in FASB ASU 2015-10, *Technical Corrections and Improvements* (ASU 2015-10) on its July 21 conference call. Specifically, paragraph 30 of ASU 2015-10 amends the definition of readily determinable fair value to add limited partnerships and venture capital entities as examples, as long as their NAVs are published and are the basis for current transactions. A condition for funds using the practical expedient is that the investee fund does not have a readily determinable fair value. The EP members expressed a concern that these amendments may preclude the use of NAV as the practical expedient for measuring fair value for certain limited partnership or venture capital investments that, in practice, were not previously considered to have readily determinable fair values. The EP also discussed the meaning of "published" and noted that "published" is not necessarily interpreted as "publicly available".

At the September 8, 2015, EP meeting, the EP members shared that an accounting firm submitted a technical inquiry to the FASB regarding the impact of the amendments on the use of the practical expedient for certain investments. It is the EP's understanding that this amendment did not intend to change current practice. The EP is monitoring this issue and

during November EP meeting determined that representatives of the EP should have further discussions with the FASB and, if those discussions are unsuccessful, the EP will consider drafting a Technical Question and Answer for consideration by FinREC.

2. The EP was informed that representatives of the EP participated in a call with the SEC staff to discuss [FinREC's comment letter](#) on the [SEC's investment company reporting modernization proposal](#). The EP representatives and SEC staff discussed FinREC's comment letter and the SEC staff shared observations from other comment letters received and sought the EP's feedback. During the November 2015 EP meeting, the EP discussed and later shared their views with the SEC staff as follows:
 - a. Certain commenters suggested amending Regulation S-X to clarify that investment companies registered with the SEC under the Securities Act of 1933, but not under the Investment Company Act of 1940, should apply Article 6 of Regulation S-X.
 - i. The EP representatives noted that, while business development companies (BDCs) file Forms 10-Q and 10-K, they are regulated by the SEC's Investment Management Division and currently apply Article 6. The EP representatives noted that there may also be other entities that use investment company accounting and reporting, such as certain commodity trading-type vehicles and certain real estate funds, which also file Forms 10-Q and 10-K, but they are regulated by the SEC Division of Corporation Finance. EP representatives generally believed it would be appropriate to make this clarification.
 - b. Certain commenters noted that it is challenging for certain registrants to determine fair value hierarchy classification on a monthly basis (in monthly Form N-PORT). The SEC staff asked the EP representatives for views regarding these comments.
 - i. EP members noted that affected registrants should perform cost/benefit analysis and provide views to the SEC staff. The EP representatives also noted that determining the categorization of certain fixed income instruments between level 2 and 3 of the fair value hierarchy may be difficult and time consuming and that registrants generally would not perform this assessment monthly. The EP also acknowledged that categorization in the fair value hierarchy on a quarterly basis (Form N-Q) may be sufficient, especially in light of FASB project to consider amending certain disclosures about fair value measurements.
 - c. Certain commenters indicated that it may be competitively disadvantageous to disclose the financing rate within a swap agreement.
 - d. Liquidity disclosure
 - i. The EP generally believes that rather than requiring the identification of illiquid investments on the schedule of investments, liquidity disclosures may be included in Form N-PORT or in other reporting (not within the financial statements).
3. The EP discussed certain financial reporting and disclosure aspects of the SEC [proposal](#) "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization", including:
 - a. presentation of adjusted ("swung") NAV in financial statements if swing pricing has been used;
 - b. presentation of the adjustment to NAV in financial statements;
 - c. auditing issues around the "reasonableness" of the adjustment to NAV;
 - d. clarification of the calculation of total return – how will it work mechanically?
4. The EP was informed that the following draft Technical Questions and Answers (TQAs, formerly known as TPAs) will be submitted to FinREC:
 - a. Liquidation Basis of Accounting;
 - b. Loan Origination;
 - c. Accounting for Convertible Bonds.

The EP determined not to proceed with developing a TQA on "the meaning of financial support".

5. The EP considered whether financial statements can be issued for a period greater than 12 months. The EP discussed that current AICPA TQA 9160.07 allows for an auditor to express an opinion on financial statements that cover a period longer than 12 months as long as both the title of financial statements and the auditor's report clearly describe the period covered by the financial statements.

An EP member also pointed out that while the US GAAP does not specifically define a reporting period for presenting financial statements, absent regulatory requirement (for example, the SEC Custody Rule requires the US GAAP financial statements to be audited at

least annually and distributed to investors within 120 days of fiscal year-end), commonly accepted practice is to use the operating cycle of the reporting entity. FASB ASC 210-10-45-3 defines an operating cycle as generally no longer than a 12 month period. The EP member further noted that while the concept of an operating cycle is generally more relevant to commercial entities, investors frequently rely on annual investment performance and returns to make investment decisions, and to benchmark the performance of a fund against other investment alternatives. As a result, an annual reporting period is widely used for investment companies with normal, recurring operations.

6. In the venture capital or private equity industries, funds may sell an investment in a portfolio company, and, as part of the sales agreement, 1) may establish an escrow amount for contingencies and/or 2) be entitled to consideration contingent on how the portfolio company performs in the future. The EP discussed the accounting treatment for these items.

Escrow

EP members generally agreed that measuring escrow for reps and warranties at fair value/net realizable value based on historical experience of receiving such amounts would be appropriate. An EP member questioned whether there would be a difference in the measurement under net realizable value or fair value. Another EP member indicated that they believed the length of time until settlement of the receivable could result in a difference in measurement between the two methods (due to discounting the expected cash flow in determining fair value). However, for escrows expected to be received in a relatively short period of time they would not expect a difference in measurement under either method.

Earn-outs

An EP member indicated that the question of how to record earn-outs had been raised at the April 2010 and March 2012 EP meetings. During both prior instances of this question being raised, 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.

An EP member questioned if earn-outs met the definition of a financial instrument and therefore obviated the accounting policy election. The EP members discussed that the FASB ASC definition of “financial instrument” (825-10-20 Glossary) involves a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument. An EP member observed that under current GAAP an investment company is not required to fair value all financial instruments unless they are also investments.

An EP member observed that EITF issue 09-04, *Seller Accounting for Contingent Consideration* (EITF 09-4), was focused on when a commercial entity deconsolidates a subsidiary that is a business and the entity has the right to earn-outs or other contingent considerations. The EP member noted that although the issue was not finalized, FASB minutes to EITF 09-4 documented the FASB staff’s view that both approaches described above are acceptable. The EP member indicated that analogizing to this might be appropriate. However, consideration of the needs of the users of the financial statements may differ for investment companies than commercial entities, particularly “open-end” investment companies that offer and redeem shares/interests at net asset value.

7. The EP considered the application of the practical expedient when the NAV is not as of the reporting entity’s measurement date and needs to be rolled forward. The EP expressed a view that in this situation, the reporting entity may reasonably estimate the NAV as of the reporting entity’s measurement date by using various inputs to which it has access, such as capital activity and market fluctuations. If it is practicable for the reporting entity to rollforward the NAV previously reported by an investment manager, then the investment is still eligible to be measured using the practical expedient and can be removed from the fair value hierarchy. This is consistent with guidance in FASB ASC 820-10-35-60 and AICPA TQA 2210.23. If it is not practicable for the reporting entity to calculate an adjusted NAV (for example, because sufficient information is not available or it is not in a position to reasonably evaluate the information available and estimate values consistent with FASB ASC 946), the reporting entity

is required to fair value the investment. In this case, the adjusted NAV may not be the appropriate fair value. This then raises the question as to what a market participant would pay for the interest in the investment company, which is the issue that the practical expedient was originally designed to alleviate.

8. The EP considered whether a transaction between investment companies that have a common manager (same investment adviser) should be considered a related party transaction.

FASB ASC 850-10-20 defines related parties to include, among others, relationships (a) and (g):

- a. Affiliates of the entity
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

The EP noted that “affiliates” under ASC 850 includes entities under common control. The EP further noted that ASC Topic 850 defines control as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.”

The EP observed that given the regulatory reporting framework for registered investment companies and the fact that “sister” funds are considered affiliates under the SEC’s rules, transactions between registered investment companies that have a common manager could be considered related party transactions. The EP also observed that generally it would be even more likely for non-registered investment companies to meet the definition of related parties under ASC 850.

An EP member noted that the adviser’s ability to control the transaction was an important consideration. The EP member noted that trades are a significant activity for investment companies and the adviser often has the ability to “control” those transactions (in certain cases, pursuant to the oversight of the board). Therefore, to the extent that an executed investment advisory agreement authorizes the investment adviser to direct the operations of the investment companies it manages (or in cases where the investment adviser had significant influence or a controlling financial interest in multiple investment companies), the EP member thought that the investment companies would be considered to be related parties.

9. The EP members considered FASB ASU 2015-02 *Consolidation (Topic 810)* as it relates to financial statements of investment advisers that have a general partner interest in limited partnerships/hedge funds. Under FASB ASC 810-10-25-38A, an entity is considered to have a controlling financial interest in a VIE if
 - a) It has the power to direct the activities of the VIE that most significantly affect performance and
 - b) the obligation to absorb losses of and the right to receive benefits from a VIE that could potentially be significant to the VIE.

FASB ASC 810-10-25-38H excludes from the analysis of (b) above fees that are both “customary” and “commensurate” with the level of effort required for the services provided. Although the FASB explicitly excluded any “bright line” guidance in its final standard in assessing “significance” under (b) above, in the basis for conclusions (BC 56-59) the FASB stressed that this is a “qualitative assessment based on all facts and circumstances...”

The EP considered the following questions:

1. When would a direct GP interest into a fund/limited partnership be considered significant?
2. Whether an incentive fee greater than 20% (20% being customary in the funds industry) is commensurate with the services provided and the fee is customarily present in arrangement for similar services in their determination of significance? How to evaluate the significance of the variable interest when these conditions are not present?

The EP expressed a view that the determination of whether fees are commensurate with the level of service provided often may be determined through a qualitative evaluation of whether

an arrangement was negotiated on an arm's length basis when there are no obligations beyond the services provided to direct the activities of the entity being evaluated for consolidation. This analysis requires a careful consideration of the services to be provided by the decision-maker in relation to the fees. An EP member noted that the evaluation of whether terms, conditions and amounts included in an arrangement are customarily present in arrangements for similar services may be accomplished in ways such as benchmarking the key characteristics of the subject arrangement against other market participants' arrangements negotiated on an arm's length basis or, in some instances, against other arm's length arrangements entered into by the decision-maker. The EP noted that a decision-maker should carefully consider whether any terms, conditions, or amounts would substantively affect the decision-maker's role as an agent or service provider to the other variable interest holders in an entity.

With respect to the question as to significance of equity, although based on facts and circumstances, certain EP members expressed a view that an equity interest of 10% or greater could be considered significant, however there were no bright lines and judgment would be required.

III. Audit and Attest Issues

1. In August 2015 Bank of New York Mellon (BNYM) was unable to timely calculate NAV for certain registered investment companies. Based on discussions with BNYM, it was determined that the inability to calculate NAV was a result of errors with a system upgrade that occurred at SunGard. SunGard is a subservice organization for BNYM and is carved out of BNYM's SOC 1 report and the service auditors' report thereon. There is a separate SOC 1 report over SunGard. BNYM was unable to use the normal system/process to calculate the NAV immediately following the failed SunGard system upgrade, and implemented a separate process to produce estimated NAVs for the affected funds.

The EP considered whether investment companies that were impacted by this issue and their auditors have evaluated the SunGard issue as a control deficiency related to the investment company's internal control over financial reporting. EP members shared some factors they have considered in their evaluation and determination of the severity of such control deficiency, including:

- BNYM's ability to calculate the NAV for transactional purposes by reprocessing and recording August 31 trades,
 - BNYM's ability to quickly identify its inability to calculate NAV timely,
 - financial statements would likely not be issued containing an error since the system issue had been identified and would need to be resolved prior to the issuance of financial statements.
2. The EP members shared their views/experiences regarding the disclosure by mutual funds under Item 11 of Form N-CSR when a material weakness in internal control over financial reporting is identified by the auditor of the mutual fund in connection with the year-end audit.

Item 11 of Form N-CSR requires the registrant to disclose the conclusions of the registrant's principal executive and principal financial officers regarding the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days of the filing of Form N-CSR based on the evaluation of these controls and procedures required by Rule 30a-3(b) under the Act and Rules 13a-15(b) or 15d-15(b) under the Exchange Act. The registrant is also required to disclose in Item 11 any change in the registrant's internal control over financial reporting that occurred during the second fiscal quarter of the period covered by Form N-CSR that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

For a non-investment company registrant, management's conclusion regarding the effectiveness of disclosure controls and procedures is as of the balance sheet date – the same date as of which the auditor is expressing an opinion on internal control over financial reporting. It's the EP member's understanding the SEC staff would expect a conclusion that disclosure controls and procedures are ineffective when a material weakness is identified as of the balance sheet date for a non-investment company registrant. However, for a registered investment company, management's conclusion regarding the effectiveness of disclosure controls and procedures is not required to be as of the balance sheet date.

At the November EP meeting, the EP considered:

- whether it may be appropriate for an investment company to disclose in Item 11 of Form N-CSR that disclosure controls and procedures are effective and to file with the annual

Form N-SAR a report from the auditor indicating that a material weakness existed at the balance sheet date;

- whether it is acceptable for a registered investment company to “qualify” the disclosure under Item 11 of Form N-CSR (disclose a conclusion that disclosure controls and procedures are effective, except for...).

The EP acknowledged that practice varies and may depend on whether an identified material weakness as of the reporting date has been remediated by the entity prior to filing Form N-CSR. The EP members generally believe that disclosures made by the registrants in Item 11 in the Form N-CSR should be consistent with the report of independent registered public accounting firm on internal control included in the Form N-SAR.

3. The EP discussed that the auditor guidance for the SEC rule 240.17Ad-13 (“17Ad-13”) report related to Transfer Agent Internal Control requirements has not been updated since the 1990’s. Due to many changes within control environments, the EP considered issuing updated auditor guidance to reflect current developments and structures within organizations (e.g., outsourcing of functions to service providers). The EP members will be asked to provide comments on the proposed amendments to the opinion and management’s assertion based on developments and the other changes that have occurred with the attest standards. The EP will then seek informal feedback from the SEC Trading and Markets Division staff.

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 meeting via conference call to discuss the following questions presented by the EP members and share additional observations:

1. The EP offered the its informal views on certain aspects of the SEC staff’s [Request for Comment on the Effectiveness of Financial Disclosures about Entities Other than the Registrant](#), as it relates to investment companies, including business development companies (“BDCs”).
2. The EP raised a follow-up question related to a discussion at the July 2015 EP meeting regarding ASU 2015-03. The ASU requires that unamortized debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, rather than as an asset.

Original EP question:

For the purposes of calculating asset coverage, should reporting entities (1) follow GAAP presentation and include as senior securities the debt liability net of debt issuance costs, as presented on the entity’s balance sheet upon adoption of ASU 2015-03 or (2) not follow GAAP presentation and include as senior securities the gross amount of the debt liability without deducting debt issuance costs, which would not agree to the balance sheet upon adoption of ASU 2015-03?

EP’s interpretation of the SEC Staff Response:

The staff believes that BDCs should include as a senior security the gross amount of debt without deducting debt issuance costs, as outlined in (2) above.

While GAAP is generally a starting point for thinking about asset coverage, there have been exceptions in the past. For example, when a BDC used the fair value option to fair value its own debt and took a write down of the debt due to the BDC’s credit risk, the staff objected to the BDC including as a senior security the fair value of the debt and instead indicated that the BDC should include as a senior security the par value of the debt, given that if the debt was called, the BDC would need to repay the debt at par.

Follow up inquiry from the Expert Panel:

If a registrant has reported debt issuance costs as a direct deduction from the carrying amount of the debt liability in accordance with ASU 2015-03, but included the gross amount of debt (without deducting debt issuance costs) as a senior security when calculating asset

coverage, would the registrant be permitted to include such debt issuance costs in the numerator as an asset when calculating asset coverage?

During the November 17, 2015, EP meeting, the SEC staff reiterated its view expressed at July EP conference call that the gross amount of debt, without deducting debt issuance costs, should be used to determine the asset coverage ratio. Furthermore, the SEC staff indicated that a registrant should include the debt issuance costs in the numerator as an asset when calculating asset coverage for regulatory purposes.

3. Non-GAAP measures:

The SEC staff reminded registrants about non-GAAP financial measures (those that are used in supplemental reporting) included in BDCs' 10-Q and 10-K filings and in public announcements. The SEC staff does not permit presenting non-GAAP financial measures on the face of a registrant's financial statements prepared in accordance with GAAP or in the accompanying notes. The SEC staff stated that Regulation G and item 10 of Regulation S-K¹ indicate, among other matters, that:

- a registrant must present a reconciliation between the non-GAAP measure and the most directly comparable GAAP financial measure;
- the most directly comparable GAAP measure must be presented with equal or greater prominence than the non-GAAP measure;
- a registrant must include a statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP measure provides useful information to investors regarding the registrant's financial condition and results of operations.
- a registrant is prohibited from making public a non-GAAP financial measure that, taken together with the information accompanying it and any other accompanying discussion of that measure, contains an untrue statement of material fact or omits to state a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading.

The SEC staff provided a specific example of an inappropriate non-GAAP measure for a BDC that invested in real estate assets. The BDC presented a "Liquidation Value" as a non-GAAP financial measure. The Liquidation Value was defined as the NAV computed assuming the BDC's investments liquidated their underlying portfolios of real estate investments and distributed those proceeds to the BDC. The SEC staff objected to the use of the non-GAAP measure for, among other things, the registrant did not provide a disclosure providing reasons why management believed the information was useful to investors; the SEC staff questioned whether the measure was misleading given that the real estate assets could likely not be liquidated at their underlying values in a reasonable time frame; and the SEC staff questioned whether the measure was misleading given that the Liquidation Value did not include fees that would be charged at the BDC's investment level during the time to liquidation of those assets. The registrant has removed the non-GAAP financial measure from its filing.

4. The SEC staff discussed a recent [enforcement case](#) filed by the SEC against Blackstone. In this case, the SEC found that Blackstone did not fully inform investors about benefits that the adviser obtained from accelerated monitoring fees and discounts on legal fees and therefore did not comply with rules and regulations.
5. The EP and SEC staff discussed certain financial reporting and audit considerations relating to the [SEC proposed rule "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release."](#)

Investment Companies Expert Panel

Highlights of the January 19, 2016 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) [May, July, and September meeting highlights](#) are available. November 2015 meetings highlights are being finalized.
2. The AICPA Asset Management Revenue Recognition Task Force (AM RRTF) chair, members, and staff provided a status update on the progress of the AM RRTF to date.
3. The AICPA publications staff discussed the timing of a review of potential updates to 2016 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. The EP was updated on recent discussions regarding financial reporting and disclosures aspects of the SEC [proposal on swing pricing](#). The EP members observed different views on how to reflect the effect of swing pricing in the financial statements of an investment company - most importantly, regarding presentation of multiple NAVs per share, and what would be the most meaningful to the users of financial statements. The EP members noted concerns regarding operational issues associated with the swing pricing adjustment and potential reconciliation from the GAAP NAV to the "swung" NAV as well as calculation of total return. The EP members also stated that the auditor should not be taking responsibility for determining and opining on the reasonableness of the investment company's swing pricing policies and the swing pricing adjustment (the swing threshold and swing factor used to make the adjustment).
2. The EP was updated on the status of Technical Questions and Answers (TQAs) under EP development.
3. The EP originally discussed the amendments to the definition of readily determinable fair value included in FASB ASU 2015-10, *Technical Corrections and Improvements* (ASU 2015-10) on its July 21, 2015 conference call. Specifically, paragraph 30 of ASU 2015-10 amends the definition of readily determinable fair value to add limited partnerships and venture capital entities as examples, as long as their NAVs are published and the basis for current transactions. A condition for funds using the practical expedient is that the investee fund does not have a readily determinable fair value. The EP members expressed a concern that these amendments may preclude the use of NAV as the practical expedient for

measuring fair value for certain investments. The EP also discussed the meaning of “published” and noted that “published” is not necessarily interpreted as “publicly available”.

At the September 8, 2015, EP meeting, the EP members shared that an accounting firm submitted a technical inquiry to the FASB regarding the impact of the amendments on the use of the practical expedient for certain investments. It is the EP’s understanding that FASB did not intend for this amendment to change current practice and that the FASB would likely not consider removing or revising the changes made by this amendment. The EP is monitoring this issue and is considering developing a TQA draft on this topic.

4. The EP continued its discussion from November 2015 EP meeting regarding whether a transaction between parties that have a common manager should be considered a related parties transaction and what is defined as management. Please refer to the SEC Staff Update for additional information.
5. The EP briefly considered potential changes to Q&A #19 of the AICPA Custody Rule FAQs in light of draft TQA on liquidation basis of accounting the EP is currently developing.
6. Some investment companies enter into both to-be-announced (TBA) purchase commitments and TBA sale commitments. When an investment company enters into a TBA sale commitment on the same TBA for which they have entered into a purchase commitment, the EP considered whether the investment company should record the TBA sale commitment similar to a short sale and present the sale commitment in a separate schedule or separate section of the schedule of investments (similar to securities sold short) or whether the TBA that is presented as a long position in the schedule of investments would be treated as sold and no longer presented. The statement of assets and liabilities will have both a payable for the TBA purchase commitment and a receivable for the TBA sale commitment (unless the right of offset exists) regardless of whether or not the TBA is recorded as both a long position and a short position. The EP member observed different presentation of these TBA sale commitments in practice. Certain EP members observed that they don’t generally see short positions disclosed. The EP noted certain factors to consider that may affect the presentation. They include entering into TBA purchase commitments and TBA sale commitments with the same counterparty and using different brokers to buy and then sell a security.
7. As money market funds are moving to a floating NAV calculated to the nearest fourth decimal place, an EP member inquired if levels of materiality in evaluating NAV errors in money market funds would need to be revised as a result of this change. One EP member expressed a view that nothing would mandate such a change from the policy perspective. Another EP member shared that in the [SEC FAQs on 2014 Money Market Reform](#), the SEC staff expressed an unofficial view that the NAV should not move by \$.0001 by stating:

If a floating NAV fund’s use of amortized cost to value a portfolio security that matures in 60 days or less were to result in a difference in the fund’s NAV used to transact in fund shares and the fund’s NAV calculated without the use of amortized cost, the staff believes that such a difference would not be compatible with the guidance provided in the 2014 release. In such a situation, the amortized cost value of the portfolio security would not be “approximately the same” as the fair value of the security determined without the use of amortized cost valuation. Accordingly, a fund should not use the amortized cost method to value such a security. As a consequence, **the staff believes that such a disparity in NAV should not arise, because a fund’s NAV used for purchases, redemptions, and exchanges should not differ from its NAV calculated without the use of amortized cost valuation.** [Emphasis added]

III. Audit and Attest Issues

1. The EP continued discussing the proposed amendments to the opinion and management’s assertion regarding a transfer agent’s internal control (auditor guidance for the SEC Rule 240.17Ad-13, previously discussed at the November EP meeting). The EP also was made aware of the [SEC’s Advance Notice of Proposed Rulemaking, Concept Release, and Request for Comment on Transfer Agent Regulations](#), in which the SEC seeks public comments regarding the Commission’s transfer agent rules. The EP will monitor this development and will proceed with updating the example report in the future editions of 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 SEC issued a proposed rule, [Use of Derivatives by Registered Investment Companies and Business Development Companies](#) that would permit a registered fund to enter into derivatives and certain other senior securities transactions if the fund complied with the rule’s conditions:
 - a. Portfolio limitations - the fund would be required to limit its amount of leverage obtained through the use of derivatives or other transactions by complying with one of two alternatives in portfolio limitation tests:
 - i. Exposure-based portfolio limit - a fund would be required to limit its aggregate exposure to 150% of net assets. A fund’s “exposure” generally would be calculated as the aggregate notional amount of its derivatives transactions, together with its obligations under financial commitment transactions and other senior securities transactions;
 - ii. Risk-based portfolio limit - a fund would be permitted to obtain exposure (as defined in i. above) of no more than 300% of net assets, provided it satisfied a value-at-risk (VAR) test. The VAR test is designed to provide an indication of whether a fund’s derivatives transactions, in aggregate, have the effect of reducing the fund’s exposure to market risk. .
 - b. Asset segregation – a fund would be required to manage risk of derivatives by segregating cash and cash equivalents equal to a sum of two amounts:
 - i. Mark-to-market coverage amount – an amount a fund is required to pay if the fund exits a derivative transaction at the time of determination **plus**
 - ii. Risk-based coverage amount – an additional (estimated) amount a fund would be required to pay if it exits a derivative transaction under stressed conditions.
 - c. Derivatives risk management program – if a registered fund invests in a complex derivatives or its derivatives’ notional amounts are over 50% of the fund’ net assets, the fund would need to establish a formalized risk management program approved by the fund’s board of directors.

The SEC staff indicated, however, that while funds would be permitted to enter into derivatives transactions to the extent allowed by section 18 of 1940 act, registrants should continue to rely [on guidance in SEC Release 1066, no-action letters, and other SEC guidance](#) until this proposed rule is finalized and effective.

2. The SEC staff discussed IRS [Notice 2016-10](#) issued on January 15, 2016. This Notice provides guidance for regulated investment companies (RICs) on how to account for refunds of foreign withholding taxes under sections 853 and section 905(c). Recently, the Court of Justice of the European Union held that member states of the European Union could not impose withholding taxes on certain foreign investors if substantially similar domestic investors were not subject to tax. Taxpayers have requested guidance on the appropriate treatment of these payments sought and/or received by RICs because of complexity and impracticality of reporting of foreign withholding tax refunds for prior years or prior shareholders. In this Notice, the Treasury Department and the IRS proposed two methods as an alternative to general treatment to meet requirement of section 905.
3. The SEC Office of Compliance Inspections and Examinations announced its [2016 examination priorities](#) for investment advisers, investment companies, broker-dealers, transfer agents, clearing agencies and national securities exchanges. Three areas of focus include protecting retail investors, including those saving for retirement; assessing issues related to market-wide risks, including cybersecurity and liquidity controls; and using data analytics to identify and investigate registrants.
4. The EP asked the SEC staff whether there are any points they would like to emphasize regarding the [remarks made by Michael W. Husich, Senior Associate Chief Accountant, Office of the Chief Accountant, before the 2015 AICPA National Conference on Current SEC and PCAOB Developments](#), in light of discussions of the EP and the SEC staff in 2015. Those EP discussions related to the application of the provision that bookkeeping and

other services are prohibited, unless it is reasonable to conclude that the results of the services will not be subject to the audit. The SEC staff stated that both the accounting firms and their clients should be cautious when engaging to perform bookkeeping or other service under the assumption that it will not be subject to the audit, and consult with the SEC staff where appropriate.

5. The SEC staff has been receiving questions from registrants and the accounting firms regarding disclosure requirements under FASB ASC 850 for related party transactions under section 17a-7 of the Investment Company Act of 1940 in light of now effective PCAOB Auditing Standard (AS) No. 18, *Related Parties*. These questions mostly focused on whether and how the inter-fund (for funds within a fund complex) transactions should be disclosed in the financial statements. The SEC staff shared examples of qualitative and quantitative disclosures used in registrants' recent filings, such as:
 - a. Qualitative – Describes a fund's general program on section 17a-7, including existence and nature of related party transactions, related parties involved, and the board of directors' oversight and review of these transactions for compliance with rule 17a-7.
 - b. Quantitative – Disclosures include 1) the reporting fund involved in the related party transactions, 2) aggregate purchases and sales by the fund from and to other related party funds and 3) aggregate related realized gain/loss or other relevant transactional amounts for the periods for which income statements are presented. The Staff noted these are typically presented in a tabular format.

The SEC staff reminded that the nature of these transactions meets the definition of a related party transaction in FASB ASC Topic 850, and should be disclosed if material. The SEC staff further noted that the qualitative materiality for these transactions should be considered relative to what the user of financial statements may find useful. The SEC staff believes that these transactions should be reviewed for materiality in the aggregate, and would not expect such review and related disclosures on an individual CUSIP basis, unless considered material.

An EP member inquired as to whether the SEC staff would object to a fund's disclosure of section 17a-7 related party transactions if the fund were to aggregate and disclose total purchase and total sale transactions between the fund and all its related parties. The SEC staff would not object to a situation where each fund within an annual report discloses total purchase transactions and sale transactions pursuant to 17a-7 for the fund in the aggregate. The SEC staff would encourage consulting with regards to specific fact patterns.

6. The SEC staff issued [IM Guidance Update No. 2016-01](#) – Mutual Fund Distribution and Sub-Accounting Fees. This guidance focuses on payments made by mutual funds to financial intermediaries for shareholder and recordkeeping services for investors whose shares are held in omnibus accounts. Resulting from a [recent OCIE examination that uncovered that a registered investment adviser and its affiliated distributor were improperly using mutual fund assets to pay for the distribution and marketing of fund shares](#), the guidance addresses whether a portion of these payments, paid by a fund, is financing distribution, and, therefore, must be paid pursuant to rule 12b-1 under the 1940 Act. The SEC staff noted that IM Guidance Update No. 2016-01 is a useful framework for mutual funds' boards of directors to:
 - evaluate whether a portion of 12b-1 fees is paid directly or indirectly for distribution;
 - receive and evaluate sufficient information from advisers and other service providers regarding intermediary distribution and servicing arrangements, including how the level of sub-accounting fees may affect other payment flows (such as 12b-1 fees and revenue sharing) that are intended for distribution;
 - review any payment related to distribution and evaluate its appropriateness and character with increased scrutiny.

Investment Companies Expert Panel

Highlights of the March 8, 2016 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 meeting:

I. **AICPA/Administrative:**

1. The Expert Panel (EP) November 2015 meeting and January 2016 call highlights are being finalized.
2. The AICPA staff shared recent developments regarding the AICPA Alternative Investments Practice Aid's update, Asset Management Revenue Recognition Task Force, and various other AICPA task forces, and thanked EP representatives for their active participation.
3. The AICPA Publications staff informed the EP about timing and status of review of proposed conforming changes to the 2016 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. **Accounting/Reporting Issues:**

1. The EP chair and staff informed the EP that the following draft Technical Questions and Answers (TQAs, formerly known as TPAs) are being reviewed by FinREC:
 - a. Liquidation Basis of Accounting
 - b. Loan Origination
 - c. Accounting for Convertible Bonds
2. Due to the current economic situation in certain jurisdictions, some central banks (e.g., Japan, ECB, etc.) have set base rates below zero. As a result, financial institutions pay interest for deposits held with such central banks. To compensate for that, financial institutions (and other entities) charge interest on cash deposited with them. In addition certain entities may issue debt with a negative yield. The EP members discussed the following questions:
 - a. How should an investment company present negative interest it pays on cash deposits or other financial assets?
 - b. If the amount is material to the financial statements, what information should be disclosed in connection with negative interest?

An EP member shared that the IFRS Interpretations Committee (IFRIC) [discussed](#) the ramifications of the economic phenomenon of negative effective interest rates for the presentation of income and expenses in the statement of comprehensive income in January

2015. The Interpretations Committee noted that interest resulting from a negative effective interest rate on a financial asset does not meet the definition of interest revenue in IAS 18 *Revenue*, because it reflects a gross outflow, instead of a gross inflow, of economic benefits. Consequently, the expense arising on a financial asset because of a negative effective interest rate should not be presented as a reduction to interest revenue, but in an appropriate expense classification. The Interpretations Committee noted that in accordance with paragraphs 85 and 112(c) of IAS 1 *Presentation of Financial Statements*, the entity is required to present additional information about such an amount if that is relevant to an understanding of the entity's financial performance or to an understanding of this item.

Certain EP members noted this is consistent with what they are seeing in practice. More specifically, that investment companies presented negative interest as an expense (generally as interest expense or, if immaterial, included within custody or bank fee expense line item) and disclosed additional information when determined necessary.

3. The EP originally discussed the amendments to the definition of readily determinable fair value included in FASB ASU 2015-10, *Technical Corrections and Improvements* (ASU 2015-10) on its July 21, 2015, conference call. Specifically, paragraph 30 of ASU 2015-10 amends the definition of readily determinable fair value to add limited partnerships and venture capital entities as examples, as long as their NAVs are published and are the basis for current transactions. A condition for entities with investments in funds using the practical expedient is that the investee fund does not have a readily determinable fair value (ASC 820-10-15-4a). The EP members expressed a concern that these amendments may preclude the use of NAV as a practical expedient for measuring fair value for certain limited partnership or venture capital investments that, in practice, were not previously considered to have readily determinable fair values. The EP also discussed the meaning of "published" and noted that "published" does not necessarily equate to "publicly available".

At the September 8, 2015, EP meeting, the EP members shared that an accounting firm submitted a technical inquiry to the FASB regarding the impact of the amendments on the use of the practical expedient for certain investments. It is the EP's understanding that this amendment did not intend to change current practice. The EP is monitoring this issue and during November EP meeting determined that representatives of the EP should have further discussions with the FASB and, if those discussions are unsuccessful, the EP will consider drafting a Technical Question and Answer for consideration by FinREC.

During the March 2016 conference call, the EP members and staff shared the substance of recent discussions with representatives of the AICPA Employee Benefit Plans (EBP) Expert Panel, where the EBP Expert Panel indicated it is now clear that certain common collective trusts and pooled separate accounts may be deemed to have a readily determinable fair value. Based on this conclusion, investors in these entities would not be able to use NAV as a practical expedient for measuring fair value. The EP discussed fair value hierarchy considerations for investments in entities that now may be considered to have RDFVs, noting that such investments may or may not be categorized as Level 1.

The EP generally agreed that additional guidance about the amended definition of readily determinable fair value was necessary as the technical correction may preclude investment companies, employee benefit plans, and other entities from using NAV as a practical expedient for fair value measurement of certain investees that were previously determined not to have readily determinable fair values. The EP members will proceed with developing a draft TQA on this issue for EP consideration at the May EP meeting.

4. At the January 2015 conference call, the EP discussed if transactions between funds managed by the same investment adviser met the definition of a related party transaction. There has been additional focus on the identification of related party transactions as a result of the PCAOB's AS 18 which was effective for audits of entities with fiscal years beginning after December 15, 2014 (i.e., December 31, 2015 calendar year-end audits). During the March 2016 EP call, the EP continued discussing the types of related party transactions that have been identified and disclosed during the current financial reporting cycle, such as purchases and sales of securities between affiliated funds that have the same investment adviser and interfund lending arrangements, as well as materiality thresholds that have been observed by reporting entities in determining the disclosure of related party interfund investment transactions. The EP members shared that many investment companies make qualitative disclosure about their ability to enter into purchases of securities from another affiliated fund managed

by the same investment adviser in order to reduce transaction costs (or for other mutually beneficial reasons). The EP also considered the materiality thresholds (that is, at what point to include quantitative disclosures about aggregate purchases and sales from/to affiliated funds). The EP members shared that the SEC staff analogized to the intercompany profit and loss guidance in Regulation S-X and FASB ASC Topic 850 *Related Party Disclosures*. According to that guidance and consistent with the Guide, amounts paid to affiliates and related parties would be disclosed and significant provisions of related-party agreements described in a note to the financial statements.

5. Often when an open-end non-registered/private investment company is in liquidation, investors are no longer able to redeem their interests pending the liquidation of assets, settlement of liabilities, and final distribution(s) to investors. As such, investors' interests may no longer be mandatorily redeemable. Certain EP members observed that some investment companies that have entered liquidation record a redemption payable for the entire amount of net assets even though investor interests are no longer redeemable, assets have not been liquidated, and other liabilities have not been settled. The EP members discussed that redemption provisions specified in legal documents of an investment company would determine timing of recording of redemption payable. The EP members also shared that Cayman Islands Monetary Authority (CIMA) likely would not accept financial statements with the remaining amounts still to be distributed to investors as the final audit report, unless the financial statements contain either 1) a subsequent event footnote indicating that liquidation occurred or 2) a redemption payable. However, the EP generally agreed that for a redemption payable on a non-public fund to be recorded the 1) amount must be known and 2) general partner or equivalent has approved the transaction (either a request of the investor or final distribution).
6. ASU 2016-01 *Financial Instruments—Overall (Subtopic 825-10)* amended FASB ASC 220-10-45-10A to require the change in fair value caused by a change in instrument-specific credit risk (own credit risk) to be presented separately in other comprehensive income (OCI) for financial liabilities measured using the fair value option in ASC 825. An EP member questioned if an investment company that elected the fair value option for its debt, would be required to present the change in fair value caused by instrument specific credit risk in OCI. EP members indicated that neither FASB ASC Topic 946 nor Article 6 of Regulation S-X currently provide any guidance for/require presentation of OCI. An EP member noted that investment companies are not excluded from presenting OCI.

III. Audit and Attest Issues

1. The EP briefly discussed unique industry issues for audit firms' internal protocol for filing PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*, for mutual funds and will form a task force. When the SEC approves [the PCAOB rule](#), disclosure of the audit partner would be required for auditors' reports issued on or after January 31, 2017, and disclosures of other accounting firms would be required for auditors' reports issued on or after June 30, 2017.

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 shared additional observations:

1. The SEC staff discussed a number of accounting and disclosure related considerations with regards to new closed-end fund products that invest in peer-to-peer (P2P) loans, noting to this point, no P2P closed-end funds have been declared effective by the SEC's disclosure and review staff. P2P lending platforms allow consumers to obtain loans directly from the P2P online lending platforms instead of more traditional lending facilities such as banks. These companies act as an intermediary between lenders and borrowers for various types of loans, such as small business loans, student loans, real estate loans and consumer loans.

The SEC staff and EP acknowledged that this is a developing area for investment companies regulated under the Investment Company Act of 1940 (1940 Act) and discussed a number of accounting and auditing considerations that exist for P2P funds, which include, but are not limited to:

- a. What is considered a unit of account – an individual loan or, if a fund holds a block of loans, the block of loans? The SEC staff commented that for 1940 Act regulated funds, the individual loan is the unit of account.
- b. Valuation of loans held - The SEC staff would expect a 1940 Act regulated fund to value each individual loan in its portfolio in accordance with the definition of “value” within Section 2(a)(41) of the 1940 Act and the Commission’s views as to the appropriate method of accounting for and valuation of investment securities of registered investment companies pursuant to ASR 118. To determine value in accordance with Section 2(a)(41) of the 1940 Act and ASR 118, the fund should receive, among other things, individual loan level data (which could include, for example, payment data, FICO scores, borrower default information, etc.) to perform the valuation analysis.
- c. Management of the reporting entity would be expected to develop and follow a methodology that is reasonably designed to value these investments at the price they would receive to sell the investment in an orderly transaction between market participants at the measurement date and that is approved by the Board. The Board would need to continuously review the appropriateness of the developed methodology and ensure that the approved methodology is consistently followed by a reporting entity.

2. The SEC staff shared that they have issued comments to certain fund complexes related to interfund lending arrangements as they observed that related party transaction and credit transaction disclosures were inadequate. In addition to the disclosure requirements under FASB ASC 850 *Related Party Transactions*, which would be implicated by an interfund lending arrangement, the SEC staff cited specific Regulation S-X disclosure requirements under Rule 6-04.13(b) for credit transactions to be disclosed in the notes to the financial statements. As previously indicated in 2013-14 “Investment Companies Audit Risk Alert”:

Rule 6-04.13(b) of Regulation S-X requires registrants to disclose the information required under Rule 5-02.19(b) of Regulation S-X regarding unused lines of credit for short-term financing and Rule 5-02.22(b) of Regulation S-X regarding unused commitments for long-term financing arrangements. Such information should be disclosed, if material, in the notes to the financial statements and should include the amount and the terms of the unused line of credit, including commitment fees and the conditions under which lines may be withdrawn.

The SEC staff noted that pursuant to the [exemptive orders granted](#)¹, similar disclosures regarding interfund lending, including the amount and terms of interfund lending and weighted average interest rate on the affiliates’ borrowings as of the balance sheet date, should be included in the notes to the financial statements. The SEC staff also noted that in all of the orders, the Commission requires each Fund’s independent public accountant, in connection with its audit examination 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 auditors N-SAR letter.

3. The SEC staff discussed requirements for inclusion of financial statements of other entities, such as a private fund, in a registration statement or other filing when a private fund is converting to an investment company regulated under the 1940 Act (RIC) by merging with a shell entity that is a RIC. The SEC staff reminded that in these situations, financial statements of private fund should be included in the statement of additional information (SAI) of a registrant. If private fund financial statements are included in the SAI, the prospectus should include a reference to alert shareholders to the location of the financial statements and that the financial statements should be read in conjunction with the prospectus, as well as provide sufficient information, such that investors are aware that they can request and obtain the prospectus and the SAI, free of charge. Where multiple funds merge together, the SEC staff suggested that if financial statements of multiple funds are included in an exhibit rather than in the SAI, a note in the registration statement about where the investors can find the additional information should be provided.

¹ Pre-2008 exemptive orders are not available online.

4. The SEC staff noted that the disclosure effectiveness remains a focus area for the Division of Investment Management, as highlighted in the [remarks by David Grim, Director, Division of Investment Management, to the PLI Investment Management Institute on March 3, 2016](#).
5. Questions arose around the exemptive relief given to Third Avenue Focused Credit Fund. The SEC staff noted the Commission granted Third Avenue [an exemptive relief order to allow](#) suspension of redemptions in the Third Avenue Focused Credit Fund on December 16, 2015. The SEC's Office of Compliance Inspections and Examinations (OCIE) conducted a review of fixed income funds following the collapse of Third Avenue's Focused Credit Fund. OCIE is concerned about a funds' ability to manage their liquidity risks, as well as the impact that certain market disruptions have on shareholders redemption activity which was the impetus for the review.

Update: issued on March 9, 2016, the [IM Guidance Update No. 2016-02 Fund Disclosure Reflecting Risks Related to Current Market Conditions](#) highlights the importance of full and accurate disclosures by mutual funds, exchange-traded funds, and other registered investment companies about fund risks, including those arising as a result of changing market conditions.

Investment Companies Expert Panel

Highlights of the May 17, 2016 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:

AICPA Investment Companies Expert Panel

Meeting highlights

May 17, 2016

I. AICPA/Administrative:

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

II. Accounting/Reporting Issues:

1. The EP chair and staff informed the EP on the latest developments regarding the following draft Technical Questions and Answers (TQAs, formerly known as TPAs):
 - a. Liquidation Basis of Accounting.
 - b. Loan Origination.
 - c. Accounting for Convertible Bonds.
 - d. Readily Determinable Fair Value.
2. The EP was made aware that several Central Counterparty Clearing Parties (CCPs) have made or are considering making changes to agreements that may impact the legal characterization of variation margin on centrally cleared derivatives. In some cases, variation margin may no longer be treated as the posting of collateral and instead may be treated as a settlement payment. The legal form of the variation margin, whether deemed to be collateral or a settlement payment, may have accounting and reporting implications. The EP noted that reporting entities that are parties to centrally cleared derivatives should have discussions with their legal counsel and CCP to evaluate any such changes.
3. The EP considered the following implementation issues relating to the liquidation basis of accounting:

- a. Instead of a complete liquidation, a fund may decide to merge its operations with another affiliated fund with a similar strategy. In doing this, the fund will typically give its investors the option of redeeming their interest in the fund or transferring their interest to the affiliated fund. The definition of “liquidation” in FASB ASC 205-30-20 states, in part, “dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity *in its entirety* and with the expectation of continuing its business does not qualify as liquidation” (emphasis added). As it relates to a merger of funds, one EP member inquired how “in its entirety” should be interpreted and if liquidation basis of accounting should be adopted if less than 100% of the net assets are merged with the affiliated fund as a result of some investors taking the option to transfer their interest to the affiliated fund.

The EP members expressed a view that if the entire operations and entire strategy of a fund is being acquired (i.e. an acquisition of all of the remaining units of the target) then “in its entirety” condition would apply, thus, such dissolution would not meet the definition of liquidation. The EP members also agreed that consideration should be given to how the merger is defined in legal documents. Furthermore, the EP members agreed that allowing unit holders of the target fund to redeem prior to the acquisition would not preclude an entity from concluding that the target entity was merged with the acquiring entity. Consideration should be given to the extent of redemptions and consistency of the investment strategies between the acquirer and target to determine if the acquisition constitutes a merger rather than a liquidation. One EP member highlighted that if a liquidating fund allowed investors to have their assets transferred into another fund within the fund complex, not as part of a merger, but rather at each investor’s discretion, this would likely meet the definition of a liquidation.

- b. Upon adoption of the liquidation basis of accounting, for investments still held at the reporting date, a fund may determine that fair value is the best estimate of liquidation value. FASB ASC 205-30-30-1 states “An entity shall measure assets to reflect the estimated amount of cash or other consideration that it expects to collect in settling or disposing of those assets 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.” One EP member inquired how subsequent events should be considered in a fund that is determining its best estimate of liquidation value of investments. For example, if an investment was subsequently sold before the financial statements were available to be issued, should the sales price be used as the best estimate of liquidation value at the reporting date? Alternatively, if the investment has not been subsequently sold, but a significant change in the fair value has occurred before the financial statements were available to be issued, should that subsequent fair value be used as the best estimate of liquidation value at the reporting date?

The EP members discussed differences under liquidation basis of accounting as compared to going concern basis related to estimating fair value and liquidation value. Specifically, the EP noted under liquidation basis the reporting entity is estimating future liquidation value rather than the exit price at a specific point in time. One EP member expressed a view that when an entity under liquidation basis of accounting subsequently sells an investment before the financial statements were available to be issued, the sales price may be a better estimate of liquidation value than the fair value at the reporting date. An EP member observed that it may be appropriate to incorporate information subsequent to the balance sheet date if it provides a better estimate of the ultimate liquidation value (i.e. if the investment was sold prior to the issuance of the financial statements) even if the event or condition did not exist at the balance sheet date. Other EP members thought that the entity should consider what conditions existed at the balance sheet date to make the best estimate of the amount that it expects to collect in disposing of the investment while carrying out its plan for liquidation. The EP members that had this view indicated that they would consider subsequent events to the extent that the conditions existed at the balance sheet date.

4. EP members discussed instances where the SEC staff has applied the investment company definition to entities, particularly real estate entities, in a manner that deviated from certain EP members’ original interpretations. The EP discussed that in applying the investment company definition, the entity should consider how the real estate fund is organized (passive investment), marketed and presented and what would be the most meaningful information for investors. The EP members acknowledged that each case is based on specific facts and circumstances.

5. An EP member discussed diversity in accounting for organization and offering costs for continuous offering funds. Some closed-end funds with continuous offering periods have historically recorded offering costs as a deferred charge until the escrow breaks with those costs subsequently amortized over a period of 12 months as a charge to paid-in capital. The member noted that the SEC staff is asserting that in accordance with paragraph 8.30 of the Guide (paragraphs 5–6 of FASB ASC 946-20-25 and 946-20-35-5), the costs during the entire offering period should be recorded as a deferred charge and amortized over 12 months to expense.

An EP member also observed that the EP acknowledged certain diversity in practice in connection with the BDC stock issuance costs discussed at the EP meeting in May 2015. See SEC Staff Update portion of these meeting highlights for additional information on this topic.

6. The EP considered Topic 946-related proposed corrections in the Proposed ASU *Technical Corrections and Improvements* (issued on April 21, 2016). Among other matters, the EP discussed whether the 2016 Guide should be updated to reflect the clarification included in the proposed ASU that the disclosure guidance for investments in other investment companies only applies to nonregistered investment companies. Paragraph 118 on page 70 of the proposed ASU points to guidance from the 2015 version of the Guide that says guidance in ASC 946-210-50-4 through 50-10 applies to non-registered investment companies.

The EP and staff noted that paragraph 7.42 (2015 Guide) will be updated for this clarification when the final ASU is issued. EP members observed that they believed reporting entities understood that the reference to all investment companies within the codification was a result of a typographical error in the codification process. Therefore, current reporting by most public investment companies is consistent with the technical correction.

7. The EP considered questions regarding the calculation of portfolio turnover when an investment company engages in certain trading strategies. While the guidance for the calculation is described within Forms N-SAR and N-1A, the questions focused on if those measures provided the users of the financial statements with the most relevant portfolio turnover information in all instances. Specifically, the EP member questioned:
 - a. For long/short or market neutral investment strategies where the calculation of portfolio turnover results in a ratio that may not be representative of the actual trading activity of the fund, what, if any, additional disclosure have EP members seen to provide transparency to investors?
 - b. In the scenario above, have EP members seen additional non-GAAP disclosures that include proceeds from short sales with payments for purchases of securities, as that represents the opening of a transaction, and payments to cover short securities with proceeds from sales of securities to represent the closing of a transaction? If EP members have seen a non-GAAP disclosure, do they generally also see the GAAP disclosure? What qualitative disclosure or discussion is included to reconcile the GAAP and non-GAAP disclosures
 - c. To calculate the denominator used in the calculation, have EP members seen the activity related to short sales that will be held for less than 1 year excluded, leaving only the gross long equity value to be the denominator?

The EP members noted diversity in the methodologies used by various registered investment companies. For example, EP members noted differences in how to project what portion of the portfolio should be classified as long-term investments and whether short sales would be included in the denominator. One EP member believed that based on a strict reading of the guidance, short sales would only be included in the numerator, not the denominator. Another EP member noted an investment company could use the absolute value in the denominator instead of excluding short sales entirely.

EP members generally agreed that registered investment companies should establish, maintain, and consistently follow clear written policies for the calculation of portfolio turnover.

8. The EP members briefly discussed the practical application of the new money market funds reform rules as the industry prepares for implementation and what others have seen through the readiness process.
9. The EP considered the following scenario. An investment company holds a 10-year payment-in-kind (PIK) Interest Term Loan that has a maturity date in 5 months. The market price of the security is quoting at 75 without accrued interest (the price including accrued interest is 77 for this example). Each coupon period the PIK Bond has issued another “baby

bond” at the stated interest/coupon rate on the stated payment date. The valuation team believes that a sizable portion of the PIK Bond may not be collectable.

FASB ASC 946-320-35-11 states “to the extent that interest income is not expected to be realized, a reserve against income shall be established. Specifically, the sum of the acquisition amount of the bond and the discount to be amortized shall not exceed the undiscounted future cash collections that are both reasonably estimable and probable.” Paragraph 3.33 of the Guide states “to the extent that interest income to be received in the form of baby bonds is not expected to be realized, a reserve against income should be established. That is, it should be determined periodically that the total amount of interest income recorded as receivable, plus the initial cost of the underlying PIK bond does not exceed the current fair value of those assets.”

In this example, the investment company recorded the accrued income/PIK bond at the fair value of 75. Since the security is so close to maturity, it is trading near the expected collectable cash flows.

The EP member inquired what have others have seen in terms of accounting for PIK bonds when one would not expect to collect the PIK? Do many see reserve reversals and reduction of cost of investments? What would be a fact pattern for that?

One EP member shared that certain entities stop accruing income if presumed not collectible. Another EP member noted that an entity should project the cash flows they expect to receive and apply the effective interest method. EP members discussed that entities may consider the amortization model that they would apply for changes in assumptions (retrospective or prospective). EP members generally agreed that if the cost basis of the investment was adjusted for the baby bonds then any reversal of income would be recognized as a realized loss rather than as a bad debt expense.

The EP member also referred to the PIK income accrual fact pattern and discussion described in the May 2012 EP meeting highlights.

10. Master feeder accounting:

Certain feeder funds (or access funds) may be unaffiliated with the master fund. In certain circumstances, the feeder fund may get permission from the master fund to distribute the financial statements of the master fund along with the financial statements of the feeder fund, but is unable to physically attach those financial statements to each other. FASB ASC 946-205-45-6 states “Nonpublic investment companies *may present a complete set of master financial statements* with each feeder financial statement, in a manner that is consistent with the requirements for public investment companies.” In addition, FASB ASC 946-235-50-3 states, in part, “Notes to financial statements of each feeder fund shall include all of the following:...(c) A statement that the feeder invests all of its investable assets in a corresponding open-end management investment company having the same investment objectives as the feeder, and *a reference to the financial statements of the master fund*, including the portfolio of investments.” The EP considered the accounting and auditing implications for the feeder fund if it is unable to physically attach the financial statements of the master fund, but includes a reference to those financial statements in its disclosures, and distributes those financial statements along with its own financial statements. The EP expressed a view that generally financial statements of the feeder fund should “stand on their own.” Specifically, if the master fund’s financial statements are not attached, the feeder fund’s financial statements should contain sufficient information so the reader can understand the activities of the master fund. EP members observed that they have seen enhanced disclosures included in feeder fund’s financial statements if feeder fund cannot physically attach master fund’s financial statements.

III. Audit and Attest Issues

1. The EP considered forming a task force that will update illustrative reports, including a 17Ad-13 report currently under revision by the EP members, in chapter 12 for 2017 Guide.
2. The EP considered application of SEC independence rules to private audit clients whose annual audited financial statements are used to satisfy the “annual audit provision” under the SEC Custody Rule. See SEC staff remarks on this topic below.

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 SEC staff discussed the application of Rule 2-01 (c) (1)(ii)(A) of Regulation S-X (“the Loan Provision”) for investment company complexes, including the extent of consultations currently being received at the Commission concerning noncompliance. The Loan Provision provides that an accounting firm is not independent when the accounting firm, or its covered persons, has a loan from “record or beneficial owners of more than ten percent of the audit client’s equity securities.” As defined, “audit client” includes any affiliate of the audit client and, when the audit client is an entity within an “investment company complex,” it also includes every entity within the investment company complex. Therefore, an accounting firm’s lack of independence with respect to one entity within an investment company complex due to a Loan Provision violation, may result in the accounting firm not being independent with respect to all entities within the investment company complex. The SEC staff provided examples of financial relationships between accounting firms and their audit clients that may trigger noncompliance, including 1) a bank that is a lender to the accounting firm is a more than 10 percent record owner of the equity securities or 2) an insurance company that is a lender to the accounting firm and owns more than 10 percent of shares as record owner on behalf of separate accounts.

Update: the SEC staff issued a [no-action letter](#) to Fidelity Management & Research Company et. al. on June 20, 2016. Also see July 2016 EP conference call highlights.

2. The SEC staff described financial statement review and comment process. As required by the Sarbanes-Oxley Act, all public companies, including regulated investment companies, are subject to the financial statement review process at least once every three years (SOX Review), but SEC staff may also perform a targeted review. As part of the SOX Review, the SEC staff reviews not only financial statements but also accounting information included in other filings with the SEC, such as websites, and merger filings to ensure consistency. The SEC staff generally provides financial statement review comments verbally, and registrants are generally required to provide written responses within 30 days. Lack of comments does not mean that financial statements have not been reviewed. At the May 2016 EP meeting, the SEC staff provided the following financial statement review comments through SOX Review:

- a. Offering Costs

The SEC staff became aware of diversity in practice in accounting for offering costs by continuously offered closed-end funds and non-listed business development companies (“BDCs”). For these types of investment companies, the SEC staff noted that FASB ASC Topic 946 has specific guidance on capitalizing offering costs and charging deferred costs to expense over 12 months once operations have commenced. The SEC staff believes that these continuously offered funds are within the scope of the guidance described in ASC Topic 946. Therefore, these entities should record offering costs as a deferred charge and then amortize these costs over a period of 12 months to expense. The SEC staff also noted, that in the case of offering costs paid for by an adviser and subject to recoupment by the adviser, if the fund has determined payment to the adviser is probable and estimable such that the fund needs to record an expense for the recoupment, that these charges to the fund may not be deferred for an amount of time over 12 months. For example, if the offering cost was incurred on May 1, 2017 but was not probable or estimable until November 1, 2017 the charge may only be deferred to April 30, 2018 (12 months after the charge was incurred) and not October 31, 2018 (12 months after it was determined it is probable the fund would have to re-pay the adviser). Continuously offered closed-end funds and non-listed BDCs not following ASC Topic 946 should change their accounting policy to be in accordance with ASC Topic 946. These entities should consider the guidance on accounting for and reporting of accounting changes and error corrections in FASB ASC Topic 250 to evaluate if the change in policy is a correction of an error or change in accounting principle.

- b. P2P/Online Marketplace Lending

The SEC staff discussed potential accounting and auditing challenges for registrants intending to invest in peer to peer (P2P) loans. P2P lending platforms act as intermediaries between lenders and borrowers for various types of loans, including consumer and small business loans. Investment companies may acquire the loans originated through the P2P lending platforms and the SEC staff is starting to review funds in registration with strategies principally focused on investing in P2P loans. Specifically, the SEC staff discussed the following accounting and auditing challenges around valuation and existence of the loans:

(1) Valuation:

- (a) Loan level data – Typically investment companies purchase a pool of loans, however the unit of account, based on the current market, is likely to be the individual loan given the anticipated exit of the loans on an individual basis. As a result, the investment company would need the individual loan level detail to determine the fair value for each loan. The SEC staff noted that it is their understanding that some platforms are not currently providing loan level data to investment companies.
- (b) Timeliness of information – The SEC staff observed that when investment companies are able to obtain loan level data it may not be timely (i.e. not available at each point in time that NAV is determined).
- (c) Integrity of information – Registrants need to evaluate the completeness and accuracy of data obtained from the platform.
- (d) Availability of information – Underwriting quality varies by platform. For example, many platforms are originating loans designated to be of prime quality (e.g., to borrowers with FICO scores in the higher range). For platforms that originate loans of a lesser or unknown quality designated to be subprime, the SEC staff expressed concern that registrants may not be able to obtain sufficient information at the individual loan level based on insufficient underwriting at origination and/or ongoing monitoring of credit quality.

(2) Existence

- (a) Qualified custodian – Loans need to be held at a qualified custodian.
- (b) Loan volume – Due to the number of loans anticipated to be held by a fund given the size of each individual loan, the SEC staff understands that there are not many qualified custodians that currently have the ability to process the volume of data.
- (c) Controls – The SEC staff noted that controls should exist around the existence of loans and reconciliation of cash received on principal and interest payments.
- (d) Loan activity – Qualified custodians may have challenges in obtaining information about par value of loans, when loans are sold, and when paydowns are received. In addition, qualified custodians may have challenges reconciling all the activity to cash.
- (e) Diligence of the platform – The SEC staff provided two examples that highlighted the importance of due diligence of P2P platforms. The first was an example in China where a P2P platform was selling the same loans to multiple people and the second was for a P2P platform that knowingly sold loans not fitting certain parameters to an investor.

Furthermore, the SEC staff noted registrants investing in loans originated by P2P platforms would be expected to disclose, pursuant to Rule 12-12 of Regulations S-X:

- each investment (i.e. the individual loan) in the schedule of investments;
- a description of the investment (although not necessarily disclosing the individual borrower's name), including the interest rate;
- the loans categorized by risk;
- the name of the originating platform, and;
- relevant performance metrics in management's discussion of fund performance.

c. Auditor's Consents

The SEC staff reminded the EP of situations where a new auditor's consent letter is needed specifically when there is an amendment to a previously filed registration statement:

1. The amendment is other than typographical to the financial highlights or financial statements.
2. A material event occurred since the last filing.
3. An extended period of time has passed (more than 30 days) since the last amendment to a registration statement where a consent letter was filed.

In addition, the SEC staff noted that when a majority-owned subsidiary's financial statements are filed pursuant to Rule 3-09 of Regulation S-X, an auditor's consent letter from the subsidiary's auditor must be included in the registration statement.

d. Valuation – Odd Lots

The SEC staff discussed valuation considerations for odd lots of fixed income securities. An odd lot trade is generally quantities of less than \$1 million dollars, although there is no standard definition. The SEC staff observed that odd lots are generally traded at different prices than round lots. Furthermore, the SEC staff noted that service providers or vendors typically provided prices based on round lots.

The SEC staff reminded the EP that investments should be valued at the exit price, consistent with ASC Topic 820. When an investment company holds odd lots, it may use the price quoted by the pricing vendor only if the fund expects to sell its odd lot at the round lot price. If a fund cannot sell the odd lots at the round lot prices that are provided by the pricing vendors, the fund should not use the round lot price to value the odd lot investment. The SEC staff also referred to a previous enforcement case and the Commission's [opinion](#) on this topic.

• Mergers

The SEC staff provided an example in which they objected to a registrant's determination of the performance and accounting survivor. The SEC staff noted, consistent with remarks made at the May 2012 and other prior EP meetings, that funds should consider guidance in [North American Security Trust no-action letter \(pub. avail. Aug. 5, 1994\)](#). That letter identified five factors, including 1) investment advisers, 2) investment objectives, policies, and restrictions, 3) expense structures and expense ratios, 4) asset size, and 5) portfolio composition (NAST Factors) in determining which entity is the performance and accounting survivor. The SEC staff noted in the specific example the funds were within the same fund complex with the same adviser, however they had different sub-advisors. When evaluating the NAST Factors, the SEC staff concluded that because the funds were within the same fund complex and therefore affiliated, the investment advisers' factor was viewed neutrally despite having different sub-advisors. The SEC staff further observed that in evaluating the other NAST Factors, excluding asset size, they indicated the acquiring fund would be the accounting and performance survivor. However, the SEC staff noted that the acquiring fund had \$1 million in assets with limited history (1 or 2 years) while the acquired fund had \$80 million in assets and a longer history (approximately 10 years). The SEC objected to the registrant's analysis, primarily due to concerns around not disclosing the past performance of the acquired fund. The SEC staff highlighted that conclusions regarding the accounting and performance survivor are based on the facts and circumstances of the specific entities and a careful evaluation of the NAST Factors.

- The SEC staff shared recent comments issued for a private fund converting to a registered investment company or a BDC through a merger with a shell entity. In these situations, the private fund should present two years of audited financial statements compliant with Regulation S-X, including a full schedule of investments (rather than a condensed schedule of investments).

3. With respect to the meaning of "an audit firm subject to regular PCAOB inspection" as it relates to compliance with the Custody Rule, the SEC staff noted that the accounting firm needs to be registered with the PCAOB as of the date the engagement commences as well as the end of the calendar year.
4. The SEC staff discussed [OCIE's 2016 exam priorities and referred to the dedicated OCIE webpage on sec.gov](#) that includes information about OCIE, its national examination program, current focus areas and other relevant information.
5. The SEC staff discussed the [Division of Enforcement's Asset Management Unit's priorities](#) on conflict of interests, valuation, and compliance with laws and regulations.

Investment Companies Expert Panel

Highlights of the July 19, 2016 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 meeting:

AICPA Investment Companies Expert Panel

Conference call highlights

July 19, 2016

I. AICPA/Administrative:

1. The Expert Panel (EP) March 2016 conference call and May 2016 meeting highlights are being finalized.
2. The AICPA staff updated the EP on recent developments regarding the AICPA Asset Management Revenue Recognition Task force and inquired of recent developments/reactions, if any.
3. The AICPA Publications staff informed the EP about timing of the 2016 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. The EP chair and staff updated the EP about latest developments regarding the following draft Technical Questions and Answers (TQAs, formerly known as TPAs):
 - a. Liquidation Basis of Accounting.
 - b. Loan Origination.
 - c. Accounting for Convertible Bonds.
 - d. RDFV.
2. Earlier this year one large investment company service provider released information to its clients about discrepancies in its billing practices for expenses incurred while serving those clients. The provider reviewed expense billing practices for the 18-year period ended November 2015 and determined that certain clients were overcharged through these billing practices. In many cases the reimbursements to be received by clients may be immaterial even in consideration of the cumulative impact of these billing practices over a significant period of time, but some may not be.

The EP considered accounting and NAV treatment for these overcharges. The EP noted that the fund management has the responsibility for determining whether these expense reimbursements represent 1) an accounting error, 2) a NAV error, and/or 3) a change in estimate. EP members agreed that the determination of whether the overcharges constitute a NAV error should be made in consultation with the entity's legal counsel and based on individual facts and circumstances. The EP member generally agreed that the criteria for determining an accounting error outlined in ASC Topic 250 *Accounting Changes and Error Corrections* and those used to determine NAV errors are not necessarily related. Therefore, management may conclude that this reimbursement is not accounting error, even if management determines it constitutes a NAV error. In reaching the conclusion that this is a change in estimate under GAAP, management would consider 1) whether they should have known that the expenses billed to the fund were overstated, 2) whether the fund is contractually obligated to pay the expense even in theoretical situations where management may have identified the billing practices being used, and 3) whether the service provider's relationship to the fund represents an extension of management. EP members further noted that, in most cases, these reimbursements are likely immaterial and therefore the distinction between error and change in estimate isn't likely to make a meaningful difference; however, in situations where the size of the fund has declined significantly, or where specific fund operations generated significant administrator expenses these overcharges could be material. The EP also considered whether the failure to identify these errors could indicate certain governance issues or control deficiencies. The EP expressed a view that generally because of the nature of the overcharges and the immateriality of the amounts in any one period, management would not have been able to identify the billing error. Therefore, this issue wouldn't result in a control deficiency or governance issues. However, funds' management should evaluate the specific facts and circumstances. EP members agreed that if funds' management was to conclude that share reprocessing was appropriate they should be sensitive to the timing of remediation effort.

III. Audit and Attest Issues

1. The EP considered proposed changes to certain illustrative reports in chapter 12 of 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. Auditor Independence Related to the Loan Provision

The SEC staff issued a [no-action letter](#) (NAL) on auditor independence on June 20, 2016. The NAL provides guidance to certain entities including registered investment companies, nonregistered investment companies subject to Rule 206(4)-02, and their investment advisers as they evaluate the independence of their audit firms in light of recent uncertainty about the application of Rule 2-01(c)(1)(ii)(A) under Regulation S-X (the "Loan Provision"). The relief is applicable to scenarios described in the NAL, including scenarios in which an institution with a lending relationship to an audit firm holds of record, for the benefit of its clients or customers, more than ten percent of the shares of a relevant entity; insurance companies that have a lending relationship with an audit firm and hold more than ten percent of the shares of a relevant entity in separate accounts that it maintains on behalf of its insurance contract holders; and an institution that has a lending relationship with an audit firm and acts as an authorized participant or market maker to an exchange-traded fund (ETF) that holds of record or beneficially more than ten percent of shares of such ETF. In such scenarios, the policy concerns underlying the Loan Provision generally are not implicated because the record or beneficial owner is not able to exercise undue influence over the relevant entity.

The NAL stated that in all cases where a Loan Provision violation is identified, even if it falls within the scope of the situations described in the NAL and was determined by the audit firm

to not impair the auditor's objectivity and impartiality, such violation must be reported to the relevant entity's audit committee given the auditor's communication requirements under PCAOB Rule 3526 (for an entity to which Rule 3526 does not apply, substantially equivalent communications must be provided to those responsible for the oversight of the entity). The NAL also included a condition that those responsible for oversight of the fund have not reached a conclusion different than the auditor about its objectivity and impartiality.

The EP raised a question about footnote 12 in the NAL regarding funds audited by other auditors than those responsible for the Loan Provision violation. The SEC staff confirmed that the NAL applies to all lending relationship violations that exist for funds within the investment company complex that the auditor does not audit. If the auditor becomes aware of an independence violation related to a fund it does not audit, the auditor has an obligation to report this violation to the applicable board(s) consistent with the requirements under PCAOB Rule 3526.

A question was asked about application of the NAL to certain limited partnerships where limited partners do not have voting rights. The SEC staff stated that lack of voting rights may present a similar situation to those described in the letter, whereby the relevant owner is not able to exercise undue influence over the relevant entity; however, further considerations should be made to determine if the limited partner has the ability to influence the objectivity and impartiality of the independent auditor through relationships such as an advisory board. The SEC staff described a situation where a limited partner has significant influence on the valuation approach or valuation results for investments held within a fund; in such a situation, the principles underlying the NAL likely would not apply, because regardless of an LP's ability to vote, it retains the ability to significantly influence the relevant entity.

The SEC staff stated its view that registrants can make their own conclusions, based on individual facts and circumstances, as to whether the NAL relief applies. However, the SEC staff encourages registrants to consult with them if there are any concerns or when a new or unusual fact pattern arises that falls outside of the scenarios described within or the conditions applicable to the NAL.

Regarding an EP question about the frequency of evaluating independence as applicable to the Loan Provision, the SEC staff stated its view that Regulation S-X requires auditors and registrants to maintain and monitor independence continually. The SEC staff, however, acknowledged that they are aware that registrants may take a differing interpretation of the independence requirements and certain registrants are establishing and follow thoughtful policy to monitor periodically.

- A question was raised about the evaluation process in the case of a trust comprising multiple funds (e.g. a series trust). The SEC staff stated its view that the independence rules apply on a fund-by-fund (or series-by-series) basis, rather than on an overall trust basis. However, if there is a fact pattern whereby the ability to influence the objectivity and impartiality of the independent auditor may occur at a different level, the SEC staff would encourage a discussion on whether the fund-by-fund level is appropriate in that circumstance.
 - Finally, the SEC staff noted that, where a registered investment adviser to a private fund has an auditor with an independence violation covered by the NAL or otherwise determined not to impair the objectivity and impartiality of the independent auditor, the SEC staff prefers that the investment adviser select "Yes" to question 23(d) as to whether their accountant is independent on Part 1A of Form ADV Schedule D Section 7.B.(1) and include explanation of the violation and conclusion reached in the "Miscellaneous" section of Schedule D.
2. The N-1A rule instructions state that funds should present per share information in the financial highlights as follows:

List per share amounts to the nearest cent. If the offering price is expressed in tenth of cents or more, then state the amount in tenth of a cent. Present the information using a consistent number of decimal places.

The [AICPA FinREC comment letter](#) noted that the MMF rule will require floating \$1.00 NAV funds to transact at four decimal points and floating \$10 NAV funds at three decimal points. The AICPA letter asked the SEC staff to consider how these funds should present such NAV in the financial highlights. During the July 2016 EP call, the SEC staff indicated that a four decimal place presentation should be included for financial statement/financial highlight purposes as it would be most relevant to users of the financial statements/financial

highlights. The SEC staff will consider updating the form through a technical correction at a later date.

3. The SEC staff discussed the current status of an initiative by the Division of Corporation Finance to review disclosure requirements (as they relate to investment companies and investment advisers). As a second phase of this initiative, the SEC staff recently [proposed amendments](#) to disclosure requirements in Regulation S-X that may be redundant, duplicative, overlapping, outdated, or superseded with U.S. GAAP. The SEC staff highlighted the following areas of interest to the Expert Panel:
 - a. Rule 6-04.17 under Regulation S-X would require presentation of the total, rather than the components, of distributable earnings on the balance sheet.
 - b. The definition of an extraordinary item was removed from GAAP and the project addresses this removal by adding a definition for extraordinary to Form N-1A where utilized in the context of expenses and financial highlight presentation.
 - c. The proposed amendment would eliminate Rule 7-02(b) under Regulation S-X related to mutual life insurance companies and their wholly-owned stock insurance subsidiaries' ability to prepare financial statements in accordance with statutory accounting requirements given the evolution of GAAP requirements with respect to accounting prescribed for insurance companies since this rule's inception and further given the SEC staff is not aware of anyone relying on this particular exemption. This proposed elimination has no bearing on the financial reporting presentation requirements applicable to insurance company sponsors registering insurance products on Forms N-3, N-4 or N-6.

Investment Companies Expert Panel

Highlights of the September 20, 2016 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:

AICPA Investment Companies Expert Panel

Meeting Highlights

September 20, 2016

I. AICPA/Administrative:

1. The Expert Panel (EP) May 2016 meeting and July 2016 conference call 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 timing of 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. Liquidation Basis of Accounting (draft TQA).
 - b. Loan Origination (draft TQA).
 - c. Accounting for Convertible Bonds.
 - d. RDFV.
2. One EP member shared that certain registered investment companies have been receiving general questions from the SEC staff regarding their investments in collateralized loan obligations (CLOs) and valuation methods used. Another EP member shared that a business development company received a question from the SEC staff regarding income on CLO investments and how the effective interest method was applied in connection with the impact of income recognition on performance fee calculation. The EP members discussed the appropriate accounting literature for determining amortization/accretion of CLOs noting that ASC 325-40 *Investments – Other* (formerly EITF 99-20) is appropriate for lower rated beneficial interests in securitizations.

3. During the March 2016 EP call, the SEC staff discussed the growth of certain closed-end funds that invest in peer-to-peer (P2P) loans. Peer-to-peer lending companies allow consumers to obtain loans directly from investors via P2P online lending platforms. These companies act as an intermediary between lenders and borrowers for various types of loans, including small business loans, student loans, and real estate loans. At previous EP meetings the SEC staff indicated this is an emerging area and discussed certain accounting and auditing considerations that exist for P2P funds regulated by the Investment Company Act of 1940 (the 1940 Act).

The EP considered the appropriate unit of account – an individual loan or, if a fund holds a block of loans, the block of loans – for registered funds and private funds in accordance with US GAAP. EP members discussed that registrants and potential registrants (as part of registration statement review) receive questions from the SEC staff whether the registrant values each loan individually. Certain registered investment advisers to private funds receive similar questions. The EP members acknowledge the SEC staff’s expectation that a 1940 Act regulated fund would value each individual loan in its portfolio in accordance with the definition of “value” within Section 2(a)(41) of the 1940 Act and the SEC staff’s views that the appropriate method of accounting for, and valuation of, investment securities of registered investment companies pursuant to ASR 118 would be the individual loan. An EP member questioned, that if ASR 118 applies, this position should be limited to registered investment companies, and not extended to private funds unless it was consistent with other US GAAP. More specifically that a private fund would be required to evaluate if the appropriate unit of account was the individual loan under US GAAP excluding ASR 118.

4. As stated in July EP conference call highlights:

Earlier this year one large investment company service provider released information to its clients about discrepancies in its billing practices for expenses incurred while serving those clients. The provider reviewed expense billing practices for the 18-year period ended November 2015 and determined that certain clients were overcharged through these billing practices. In many cases the reimbursements to be received by clients may be immaterial even in consideration of the cumulative impact of these billing practices over a significant period of time, but some may not be.

The EP considered accounting and NAV treatment for these overcharges. The EP noted that the fund management has the responsibility for determining whether these expense reimbursements represent 1) an accounting error, 2) a NAV error, and/or 3) a change in estimate. EP members agreed that the determination of whether the overcharges constitute a NAV error should be made in consultation with the entity’s legal counsel and based on individual facts and circumstances. The EP member generally agreed that the criteria for determining an accounting error outlined in ASC Topic 250 *Accounting Changes and Error Corrections* and those used to determine NAV errors are not necessarily related. Therefore, management may conclude that this reimbursement is not accounting error, even if management determines it constitutes a NAV error. In reaching the conclusion that this is a change in estimate under GAAP, management would consider 1) whether they should have known that the expenses billed to the fund were overstated, 2) whether the fund is contractually obligated to pay the expense even in theoretical situations where management may have identified the billing practices being used, and 3) whether the service provider’s relationship to the fund represents an extension of management. EP members further noted that, in most cases, these reimbursements are likely immaterial and therefore the distinction between error and change in estimate isn’t likely to make a meaningful difference; however, in situations where the size of the fund has declined significantly, or where specific fund operations generated significant administrator expenses these overcharges could be material. The EP also considered whether the failure to identify these errors could indicate certain governance issues or control deficiencies. The EP expressed a view that generally because of the nature of the overcharges and the immateriality of the amounts in any one period, management would not have been able to identify the billing error. Therefore, this issue wouldn’t result in a control deficiency or governance issues. However, funds’ management should evaluate the specific facts and circumstances. EP members agreed that if funds’ management was to conclude that share reprocessing was appropriate they should be sensitive to the timing of remediation effort.

At the September 2016 EP meeting, the EP members considered financial presentation of these reimbursements for entities that determined the overcharges constitute a change in estimate (therefore would be recognized in the current period). Specifically, the EP members considered the following alternative views:

Statement of Operations:

View 1:

As with EITF 01-10, *Accounting for the Impact of the Terrorist Attacks of September 11, 2001*, the fund could record the reimbursement against the expense line item, in which the expenses were previously recorded, until that expense line item was eliminated and any remaining amounts would be recorded in income.

View 2:

The fund could record the entire amount of the reimbursement against the expense line item in which the expenses were previously recorded and allow such expense to become negative.

View 3:

The reimbursement is an unusual item and hence meets the standard as described within paragraph 8.36 of the Guide, which states “Items relating to specific portfolio securities are typically recorded as an adjustment to realized and unrealized gains or losses. Otherwise, the item and a subsequent revaluation should be presented as other income, if any, or a separate income item. If the item is sufficiently material in relation to net investment income, it should be presented as a line item immediately before net investment income, unless the item is clearly identifiable with realized and unrealized gains or losses.” Based on this assessment, the amount is recorded as a separate line item and recorded as a separate line before net investment income.

The EP members did not express a view as to the preferred accounting treatment. One EP member highlighted that under Rule 6-07 (f) of Regulation S-X, “Reimbursement to the fund of expenses incurred under such plan (12b-1 expense reimbursement) shall be shown as a negative amount and deducted from current 12b-1 expenses. If 12b-1 expense reimbursements exceed current 12b-1 costs, such excess shall be shown as a negative amount used in the calculation of total expenses under this caption. That EP member believes that this guidance would support a reimbursement treated as a change in estimate, as opposed to an accounting error.

An EP member noted that an additional alternative for presentation in the statement of operations would be to present the entire amount of the reimbursement as a reduction of total expenses, which would allow the fund to report the current period expense amount (prior to the reimbursement) and present the total reimbursement on the statement of operations.

Financial Highlights:

View 1:

Several EP members noted that the presentation should follow the statement of operations presentation. Specifically, the financial highlights would be determined consistent with the statement of operations presentation and those financial highlights would be presented more prominently than any additional non-GAAP supplemental disclosures in accordance with the SEC’s view on Non-GAAP measures. A footnote and/or supplemental disclosure would be presented to describe the impact of the reimbursement.

View 2:

Presentation consistent with the statement of operations should be shown, but after a calculation which describes the recurring statement of operations ratios. Proponents of this view would conclude that it is more relevant to show the recurring financial highlights information. This view is based on the fact that the presentation with the reimbursement includes items that will not reoccur.

The EP did not note a preference for the statement of operations presentation, but generally preferred views 1 and 3, and generally agreed that view 1 was preferable for the financial highlights.

5. The EP briefly discussed FASB’s tentative decision to require callable securities to amortize premium to first call date instead of to maturity. The EP noted the decision would align book basis with tax, yet, noted it may seem inconsistent to require amortization of premium to first call date if the intent to hold these securities is longer. An EP member observed that “yield-to-worst” is often used as an

amortization policy in practice and may be more consistent with the economics than the proposed yield to first call.

6. Some EP members have seen an increase in private equity funds entering into a subscription-secured credit facility in order to provide liquidity to funds by obtaining capital for investments more quickly than by having the fund call the capital from its limited partners (LPs) to purchase investments. More specifically the fund would obtain cash through a credit facility rather than waiting to receive the called capital from the LPs. Generally, the facility is a revolving line provided by a financial institution and collateralized by a pledge to call and receive capital contributions from the fund's investors.

Although such credit facilities are commonly used as a short term bridge financing, an EP member observed situations where funds let the LP use such facilities to bridge capital contributions for a longer term – 30, 60, or even 90 days. In addition, certain real estate funds let LPs bridge capital contributions for the entire investment period of 3 years.

When calculating the internal rate of return (IRR), certain funds are using the date an LP settles the credit facility as the date of cash inflow, and not the date the credit facility was drawn down. This time delay of between 30, 60, 90 days or 3 years results in an increase in the IRR. For purposes of calculating the preferred return on capital used for determining the performance based management fee, certain funds are using the date the credit facility is drawn.

The EP considered whether it would be appropriate to calculate IRR using the date the credit facility is paid back by an LP as the cash inflow date/capital called date (the delayed or deferred contribution date), thereby increasing the IRR calculation as compared to using the date the credit facility was originally drawn down.

The EP members observed that the fund should follow guidance in paragraph 7.180 of the Guide and disclose how IRR is calculated. EP members discussed the similarities and differences in the above fact pattern and when a fund obtains a loan at the fund level. Some EP members believed that disclosing both levered and non-levered IRR is appropriate in the fact pattern described above.

7. The EP members discussed the following fact pattern. A private equity fund has management fees per the LPA of 2% per year of capital commitments. The investment manager of the fund entered into a side-letter agreement with a single investor which provides for a management fee of 0% in year 1, 3% in years 2 and 3, and then 2% thereafter. The fund is locked up and unless the investment manager terminates the fund, the payment of fees is certain. Mathematically, this works out to an average fee of 2% per year and appears to be structured as a mechanism to defer the investor's payment of management fees. The EP considered whether the private equity fund should accrue management fees in year 1 (at 2% per year) or if it should be treated as a fee waiver.

EP members noted that the appropriate accounting would depend on the facts and circumstances of the fund. For example, in the fact pattern described above, the investor is locked up and the fee is calculated on committed capital, a fixed amount. Under these circumstances the EP members generally agreed that the fee should be recorded based on the average effective rate (2%). Alternatively, if the investor could redeem and the basis used to determine the fee was variable (i.e. net assets) then it might be appropriate to recognize the fee based on the contractual rate in effect in the period.

8. A fund of funds invests in private equity funds and receives distributions. Private equity funds of funds generally allocate the proceeds from these distributions between realized gains (effectively as a partial sale of the investment) and return of capital in accordance with FASB ASC 946-320-35-5, which states "Distributions that represent return of capital shall be credited to investment cost rather than to investment income." Funds may use information obtained from the underlying fund to determine these amounts. Some funds are concerned that losses may be building up in the underlying fund due to expenses and losses on investments that are not distributed. This may result in realized gains being recorded when early distributions are made, only to result in later realized losses when subsequent distributions are made or the fund liquidates. The EP discussed whether a fund of funds can calculate realized gains and return of capital from distributions using an average cost basis (using the ratio of distributions to the fair value of the investment) in accordance with FASB ASC 946-320-40-1, which states "The cost of investment securities held in the portfolio of an investment company and the net realized gains or losses thereon shall be determined on the specific identification or average-cost methods. An investment company shall use only one method for all of its investments."

The EP members noted diversity in practice in how fund of funds determine the amount of proceeds to apply to a specific investment. EP members generally agreed that applying a reasonable method to allocate expenses and losses may be acceptable as long as it was consistently applied. Regardless of the method, the EP members expressed a view that an investment company should choose the method for all of its investments and that method should be consistently applied.

9. Questions have arisen related to whether or not nonregistered investment companies can have a balance sheet caption combining cash and cash equivalents, and more specifically, whether money market funds (or similar nonregistered products) can be classified as cash equivalents by nonregistered investment companies. Additionally, there seems to be diversity in practice around the presentation of money market funds in the schedule of investments and fair value hierarchy leveling table. The EP members discussed the following alternative views:

Statement of Assets and Liabilities

View 1

- FASB ASC 946-305 (the presumptive authoritative guidance for cash for investment companies) is silent as to the concept of cash equivalents.
- Article 7 of Regulation S-X requires a cash caption, and while not a registered fund, investment company guidance is generally modelled off registered fund guidance.

As such, one could conclude that FASB ASC Topic 946 limits the range of acceptable practices that would otherwise be accepted under FASB ASC Topic 305 and, therefore, investment companies would not be allowed to present cash equivalents.

View 2

- Although not specifically discussing the concept of cash equivalents, cash equivalents are mentioned in chapter 7 of the Guide when discussing the statement of cash flows and are included in some illustrations (e.g., paragraphs 7.232 and 7.234).
- FASB ASC 230-10-45 states that an entity shall establish a policy governing which short-term, highly liquid investments shall be classified as cash equivalents and that the policy will vary depending on the nature of the entity.
- Private investment company balance sheet captions are not defined.
- General entity guidance combines cash and cash equivalents.

As such, one could conclude that where FASB ASC Topic 946 is silent to cash equivalents, it is not limiting. In this view, FASB ASC Topic 305 applies to all entities and allows for the presentation of cash equivalents, in which money market funds are included as an example and could be acceptable to be presented as a cash equivalent by a nonregistered investment company.

The EP members expressed a view that guidance in FASB ASC Topic 305 may apply to nonregistered investment companies. However, View 1 and View 2 would be acceptable. One EP member highlighted that the presentation may depend on the type of fund (i.e. private equity funds may prefer to present money market funds as cash equivalents while hedge funds may be more likely to present money market funds as an investment). EP members noted under view 2, a fund would need to consider if an investment in a money market fund no longer met the definition of cash equivalent. As documented in July 2014 SEC Staff Update section of EP call highlights:

The Commission indicated in the adopting release that under normal circumstances, an investment in a money market fund with a floating NAV or a money market fund that has the ability to impose a fee or gate qualifies as a “cash equivalent” for purposes of U.S. GAAP. However, as is currently the case, events may occur that give rise to credit and liquidity issues where shareholders would need to reassess their investments in money market funds to determine whether they continue to meet the definition of a “cash equivalent.” If events occur that cause shareholders to determine that their money market fund shares are not cash equivalents, the shares would need to be classified as investments, and shareholders would have to treat them as trading securities or available-for-sale securities in accordance with ASC 320.

The EP observed that registered investment companies would include investments in money market funds in the schedule of investments. EP members generally agreed that private funds would present money market funds consistent with how they present them on the statement of assets and liabilities.

Specifically, under view 1 above, the fund would present money market funds on the schedule of investments and under view 2 they generally would not (EP members expressed different views regarding whether under view 2 the money market fund or similar investment would be included in the schedule of investments).

The EP members considered the following presentation options for money market funds within the fair value hierarchy table.

a. Measured at cost

No; if the money market fund is measured at cost or cost and accrued income and classified as cash and cash equivalents, it would not include this in the leveling table. However, you would have to disclose in the footnotes the fair value, its level in the fair value hierarchy, and a description of the valuation technique(s) and inputs used in the fair value measurement in accordance with ASC 820-10-50-2E. This is subject to change under ASU 2016-01 depending on the determination of whether the fund is a public business entity.

b. Measured using NAV as a practical expedient

No; in accordance with ASU 2015-07, if the money market fund or similar product is measured using NAV as a practical expedient, you would not categorize this within the fair value hierarchy or include in the leveling table as prescribed by ASC 820-10-50-2. However, you would provide the amount measured using the net asset value per share (or its equivalent) practical expedient to permit reconciliation of the fair value of investments included in the fair value hierarchy to the line items presented in the statement of financial position in accordance with paragraph 820-10-50-2B.

c. Measured at fair value

Yes, if the money market fund is measured at fair value then it would have to be included in the leveling table in accordance with ASC 820-10-50-2.

III. Audit and Attest Issues

1. The EP considered potential proposed changes and updates for 2017 edition of the Guide.
2. The EP members considered proposed changes to the example 17Ad-13 report.
3. Pricing vendor IDC's acquisition of S&P Global's Securities Evaluations (SPSE) will reduce the number of pricing vendors providing prices for certain investments. The EP considered how auditors and investment companies are evaluating if prices provided by SPSE and IDC are independent, and if auditors are considering prices provided by SPSE to be independent from those used by management, and if so, what factors would result in the prices no longer being considered independent. EP members indicated that they were monitoring the transaction between IDC and SPSE to evaluate when the prices could not be deemed to be independent.

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 meeting via conference call to discuss the following questions presented by the EP members and shared additional observations:

1. The SEC staff reiterated its view previously presented during July 2016 EP conference call, that with regard to floating rate money market funds, a four decimal place presentation for per share information in the financial highlights is the most relevant to users of the financial statements. As such, the SEC staff would expect a fund to present four decimal places in the beginning NAV for financial highlights of the current period. However, a fund would not go back and restate prior period NAVs to four decimal places. More specifically, the beginning NAV of per share information would be based on amortized cost and would include four decimal places, but prior periods presented would include only two decimal places. The SEC staff noted inconsistency with Form N-1A instructions related to the amount of decimal places required for financial highlight purposes and indicated that the instructions may be updated for money market funds in the future.

2. The SEC staff was asked a number of questions with regard to the Fidelity Management & Research Company et al. [no-action letter](#) (NAL) related to the loan provision in the SEC independence rules issued on June 20, 2016 (also see July EP call highlights) and highlighted a few areas:
 - a. If a registrant, audit firm, or those charged with governance encounter a scenario that they believe does not impair the auditor's independence but that violates the loan provision and falls outside of those circumstances described in the NAL, they would not be covered by the SEC staff's NAL. However, when determining the severity of the violation and whether to consult with the SEC staff, the auditor and registrant should consider whether the auditor's objectivity and impartiality was impaired, consistent with the general standard of independence in Rule 2-01(b), which may also include assessing whether the investor had the ability to significantly influence the fund or the auditor throughout the audit period. The SEC continues to review consultations with registrants and auditors that fall outside of the NAL.
 - b. The SEC staff is aware that the assurances provided in the NAL are temporary and currently set to expire on December 20, 2017. The SEC staff noted that they do have the ability to extend NALs.
 - c. If a registrant concludes that a violation of the independence rules has occurred, but determines that the audit firm remains objective and impartial despite the violation, a registrant may choose to select the box on Form ADV indicating their auditor is independent. Some registrants are also including a description of the violation in the miscellaneous section of the Form however the SEC is not requiring this disclosure for technical violations that fall within the scope of the NAL.
3. The SEC staff shared that they have provided financial statement review comments regarding how investment companies, which invest in CLOs, should recognize amortization/accretion of interest income over the life of the beneficial interest using the effective yield method pursuant to FASB ASC 325-40. Furthermore, the staff noted that there have been instances where an improper method was used to determine the interest income and resulted in error corrections for the registrant's financial statements. The SEC staff will continue to focus on how investment companies that invest in CLOs determine the amount of interest income to recognize.
4. The SEC staff discussed merger transactions involving business development companies. Specifically, the SEC staff indicated that they have identified instances, as part of the SEC staff's review of Form N-14 filings, where a business development company has not determined if the acquisition was an asset acquisition or a business combination. The SEC staff highlighted that the determination of what constitutes a business for reporting purposes (e.g., S-X 3-05) is made by reference to the definition of a "business" in S-X 11-01(d). The determination of what constitutes a business for accounting purposes (e.g., whether acquired net assets constitute a business for purposes of determining whether a business combination as defined in ASC 805 has occurred) is made by reference to the definition of a business in the ASC master glossary and both pieces of guidance should be considered.

The SEC staff highlighted that the conclusion of whether the acquisition is an asset acquisition or a business combination may result in different accounting treatment for, among others, acquisition costs, cost basis of investments, and certain components of the purchase price, as well as if goodwill exists. Registrants have been asked to provide accounting analysis and encouraged to present specific facts and circumstances and discuss them in consultation with SEC staff.

Investment Companies Expert Panel

Highlights of the November 15, 2016 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) May and July 2016 conference call highlights have been submitted for posting to aicpa.org; September 2016 meeting 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 Investment Companies TQAs](#) on loan origination and liquidation basis of accounting have been issued.
4. The AICPA Publications staff informed the EP about timing of 2017 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide) and related reviews and also sought reviewers for each chapter.

II. Accounting/Reporting Issues:

1. The EP members and staff discussed status of the following projects:
 - a. Accounting for Convertible Bonds.
 - b. Readily Determinable Fair Value (RDFV).
2. The EP discussed whether it is a change in accounting principle or a change in estimate when a money market fund (MMF) is required by the new MMF rules to change from a Stable NAV MMF using amortized cost to a Floating NAV MMF using fair value prices to value its investments for daily NAV and financial statement purposes. The EP believes such change is a change in accounting estimate since amortized cost was used as a proxy for fair value. Also see SEC Staff Update section of these highlights.
3. The EP briefly discussed current [callable bond proposal](#) and its proposed amendments to Subtopic 946-320, *Investments – Debt and Equity Securities*.
4. The EP discussed a proposed change in a [Proposed FASB Technical Corrections ASU \(an amendment to Subtopic 820-10, Fair Value Measurement — Overall as part of Proposed Accounting Standards Update, Technical Corrections and Improvements \(File Reference No. 2016-220\)\)](#) that would require an entity to disclose for level 2 and level 3 investments when it makes a change in either a valuation approach or a valuation technique and explain the reason for the change (disclosures are made for each class of assets and liabilities). The EP members shared that under current GAAP, the terms “valuation approach” and “valuation technique” are used interchangeably in Topic 820, *Fair Value*

Measurement. The EP discussed the impact to funds if the changes are adopted as proposed and will revisit this topic on the January EP conference call. Subsequent to the November 2016 EP meeting, the FASB issued Accounting Standards Update (ASU) No. 2016-19, *Technical Corrections and Improvements*, which amended Subtopic 820-10, *Fair Value Measurement – Overall*.

5. One EP member discussed that questions have arisen regarding how the accounting for convertible debt with a “cash conversion feature” 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. 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 and will revisit this topic at the January 2017 EP conference call after the EP members consider options presented.
6. The EP discussed interest income and impairment for an investment company that holds distressed investments. An investment company records its investments at fair value and for debt securities recognizes interest income using the effective interest method in accordance with the applicable guidance.
During the September 2016 EP meeting, the accounting for amortization and accretion of premiums and discounts was discussed as it relates to the period over which the calculation would occur. During the July 2014 EP call, it was discussed that it may be difficult to estimate the timing and amount of future cash flows for distressed assets. Certain EP members noted that some entities, when they apply FASB ASC 325-40 (formerly, EITF 99-20), believe that impairment should be evaluated and recognized as realized losses for beneficial instruments subject to ASC 325-40 when, based on judgment, the cost of distressed assets will not be recovered. At the same time, other entities note that the impairment guidance in ASC 325 references ASC 320 (formerly, FAS 115) for additional guidance, but ASC 320 exempts investment companies and other entities that report investment at fair value from the guidance. At the November 2016 EP meeting, the EP acknowledged that practice varies regarding using the impairment model in ASC 325 and applying it to investment companies.
7. The EP considered a question that arose in practice relating to [CDS Anti-Trust Lawsuit](#). In a class action lawsuit, which alleges that the Defendants engaged in anticompetitive acts that affected the price of CDS (violation of Section 1 of Sherman Act, 15 U.S.C. § 1.), settlements have been reached and Defendants have collectively agreed to pay \$1,864,650,000. The deadline to submit a claim or additional transaction information passed on May 27, 2016. The claims administrator continues its work processing claims and responding to challenges. At this time the claims administrator is not able to estimate when a distribution of the net settlement funds will be made. The claims administrator, in consultation with Lead Counsel, believes that distribution will occur in 2016. Claims relating to this lawsuit are being traded in the over-the-counter market (bid/ask is approximately 11.5 cents to 12.5 cents). In scenarios where an investment company opted into the class action settlement relating to the CDS Antitrust Litigation earlier this year (that is, they filed a claim and are a party to the Settlement), the EP discussed whether it is more appropriate to account for these claims based on the contingent gain criteria¹ (excluded from recognition in the financial statements until realization) or to include them in the NAV of the fund at fair value. During the November 2016 EP meeting, the EP members expressed a view that gain contingency accounting would be appropriate when an entity filed a claim. However, if the investment company purchased the claims for investment purposes, they would be reflected in the entity’s financial statements as investments carried at fair value. Subsequent to the November 2016 EP meeting, a payment was issued to all eligible class members.
8. One EP member inquired if entities other than those registered under the Investment Company Act of 1940 have used 12b-1 accounting (so the expense is recorded over time as opposed to up front). The EP members have not seen this in practice yet.

¹FASB ASC 450-30-25-1 states that ‘a contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization’.

FASB ASC 450-30-50-1 states that ‘adequate disclosure shall be made of a contingency that might result in a gain, but care shall be exercised to avoid misleading implications as to the likelihood of realization’.

9. The EP briefly discussed potential financial reporting implications in connection with a [new SEC rule](#) that will permit a registered open-end management investment company (other than a money market fund or exchange-traded fund), under certain circumstances, to use “swing pricing.” Swing pricing is the process of adjusting the fund’s net asset value per share to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity. The EP also noted that the determination on whether there is an error that should be corrected if a fund’s NAV/share swung when it should not have swung based on estimated fund flows prior to the calculation of NAV/share (or vice versa) is a legal determination.
10. The EP considered accounting for funds of funds that have investments in liquidating funds where underlying funds account for their investments using liquidation basis of accounting. One EP member inquired whether those liquidation NAVs would fall within the practical expedient. The EP discussed that reporting entities are generally permitted to use NAV as a practical expedient to measure the fair value of an investment when the investment does not have a RDFV and the investment is in an investment company within the scope of FASB Topic 946 *Investment Companies*. The EP acknowledged that many funds do use NAV as a practical expedient for investments in funds that go into liquidation (except when there is forced liquidation or distressed sale) if the NAV is calculated in a manner consistent with the measurement principles of FASB Topic 946. The EP also noted that in most cases when the liquidation is not expected to be a long process, liquidation value would approximate fair value.
11. An EP member shared information about a prospectus for an offshore fund (non-SEC registrant) being sold to certain foreign investors. The fund sponsor has entered into an agreement with a single broker-dealer to distribute the fund. The fund has a distribution fee based on a percentage of net assets (payable on a monthly basis) and contingent deferred sales charge (CDSC) declining over a five-year period. The prospectus states that, at inception, the fund expects to invest in “performance-linked notes” issued by an affiliate of the distributor to allow the distributor to hedge certain of its exposures. The initial amount of notes to be purchased from the distributor affiliate by the fund will approximate the amount of the up-front fee paid by the distributor and to be recovered from the CDSCs/distribution fees. The notes will be indexed to the performance of the fund itself, and the prospectus also clearly states that part of the notes will be redeemed by the distributor each year “in order to maintain the total value of the [notes]..... equal to or below the amount of the [CDSC] applicable to the respective [class] plus 0.20% multiplied by the net asset value of the respective [class]”. The EP member inquired about appropriate accounting for this fund:
 - a. How the notes would need to be presented on the balance sheet for financial reporting purposes - as assets or as a reduction of equity?
 - b. How should the unrealized (and, as they are paid down, realized) appreciation/depreciation on the notes be classified on the income statement?
 - c. Or should an entirely different accounting model be employed for these notes, similar to “deferred commission assets” (although under that model the fund would be “paying” itself) or to an “enhanced 12b-1 plan” (SOP 95-3, later made part of the FASB codification, in that between the distribution fees and any loss realized on the notes, it appears that the fund in some way will eventually bear the full cost of the commissions)?

The EP discussed, among other things, the rationale behind such structure, whether this should be accounted for as a reimbursement, and whether there are gross vs. netting issues.

12. The EP discussed accounting and reporting considerations for Sukuk bonds. Sukuk are Islamic bonds, typically issued in registered global form, and are structured in such a way as to generate returns to investors without infringing on Islamic law, which prohibits the charging or payment of interest. Sukuk bonds allow investors to take advantage of investment opportunities within emerging market countries. They link their issuers, primarily sovereigns and corporations in the Middle East and Southeast Asia, with a wide pool of investors. In contrast to conventional bonds, where the issuer has a contractual obligation to pay interest and principal, under a Sukuk bond structure, the Sukuk holders each hold an undivided beneficial ownership in the bond’s underlying assets and are entitled to a share in the revenues (and risks) generated by those assets. The sale of a Sukuk holding represents the sale of a proportionate share in those underlying assets. The [first Sukuk bonds](#) were issued by Malaysia in 2000. The EP considered whether Sukuk bonds are bonds/debt securities and whether income would be interest income. The Sukuk instrument has a par value (based on the value of the underlying asset), a periodic interest rate (assume this is purchase yield) and a maturity date, but under Islamic law the issuer cannot issue a debt instrument.

An EP member noted that in certain funds with only a small percentage of their portfolio invested in Sukuk, the instrument is being listed in the schedule of investments as a bond and income is being presented as part of interest income on the statement of operations, while in certain funds with a much larger percentage of their holdings in Sukuk, the instrument is being listed in the schedule of investments as Sukuk (with rates and maturity dates like a bond included in the security description) and income is being presented as Sukuk income or profit payments on Sukuk. One EP member noted that funds which have policies requiring them to classify investments according to their legal form should not classify Sukuk bonds as debt if they are not debt in legal form. The EP also expressed a view that income earned on these Sukuk bonds would need to be reflected as investment income, if material.

13. 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 2016 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. The EP noted the SEC staff has been focusing on the accounting for offering costs by closed-end funds with continuous offering periods and will inquire of the SEC staff for their views on this question on the January 2017 EP conference call.

III. Audit and Attest Issues

1. The EP members considered comments regarding proposed changes to 17Ad-13 report.
2. The EP was updated on recent developments regarding potential dual reporting for certain attestation reports included in the Guide.
3. An EP member shared that the Investment Company Institute issued a set of frequently asked questions and answers in connection with the SEC [no-action letter](#) (NAL) on independence issued on June 20, 2016. One of the FAQs indicates that a registered investment company may send a “negative consent” (negative confirmation) to certain identified owners (owners that may have greater than 10% record or beneficial ownership of a fund and have a lending relationship with the audit firm) informing them that the fund will assume that the owner will not exercise discretionary voting authority unless the fund receives a written response indicating otherwise when conducting the “reasonable inquiry” prescribed by the NAL to determine whether an entity will exercise discretionary voting authority with respect to greater than 10% of the shares. The fund should allow adequate time for response.

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 meeting via conference call to discuss the following questions presented by the EP members and shared additional observations:

1. During the November 2016 EP meeting, the EP discussed whether it is a change in accounting principle or a change in estimate when certain money market funds (MMFs) are required by the new SEC MMF rules to change from a Stable NAV MMF using amortized cost, to a Floating NAV MMF which would no longer have the ability to use amortized cost for the majority of its investments. The EP believes such change is a change in accounting estimate since amortized cost is a proxy for fair value. The EP sought the SEC staff’s views on this topic.
The SEC staff did not object to accounting for such a change as a change in estimate provided quantitative and/or qualitative disclosures are made, depending on the materiality to the registrant.
2. Regulation S-X:

- a. The EP inquired about the compliance date for the amendments to Regulation S-X on August 1, 2017. Does this mean that (1) any financial statements filed with the SEC on or after August 1, 2017 would need to comply with the amendments to Regulation S-X (e.g., semi-annual or annual reports for the periods ending May 31, June 30, or July 31, 2017, BDC 10-K filings for the same periods, as applicable, or BDC 10-Q filings for the periods ending June 30 or July 31, 2017) or (2) the first financial statements filed with the SEC that would need to comply with the amendments to Regulation S-X would be any financial statements for a period ending on or after August 1, 2017? The SEC staff informed the EP that the first financial statements filed with the SEC that would need to comply with the amendments to Regulation S-X would be based on the financial reporting date as opposed to the filing date. For example, any financial statements for a period ending on or after August 1, 2017 (e.g., August 31, 2017 quarterly, semi-annual, or annual reports) would need to be in compliance with the new requirements. The SEC staff noted that early adoption of the S-X amendments is permitted, as long as funds adopt all S-X amendments and don't cherry pick (e.g., funds cannot omit the written options rollforward without early adopting all other S-X amendments).
 - b. [A marked version of the text of amended Regulation S-X](#) is publicly available.
3. The SEC staff noted that upon finding any material discrepancy (MD) during the course of the surprise examination required under Advisers Act Rule 206(4)-2 (Custody Rule), the accountant is required to notify the SEC's Director of OCIE within one business day of the finding. For the purposes of this examination, as per the SEC's guidance for accountants in [Release No. IA-2969](#), a MD is material non-compliance with the provisions of either Rule 206(4)-2 or Rule 204-2(b) under the Advisers Act. The SEC staff noted that questions have arisen if an accountant identifies a MD that occurred outside of the current surprise examination period (e.g., a new accountant performing the current year's surprise examination identified a MD that occurred in a prior period where another accountant performed the surprise exam in the prior period). While the accountant is not required to reflect the MD in the current year's surprise exam report, the SEC staff would not object if the accountant included such MD in the current year's surprise exam report. The SEC staff also noted there is no "cure" for prior period non-compliance with the Custody Rule.

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 contract 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 complete sale of the investment. In year 1, the fund would recognize a realized loss 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 gain of \$12,000,000 (proceeds of \$12,000,000 less cost basis of \$0).
2. Account for the initial proceeds as a partial sale of the investment. In year 1, the fund would recognize a realized gain 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 gain 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.

Investment Companies Expert Panel

Highlights of the March 21, 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) January 2017 call highlights are being finalized; September and November 2016 meetings' highlights are now [available](#).
2. The AICPA staff updated the EP on [recent developments](#) regarding the AICPA Asset Management Revenue Recognition Task force.
3. The EP considered potential conforming and other changes to the 2017 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide).

II. Accounting/Reporting Issues:

1. The EP was updated that earlier in March 2017, the FASB decided not to add a project on the Master Glossary definition of *readily determinable fair value* to its agenda but decided to amend the illustrative example in paragraph 962-325-55-17 as part of the technical corrections and improvements project. The EP determined not to proceed with developing a TQA.
2. The EP was updated on discussion regarding variation margin. See SEC Staff Update for more information.
3. 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 or both a valuation approach and/or a valuation technique. The EP agreed to identify factors to consider in applying the amended guidance and discuss and document them in future meeting highlights. The EP will resume this discussion at the May EP meeting.
4. EP revisited a topic originally discussed at its December 12, 2012 EP meeting:
“For private equity funds, the EP noted that industry practice is generally to defer placement agent fees and charge to capital when called. EP noted that the fund may have negative capital if placement fees are greater than seed capital.”
The EP reaffirmed that EP views remain consistent with those expressed in 2012.
5. Accounting for earn-outs:
 - a. During the January 2017 EP conference call, the EP discussed accounting by an investment company for contingent consideration (earn-out) received as a result of a sale of its investment in a portfolio company. Specifically, 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. During the January EP conference call, the EP considered the following fact pattern and 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 complete sale of the investment. In year 1, the fund would recognize a realized loss 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 gain of \$12,000,000 (proceeds of \$12,000,000 less cost basis of \$0).
2. Account for the initial proceeds as a partial sale of the investment. In year 1, the fund would recognize a realized gain 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 gain of \$8,800,000 (proceeds of \$12,000,000 less cost basis of \$3,200,000).

During March 2017 EP call, the EP revisited the discussion and considered a third alternative:

3. Account for the initial proceeds as a complete sale of the investment. In year 1, the fund would recognize a realized gain of \$6,000,000 (cash proceeds of \$2,000,000 plus fair value of earn-out received of \$8,000,000 less cost basis of \$4,000,000). The fund would also recognize a financial instrument/investment of \$8,000,000 with \$8,000,000 cost basis. In year 2, the fund would recognize a realized gain of \$4,000,000 (proceeds of \$12,000,000 less cost basis of \$8,000,000).

Most EP members believe alternative 3 is preferable, because the original investment has been sold in its entirety. Some EP members expressed a view that alternative 1 may also be acceptable.

- b. Private equity funds may acquire an investment and agree to pay an earn-out to the seller if certain operating metrics are met and/or if the investee IPOs is sold at a gain within a certain period. The EP considered whether such earn-out should be recorded as a payable under ASC 450 (when probable and estimable) or as a financial instrument that is carried at fair value. The EP expressed a view that an investment company (private equity fund) would record such earn out as a financial instrument recognized at fair value.

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.

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 SEC staff offered the following observations from recent ICI conference:
 - a. During a Q &A with David Blass, David W. Grim, Director, Division of Investment Management, highlighted some of the priorities of the Division, including a potential ETFs rulemaking, disclosure effectiveness project similar to the Division of Corporate Finance and third-party compliance assessments. In connection with the Division's disclosure effectiveness priority, the SEC staff encouraged feedback on areas where the disclosures in the financial statements, registration statements or prospectuses could be strengthened from investor protection or regulatory perspective.
 - b. During the Accounting and Auditing Update Panel, Matt Giordano and Mike Barkman discussed a recent industry consultation paper related to the accounting for changes in value on centrally cleared derivatives and the related movement of variation margin. The submission focused on two different views with regard to the categorization of income for daily movements in variation margin on centrally cleared derivatives (unrealized vs. realized). View A, which is consistent with the current practice for futures contracts, supports accounting for the change in fair value of open settled-to-market derivative contracts as unrealized gains and losses until the contract delivery or termination date, at which point they would be reclassified to realized. View B supports realizing gains and losses on such contracts when variation margin is transferred. The SEC staff indicated that they would not object to either view, as long as the elected policy is applied consistently to all settled-to-market derivative contracts.
2. The SEC staff discussed a situation where a registrant's audit firm waived its audit fees for the current year audit. The SEC staff noted that the waiver was intended to help the registrant to maintain a positive yield. The SEC staff raised questions around auditor independence, and whether or not the auditor in this situation, was independent in accordance with Rule 2-01(b) of Regulation S-X:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement.

In response to the SEC staff's questions, the registrant subsequently notified the staff that they determined to pay audit fees for the current years audit.
3. In connection with the DOL rule, the SEC shared a situation where a registered existing multiple-class fund created a new share class and provided information about principal risks for the new class in accordance with Item 4 (b) (2). The SEC staff reminded that Instruction 3(b) for Multiple Class Funds of Form N-1A states:

When a Multiple Class Fund offers a new Class in a prospectus and separately presents information for the new Class in response to Item 4(b)(2), include the bar chart with annual total returns for any other existing Class for the first year that the Class is offered. Explain in a footnote that the returns are for a Class that is not presented that would have substantially similar annual returns because the shares are invested in the same portfolio of securities and the annual returns would differ only to the extent that the Classes do not have the same expenses. Include return information for the other Class reflected in the bar chart in the performance table.

Investment Companies Expert Panel

Highlights of the May 16, 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 AICPA staff announced new AICPA volunteer year periods:
 - a. October 25, 2016 – January 31, 2018
 - b. February 1, 2018 – May 2019
2. The Expert Panel (EP) [January](#) and [March](#) 2017 call highlights are being finalized.
3. The AICPA staff updated the EP on [recent developments](#) regarding the AICPA Asset Management Revenue Recognition Task force.
4. The AICPA Publications staff and the EP discussed status and timing of conforming changes to the 2017 edition of the AICPA Audit and Accounting Guide Investment Companies (the Guide) and considered certain proposed conforming changes to the Guide.

II. Accounting/Reporting Issues:

1. The SEC staff requested the EP's views regarding private equity trading platforms. The industry and regulators anticipate an accounting question in the future of whether investments in alternative funds trading on such trading platforms would be considered to have a "readily determinable fair value" and therefore no longer eligible for use of NAV as a practical expedient. The EP members noted that current trading of alternative funds on these platforms is fairly limited, so it's unlikely that someone would reach the point of concluding that such investments have readily determinable fair values. However, theoretically, if the volume of activity were sufficient to conclude that there is an observable market for these products, a readily determinable fair value would be attained.
2. FASB Accounting Standards [Update \(ASU\) 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 or both a valuation approach and/or a valuation technique. During the March EP call, an EP member noted that in certain cases, a company's valuation policy may permit a choice of multiple valuation techniques or approaches, or the use of multiple approaches and/or techniques, depending on market conditions and the availability of data to maximize the usage of observable market information. EP members generally agreed that under the amended guidance, companies may limit their disclosure to changes of the valuation policy for

each class of instrument at the measurement date. The EP members also noted that no disclosure of the change in approach/technique would be required if both approaches/techniques were contemplated by the policy and disclosed.

3. Private equity funds sometimes enter into tax receivable agreements (TRAs) in conjunction with the IPO of a portfolio company. Under a TRA, the public company agrees to pay the pre-IPO equity owners a portion of certain tax benefits that the public company may realize in the future. The tax benefits may result from the IPO's step up in tax basis of the public company's assets (e.g., goodwill) which results in increased amortization and depreciation expense or the use of previous net operating losses. The TRA payments can extend for many years (sometimes decades) and can be received by the fund even after it has disposed of its interest in the public company. An EP member inquired whether funds should account for TRAs as a gain contingency and only record any gain when realized or account for TRAs as a financial instrument at fair value. An EP member indicated that historically industry participants have viewed the accounting for TRAs as a gain contingency or financial instrument is an accounting policy election, similar to earn outs. The EP members favored a view that TRAs would generally be accounted for as a financial instrument, which would be measured at fair value.
4. [FASB ASU 2017-08](#), *Receivables—Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities* implementation issues:
 - a. The transition guidance for ASU 2017-08 indicates that the “pending content that links to this paragraph shall be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption”. For an investment company, which carries all investments at fair value, the cumulative net impact on retained earnings would be zero, as any change in in the amount of reduction to interest income due to shortened amortization period would be offset by change in unrealized appreciation/depreciation amount. However, for a registered investment company, components of net assets could be impacted. An EP member inquired whether an entity would be required to analyze all callable debt securities ever held to determine cumulative-effect adjustment in the year of adoption or whether an entity would only analyze the debt securities held on the date of the adoption to determine the cumulative-effect adjustment. The EP members generally agreed that, based on the transition guidance, it would be appropriate to calculate the cumulative-effect adjustment based only on the positions held by the fund as of the transition date since any differences between book and tax income on previously held instruments would have been adjusted through the “ROCSOP” reclassification entries.
 - b. In terms of implementation at adoption, most will likely follow an approach similar to what was outlined in the August 2000 ICI White Paper on Mandatory Amortization. The EP member inquired about what happens if the bond is not called at first call date. FASB ASC 310-20-35-33 states in part that “after the earliest call date, if the call option is not exercised, the entity shall reset the effective yield using the payment terms of the debt security”. Does this mean that on a going-forward basis an entity would amortize on a yield to maturity (“YTM”) basis any remaining premium (e.g., the call price for the bond was \$102, so there is still \$2 of premium) to maturity? Or does it mean that an entity would recalculate amortization on a YTM basis for the full premium since date of purchase and recognize the difference in amortization over the remaining life of the bond? The EP members expressed a view that the remaining premium between the call price and par would be amortized prospectively after the initial call date. Discussion was held on whether the premium would be amortized to the next call date or to maturity. The relevant ASU is silent to application of the amortization approach beyond the initial call date; however, paragraph BC21 in the ASU states, “In situations in which an entity amortizes a premium to a call price greater than par and the debt security is not called on the earliest call date, an entity would reset the yield using the payment terms of the debt security. If the security contained additional future call dates, the entity would consider whether the amortized cost basis would exceed the amount repayable by the issuer at the next call date. If so, the excess would be amortized to the next call date.” Accordingly, if a security has more than one call date and the premium was amortized to a call price greater than the next call price, any excess of the amortized cost basis over the amount repayable at the next call date will be amortized to that date. If there are no other call dates, any excess of the amortized cost basis over the par amount will be amortized to maturity.
5. Rule 6-04.6 states: “Deposits for securities sold short and other investments. State separately amounts held by others in connection with: (a) Short sales; (b) open options contracts; (c) futures contracts; (d) forward foreign currency contracts; (e) swap contracts; and (f) investments-other than

those presented in 12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B and 12-13C.” This appears to require separate presentation of collateral pledged (i.e., deposits with brokers) by type of investment/derivative. Collateral for derivatives is generally held by counterparty and not by derivative contract type, so this requirement to show by derivative type would be problematic. There is some discussion in the industry of creating a methodology for allocating collateral to the various derivative types; however, this does not reflect the legal terms of the agreements under which these derivatives are traded. During May 2017 EP meeting, the EP discussed the practicality of applying the guidance and the inherent limitations on how this information is tracked by industry participants. It was noted that counterparties and prime brokers often don’t evaluate collateral by investment type, which creates significant challenges in the application of the guidance. EP members discussed the fact that the SEC staff is expected to release Investment Company Reporting Modernization FAQ. Subsequent to the May EP meeting, the SEC staff released an [FAQ](#) for Investment Company Reporting Modernization, which addresses this issue.

6. In reviewing FASB ASU 2016-13, In going through [FASB ASU 2016-13, Financial Instruments: Credit Losses \(Topic 326\): Measurement of Credit Losses on Financial Instruments \(CECL\)](#), an EP member noted that they believe investment companies may be impacted and have highlighted the following broad areas for investment companies as being affected by this ASU:

- Beneficial interests accounted for under FASB ASC 325-40 - creation and release of allowance account.

The EP agreed that where fair value is estimated by an investment company using amortized cost, it is not appropriate to consider the investments to be carried at cost and therefore subject to impairment testing. This is because even when amortized cost is used, for example in a mutual fund, it is used as an estimate of fair value.

- Other income models that may have been used by analogy (e.g., FASB ASC 310-30 purchased credit deteriorated) will be superseded.

The EP will continue discussing this topic at future meetings.

7. The EP considered a question and related example offered by one of the EP members concerning investment rebalancing. An investment manager expects to launch a group of closed ended, unregistered, finite lived funds, which will co-invest in private debt instruments. Given the expectation that the funds will be established over a period of time, and recognizing that the funds are intended to be co-investment vehicles, the governing documents allow for a “rebalancing of investments” between the various funds through the final closing of commitments in the last fund. At each rebalancing, each fund is allocated its proportionate share of the investment subject to rebalancing, including principal, cumulative interest since initial purchase, and unrealized gains or losses (if any). The objective of this rebalancing is to treat each fund as though it had been a party to the portfolio company credit agreements at the initial underwriting. As consideration for this rebalance, the transferring fund receives and the transferee fund pays an amount equal to its proportionate share of the initial purchase price. The EP member inquired about appropriate accounting for the rebalancing by the transferor and the transferee funds and offered

View A: Treat income earned during period prior to the transfer based on legal ownership of the investment (i.e., transferor recognizes interest income prior to rebalancing and transferee – subsequent to rebalancing).

View B: Recognize investment on a rebalanced basis (i.e. as if each fund was party to the credit agreements at initial deal close, including classification of accumulated interest income received by the transferee fund in interest income).

The EP generally agreed that unless subsequent investors are legally bound to future commitments and the commitments are quantifiable as of the original purchase date, the rebalancing should be evaluated on a prospective basis (View A). Under this view the income would be recorded based on legal ownership of the investment until the date of the rebalancing and then a capital adjustment would be recorded between the funds for the cumulative income/loss that was transferred between funds.

8. At the January 2016 EP meeting, the SEC staff shared examples of qualitative and quantitative disclosures of inter-fund transactions (under section 17a-7 of the Investment Company Act of 1940) used in registrants’ recent financial statement filings pursuant to the disclosure requirements under FASB ASC 850 for related party transactions. The quantitative disclosure examples included 1) the

reporting fund involved in the related party transactions, 2) aggregate purchases and sales by the fund from and to other related party funds and 3) aggregate related realized gain/loss or other relevant transactional amounts for the periods for which income statements are presented. FASB ASC 850-10-50-1(c) states that the related party disclosure shall include “the dollar amounts of transactions for each of the periods for which income statements are presented and the effects of any change in the method of establishing the terms from that used in the preceding period.” An EP member inquired if funds are disclosing the realized gain or loss associated with inter-fund transactions and how funds have calculated the realized gain or loss. For example:

- Fund A purchased Investment Z for \$100 in 20X2
- As of December 31, 20X6, Fund A valued Investment Z at \$150
- On February 1, 20X7, Fund A sold Investment Z to Fund B, a related party, for its current fair value \$160
- Fund A records a realized gain on the sale of Investment Z for \$60 in its 20X7 financial statements.
- Options considered for the related party quantitative disclosure: View (1) \$160 proceeds and \$60 realized gain, View (2) \$160 proceeds and \$10 net gain for the 20X7 period, View (3) \$160 proceeds and no disclosure of the realized gain since the investment was sold at fair value.

The EP members discussed that if the quantitative disclosure of realized gains and losses is determined to be material to the financial statements and, therefore, is separately presented, the disclosure should reflect the actual realized gain or loss on the transaction as suggested in View 1.

III. Audit and Attest Issues

1. The Expert Panel considered confirmation of derivative positions in audits of registered investment companies, particularly for the funds with significant numbers of derivatives positions. The EP members observed that while practice varies, from industry perspective, a preference may be to confirm all derivative positions.
2. At the November 2014 EP meeting, the EP considered whether FASB ASU, [ASU No. 2014-15, Presentation of Financial Statements— Going Concern \(Subtopic 205-40\): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern](#), would apply to investment companies. The EP observed that the guidance from [ASU No. 2013-07, Presentation of Financial Statements \(Topic 205\): Liquidation Basis of Accounting](#), doesn’t apply to investment companies regulated under the Investment Company Act of 1940 or limited-life entities that follow liquidation plans established at their inception. The EP members noted that most funds have substantially greater equity than they do debt and other obligations and it would be relatively rare that a fund would not be a going concern. An EP member inquired if an auditor’s report of a private equity fund that is within one year of the end of its limited life or a registered investment company that is in the process of being liquidated is required to have an emphasis of matter paragraph or an explanatory paragraph about the entity’s ability to continue as a going concern.

At the May 2017 EP meeting, the EP discussed situations in which the conclusions reached from an accounting perspective and an auditing perspective would differ on an entity’s ability to continue as a going concern. The EP members noted that AU-C Section 9570A requires the auditor to use the definition of *substantial doubt about an entity’s ability to continue as a going concern* included in the applicable financial reporting framework when applying section 570A. As a result, for private equity funds, the conclusions reached on an entity’s ability to continue as a going concern would generally not differ from an accounting perspective and an auditing perspective.

On the other hand, the EP noted that [PCAOB Staff Audit Practice Alert No. 13](#) requires the auditor (1) to assess management’s going concern evaluation under the requirements of the applicable financial reporting framework, and (2) to make a separate evaluation of the need for disclosure in the auditor’s report in accordance with the requirements of AU sec. 341 (AS 2415). As a result, for registered investment companies, the conclusions reached on an entity’s ability to continue as a going concern may differ from an accounting perspective and an auditing perspective. EP members generally agreed that in certain situations, if from an auditing perspective, there is substantial doubt about an entity’s ability to continue as a going concern, but the accounting definition of substantial doubt is not met (e.g., a fund is liquidating in an orderly manner and is expected to be able to meet its obligations as they become due), discussing the investment manager’s decision to liquidate the fund in an orderly liquidation in the explanatory paragraph may be appropriate.

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 meeting to discuss the following:

1. Final Rule FAQ Update: The SEC staff is developing frequently asked questions (FAQs) on the Investment Company Reporting Modernization, Liquidity, and Swing Pricing final rules. Subsequent to the May EP meeting, the SEC staff released [FAQs](#) related to Investment Company Reporting Modernization.
2. Agency Rule List: The SEC staff informed the EP that a list of rulemakings the SEC is working on will be included in the Spring 2017 Agency Rule List. An Agency Rule List is published semiannually by the Office of Information and Regulatory Affairs and the Office of Management and Budget. Subsequent to the May meeting, the [Update 2017 Agency Rule List](#) was published.
3. Loan Provision of the Auditor Independence Rule: In connection with the [no-action letter \(NAL\)](#) issued to Fidelity Management & Research Company et. al. on June 20, 2016 regarding the “loan provision” of the auditor independence rule, the SEC staff highlighted two recent speeches wherein the rulemaking efforts were publicized:
 - a. [May 2017 speech](#) by Commissioner Piovowar
 - b. [May 2017 speech at Baruch College](#) by Wes Bricker, Chief Accountant of the CommissionSubsequent to the May EP meeting, the SEC staff issued an [extension of the no-action relief](#) to Fidelity. The [Update 2017 Agency Rule List](#), issued subsequent to the May meeting, includes reference to the rule titled *Auditor Independence With Respect to Loans or Debtor-Creditor Relationships*.
4. The SEC staff provided the following perspectives on financial statements review comments:
 - a. Mergers: The SEC staff has seen an increase in merger filings and reminds registrants that when multiple funds are merged into a single remaining entity, the shell fund is unlikely to be the accounting survivor.
 - b. Debt Issuance Costs: Application of [FASB ASU 2015- 03, Interest—Imputation of Interest \(Subtopic 835-30\) – Simplifying the Presentation of Debt Issuance Costs](#) guidance to preferred shares and line of credit:
 - Debt issuance costs related to term loans should be presented as a direct deduction from the carrying amount of the associated debt liability (net presentation). This would also apply to preferred shares within the scope of FASB ASC 835-30, such as variable rate municipal term preferred shares, or VMTPs, within the scope of FASB ASC 835-30.
 - As discussed and documented in the [minutes from June 18, 2015, EITF meeting](#), “given the absence of authoritative guidance within Update 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement.”
 - c. Portfolio Yield Disclosure in MD&A: When business development companies (BDCs) are including portfolio yields in their financial results in the MD&A, those portfolio yields should be presented for the full portfolio and should not be limited to income producing assets. If a BDC believes presenting portfolio yield of income producing securities is meaningful information to investors, it would not be precluded from including such yield, as long as it also includes the full portfolio yield.
 - d. Change of Accountant Disclosure: Changes of certifying accountant should be disclosed by the registered investment company in sub-item 77-K on Form N-SAR. Additionally, Item 27(b)(4) of Form N-1A and Item 24(4)(b) of Form N-2 require that a disclosure of information concerning a change in accountant is made in the annual report to shareholders. The SEC staff indicated that the disclosure should be made in the first annual report issued after the board of directors’ approval of the change. These requirements are incremental to the requirement that the auditor communicate the change within 5 days in a letter to the SEC staff for investment companies that are not required to file current reports on Form 8-K, pursuant to the [PCAOB’s SEC Practice Section Requirements of Membership \(Section 1000.08\(m\)\(2\)\)](#).
 - e. Trailing Commissions in BDCs and Closed-End Funds: The SEC staff discussed a scenario where a BDC with a continuous offering period was charged a fee comprised of front-end load payable upon sale of shares and a distribution fee payable periodically commencing

after the BDC's close (deferred fee). The SEC staff indicated that, to the extent the deferred fee is related to the distribution of BDC's shares and represents an offering cost, the deferred fee should be accounted for as an offering cost when shares are sold. For BDCs or closed-end funds that have continuous offering periods, the deferred fee should be deferred and amortized to expense over a 12 month period. To the extent a portion of the fee relates to ongoing shareholder services, such fee should be expensed as the services are performed. Open-end funds should consider the impact of shareholder servicing expense caps on these arrangements.

- f. Payments by Affiliates: FASB ASC 946-20-05-2 discusses two types of payments by affiliate (investment adviser) made to a fund (investment company) for investment losses: (1) make the fund whole for realized losses incurred as a result of violation of investment restrictions and (2) reimbursement for a loss due to a situation outside of fund's control (for example, a fund holds an investment in an investment grade bond that suddenly defaulted). The impact should be presented as a separate line on the statement of operations and included within the financial highlights as an adjustment to the total return in addition to disclosure of the event in the notes to the financial statements.
- The SEC staff encountered scenarios where an investment adviser is providing a fund with payments regularly to improve returns. The SEC staff expressed a view that such payment by affiliate does not fit into two scenarios described in ASC 946 and a registrant should consider treating such payments as a capital contribution to the fund.
 - Additionally, the SEC staff commented on situations where BDCs don't settle such payments on a timely basis, which could result in the payment being deemed a loan from the investment manager under Section 17 of the Investment Company Act of 1940.

To the extent registrants or their auditors see these kinds of payments, the SEC staff encouraged consultation.

- g. Peer-to-peer (P2P) or Marketplace Lending: the SEC staff updated the EP about the staff's activities related to this asset class:
- Two closed-end funds that invest in P2P loans have registered and launched.
 - SEC staff noted recent reviews have focused on the presentation of the loans within the schedule of investments (SOI). For example, one registered fund presented a summary SOI in accordance with rule 12-12B of Regulation S-X and included more investments than the rule requires (top 50 investments and any individually greater than 1% of NAV). The SEC staff encourages registrants to consult the SEC staff for funds with a strategy that results in voluminous SOIs and where adaptations to the summary SOI requirements are being considered.
 - The SEC staff understands that private funds are also investing in loans issued by P2P or Marketplace Lending platforms and is actively monitoring fundraising activity, default rates, and performance for this market where data is available.
5. The SEC Office of Compliance Inspections and Examinations (OCIE) announced its [2017 examination priorities](#) for investment advisers and investment companies, broker-dealers, transfer agents, clearing agencies, private fund advisers, national securities exchanges, and municipal advisers. SEC staff noted a focus on data analytics embedded in every process. The SEC staff also noted common findings specific to investment adviser's exams as summarized in the [OCIE Risk Alert](#).
6. The SEC staff discussed several recent enforcement cases related to audit and accounting and investment advisers' matters against:
- a. a former [dually-registered investment adviser and broker-dealer](#) – 3 sets of violations:
- for falsely representing to advisory clients that it was performing ongoing due diligence and monitoring of certain third-party managers who managed advisory clients' assets using certain investment strategies, when it was not performing such due diligence;
 - for charging thousands of client accounts excess fees of approximately \$2 million; and
 - for disadvantaging certain retirement plan and charitable organization brokerage customers ("Eligible Customers") by recommending and selling them more expensive mutual fund share classes when less expensive share classes were available, without disclosing that it had a material conflict of interest, i.e., that it would receive greater compensation from the Eligible Customers' purchases of the more expensive share classes.

- b. [an investment adviser](#) who negligently used mutual fund assets to pay for (i) distribution and marketing of fund shares outside of a written, board-approved Rule 12b-1 plan and (ii) sub-transfer agent (“sub-TA”) services in excess of board-approved limits. These payments totaled approximately \$1.25 million and rendered certain of the adviser’s funds’ disclosures concerning payments for distribution and sub-TA services inaccurate.
- c. a [large investment advisory firm](#) overcharged its advisory clients through inadequate policies and procedures and also failed to comply with the custody rule through, among other matters, not providing a full population of customer accounts for annual examination.
- d. [a founder of an investor advisory firm](#), who defrauded a client through not disclosing a referral fee the advisory firm paid to a lawyer for referring this client’s large account. This founder also lied to its other clients about the status of the SEC’s investigation and attempted to mislead SEC staff investigating the matter.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought. Copyright © 2018 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.

Investment Companies Expert Panel

Highlights of the July 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) [March 2017](#) call and May 2017 meeting 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 conforming changes to the 2017 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide), and sought feedback on open items.
4. The AICPA staff inquired about the EP's interest in developing certain AICPA products for investment companies and investment advisers.

II. Accounting/Reporting Issues:

1. The EP discussed accounting for distribution fees for business development companies (BDCs). Certain closed-end interval funds and BDCs with continuous offerings of shares have implemented distribution and shareholder servicing plans to compensate the distributor (who may, in turn, compensate others) for servicing shareholder accounts and marketing, sales and distribution related services. These distribution fee plans for BDCs are similar in operations to 12b-1 plans used by open-ended mutual funds registered under the Investment Company Act of 1940. These fees are net asset based fees and certain fee arrangements may provide for these fees to be capped (e.g., capped to a certain percent of gross proceeds from the offering). Questions have been raised on the accounting for such fees and whether they can be recorded as expenses over time, similar to 12b-1 fees for open-end funds and shareholder servicing fees. The Expert Panel members shared their views and then discussed the accounting for these types of fee arrangements with the SEC staff. See SEC Staff Update below for more information.
2. During May EP meeting, an EP member noted that they believe investment companies will be impacted by guidance in [FASB ASU 2016-13](#) *Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (CECL)* and have highlighted several broad areas for investment companies as potentially being affected by this ASU. One of the topics discussed at July EP conference call was –the creation and release of an allowance account for all future expected credit losses for beneficial interests accounted for under FASB ASC 325-40.

Additionally, during the July EP conference call, the EP discussed the impact of this standard on assets carried at amortized cost (i.e., investments held by money market funds, not subject to money market fund reform, such as short-term debt securities (remaining maturities of 60 days or less) or repurchase agreements). In accordance with FASB ASC 946-320, investment companies record investments at fair value; investment companies may use the amortized cost method to value investments, as described above, when it can conclude that the amortized cost value of the investment approximates fair value. The EP members believed these assets would be scoped out of the ASU, as amortized cost should approximate fair value.

The EP will continue discussing this topic at September EP meeting.

3. Carried Interest:

- a. Carried interest treatment by private asset managers. The FASB has expressed that it was the Board's intention that FASB ASC Topic 606 *Revenue from Contracts with Customers* would cover asset manager service contracts regardless of whether the fee is paid in cash or a capital allocation. It is the FASB's view that the additional capital allocations are fees designed to compensate the manager for services performed. However, the EP members understand that the SEC staff did not object to the conclusion in certain asset manager fact patterns that the partnership investment inclusive of the carried interest could be accounted for in accordance with ASC Topic 323 *Investments-Equity Method and Joint Ventures*. Therefore, it would not be in the scope of the new revenue guidance. An EP member expressed a view that this would only be an acceptable alternative to the extent the carried interest was structured as an allocation of profits through a partnership interest or other equity interests. However, if the carried interest was not structured in this form, the EP member understands the SEC staff would expect that the new revenue standard would apply. The contract to provide investment management services would be subject to FASB ASC Topic 606. The SEC staff also did not object to the conclusion that the hypothetical liquidation at book value ("HLBV") method would be an acceptable method in applying ASC 323 for the asset manager's pro-rata (e.g., 1 percent) ownership interest and disproportionate interest (carried interest). The EP member also understands that the SEC staff would object to electing the fair value option on these equity method investments. Additionally, the SEC staff did not object, in these circumstances, to the presentation of the results in the application of the equity method as operating income (i.e. "above the line") or in a revenue line provided that it was separate from "Revenue from contracts with customers" recognized under ASC 606. There should be clear and transparent disclosure of what is reported in the different financial statement line items particularly in instances where a registrant has carried interest arrangements accounted for under the equity method and other incentive arrangements accounted for under ASC 606. In these instances, it would be important to include an explanation of management's judgements in determining the appropriate accounting model. Notwithstanding whether the carried interest element is accounted for under the equity method or the new revenue standard, the SEC staff did not object to the conclusion that, for the purposes of applying the consolidation guidance for variable interest entities, the carried interest element of these arrangements could be viewed as fees paid to the decision makers rather than an interest in the fund. As such, it would be possible for these fees to not be considered variable interests under ASC Topic 810 *Consolidation*. Given the FASB's and the SEC staff's differing views on the treatment of carried interest, the EP considered whether a private asset manager could apply the accounting allowed by the SEC staff. They noted the belief that private advisers should not be held to a different standard than public advisers. As such, the EP therefore believes that it would be acceptable for a private asset manager to apply the accounting allowed by the SEC staff.
- b. Carried interest – AICPA TQA 6910.29 states "If a nonregistered investment partnership reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents." The EP discussed whether a private equity fund could record carried interest if under the partnership agreement it is not required to be paid for the first 5 years of the fund, including fund liquidations during that time. In making that determination,

consideration should be given to whether or not the fund is expected to be liquidated during the first 5 years, how the fee is calculated, and the rights of the limited partners, including kick-out rights, and whether the 5-year provision was substantive.

4. FASB ASC 230-10-50-3 and 50-4 requires all non-cash investing and financing activities to be disclosed in the statement of cash flows:

50-3 Information about all investing and financing activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be disclosed. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items.

50-4 Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities.

An investment company classifies its investing activities within operating cash flows. The EP discussed whether an investment company that exchanges an investment for another investment is required to disclose it in the statement of cash flows as a non-cash investing activity and considered the following 2 views:

View A: Yes. FASB ASC 230 requires all non-cash investing activities to be disclosed and provides an example of exchanging noncash assets or liabilities for other noncash assets or liabilities. An investment company's classification of its investing activities does not impact that requirement.

View B: No. An investment company does not present its portfolio transactions within the "investing activities" on its statement of cash flows, but rather such transactions would be recorded within the "operating activities" section of the statement of cash flows.

The EP observed that even though technically, such an exchange may be considered within the scope of FASB ASC 230, industry practice is mixed; however, if material, funds may disclose these non-cash transactions. FASB ASC 230-10-50-3 states that the "disclosures may be either narrative or summarized in a schedule".

The EP noted that the entity should consider individual arrangements and specific facts and circumstances and apply GAAP.

5. A regulated investment company (a BDC) invests substantially all of its portfolio in floating rate loans. A sizeable portion of that floating rate loan portfolio is also subject to unitranching, whereby a consortium of lenders within a given tranche – first lien in all cases – agree through a side letter (the agreement among lenders or AAL) to re-allocate priority of payment and interest rate features of the loan into first out and last out components with the lenders electing the various components. The borrower may or may not be made aware of the agreement among lenders to modify the terms of the loan. In addition, the agreement among lenders may prohibit disclosure of the terms of the agreement.

An EP member inquired whether it would be adequate to disclose the original terms of the loan and indicate that the loan is subject to priority of payment reallocation and interest rate modification through separate agreement among lenders or must the modified terms of the investment held by the investment company be disclosed.

Several EP members observed that a BDC should evaluate whether the AAL represents a separate financial instrument (e.g., derivative). If there are two financial instruments – (1) the original loan and (2) a separate contract amongst the lenders - they should be accounted for and disclosed separately. If the AAL does not represent a separate financial instrument, judgment is needed in choosing an appropriate disclosure framework. for the modified terms of the loan.

III. Audit and Attest Issues

1. An EP member observed that the SEC staff is receiving inquiries from the audit firms on whether the auditor's report would need to identify the new schedules under Article 12 of Regulation S-X. The EP believes that the auditor's report would not change regarding the new schedules, provided that the new schedules are included within a fund's schedule of investments, including tables immediately following/associated with/in the notes to the schedule of investments, as the [final rule "Investment Company Reporting Modernization"](#) specifically states:

Our amendments will require prominent placement of details regarding investments in derivatives in a fund's **schedule of investments (emphasis added)**, rather than allowing such schedules to be disclosed in the notes to the financial statements.

If the new schedules are separately stated (i.e., not included within the schedule of investments and titled as separate schedules or statements), the auditor's report would need to specifically identify those schedules.

2. The EP is evaluating the impact of the new disclosure requirement for the new audit report model on registered investment companies as it relates to the definition of "the tenure" and a concept of funds within a *'group of investment companies.'* The legal definition of a group of investment companies under Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 which is included in the [new PCAOB standard](#) differs from the definition of the Investment Company Complex (ICC) under Rule 2-01 of Regulation S-X.

Extracts from the Final Standard:

AS 3101.10 The auditor's report must include the following elements:

- b. A statement containing the year the auditor began serving consecutively as the company's auditor;¹⁸

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

¹⁸ For an investment company that is part of a group of investment companies, the statement contains the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. See Section 12(d)(1)(G)(ii) of the Investment Company Act.

⁸² A group of investment companies, as defined by Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"), means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. For purposes of determining auditor tenure, any tenure with other entities that may be part of an investment company complex, such as investment advisers or private investment companies, is not included.

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:

1. Distribution Plans for CEFs and BDCs: Certain closed-end interval funds and business development companies (BDCs) with continuous offerings of shares have implemented distribution and shareholder servicing plans to compensate the distributor (who may in turn compensate others) for servicing shareholder accounts and marketing, sales and distribution related services. These plans prescribe net asset-based fees and certain plans may provide for fee caps (e.g., to a certain percent of gross proceeds from the offering). Some of these registrants are accounting for such fees based on FASB ASC 946-20-30-2, which applies to investment companies that adopted plans to comply with rule 12b-1 of the Investment Company Act of 1940 ("rule 12b-1") (which is for registered open-end management investment companies, i.e., mutual funds) and questions have been raised on whether that is appropriate.

The EP shared their views on the appropriate accounting for such fees by certain closed-end funds and BDCs, expressing a view that if a registrant can make an argument or provide a legal opinion that the entity "stands ready" to offer distribution and shareholder services on a continuous basis over time and its legal arrangements are similar to a 12b-1 plan, as defined in rule 12b-1, the current 12b-1 fee accounting framework under FASB ASC 946-20-30-3 through 30-5 could apply to

certain entities other than mutual funds. However, concerns remain about applying this guidance in certain circumstances, including where a fee arrangement diverges from those arrangements prescribed by rule 12b-1, where the offering is not continuous, or if the plan has been adopted but not followed in practice.

Registrants are encouraged to consult with the SEC staff with specific fact patterns if they are looking to apply this guidance to non-mutual fund investment companies.

2. Rule 6-04.6 Disclosure of Collateral for Derivatives: The EP sought the SEC staff's views on the following question previously considered by the EP. Rule 6-04.6, as amended by the Investment Company Reporting Modernization final rule, says:

“Deposits for securities sold short and other investments. State separately amounts held by others in connection with: (a) Short sales; (b) open options contracts; (c) futures contracts; (d) forward foreign currency contracts; (e) swap contracts; and (f) investments other than those presented in 12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B and 12-13C.”

This appears to require separate presentation of collateral pledged (i.e., deposits with brokers) by type of investment/derivative contract. Collateral for derivatives is generally held by counterparty and not by derivative contract type, so this requirement to show by derivative type is burdensome to generate.

Subsequent to the July conference call, the SEC staff released [FAQs](#) for Investment Company Reporting Modernization, which notes that the staff would not object to a fund providing the amounts held by others in connection with derivative contracts by counterparty in the notes to the financial statements when it is not practicable for a fund to identify the portions of collateral attributable to each derivative type, provided that the disclosure also includes the rights of setoff associated with the investment and the effect of the arrangements with counterparties on the fund's balance sheet in accordance with ASC 210-20-50.

Investment Companies Expert Panel

Highlights of the September 19, 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) May 2017 meeting and July 2017 call highlights are being finalized.
2. The AICPA staff will update the EP on [recent developments](#) regarding the AICPA Asset Management Revenue Recognition Task force.
3. The AICPA Content Development staff informed the EP about status of the 2017 edition of the AICPA Audit and Accounting Guide *Investment Companies* (the Guide). The EP and AICPA staff also considered various open items for 2018 Guide.
4. The EP and AICPA staff discussed updating an illustrative attestation report on management's assertion regarding controls at a custodian on the AICPA [EP webpage](#). This report is applicable when the investment adviser or its related person maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients. In the illustrative report, an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB examines management's assertion and reports on that assertion. The update is necessary to conform the report to reflect Statement on Standards for Attestation Engagements No. 18, Attestation Standards: Clarification and Recodification. The updated webpage will present the same content found in paragraph 12.45 of the 2017 Guide. An [SEC page](#) links to the AICPA page will also be updated.
5. The EP discussed the dates for 2017-2018 meetings and conference calls.

II. **Accounting/Reporting Issues:**

1. The EP discussed the amendments in FASB [ASU 2016-01](#), which require an entity to present separately in other comprehensive income (OCI) the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. The EP discussed this issue with respect to investment companies. The EP recognized that investment companies typically do not have OCI; however, the EP believes the guidance provided by ASU 2016-01 should be considered by investment companies.

2. During the May EP meeting, an EP member noted that they believe investment companies will be impacted by guidance in [FASB ASU 2016-13 Financial Instruments: Credit Losses](#) (CECL) and have highlighted several broad areas for investment companies as potentially being affected by this ASU. One of the topics discussed at the July EP conference call was beneficial interests accounted for under FASB ASC 325-40 - creation and the release of the allowance account for all future expected credit losses.

The EP will continue discussing this topic at the November EP meeting.

3. The EP discussed the treatment of taxes withheld for Effectively Connected Income (ECI) in a master feeder structure, where the Master and Feeder Funds are both Cayman domiciled limited partnerships. The Master Fund is taxed as a partnership for US tax purposes and the Feeder is taxed as a corporation for US tax purposes. The Master Fund makes investments in companies and private equity investment funds domiciled in the US. Because of the Master Fund's domicile, amounts are withheld at source for US tax purposes when the underlying investment (fund or company) makes a distribution to the Master Fund that is effectively connected to a US trade or business.

The Master Fund receives cash net of the taxes withheld at the investment level. The amount of taxes withheld at the source is treated as a distribution to the Feeder Fund from the Master Fund since the Master Fund is taxed as a partnership for US tax purposes. At the Feeder Fund level, the amount of tax withheld at source is used as a credit on the Feeder Fund's tax return since the Feeder Fund is taxed as a corporation for US tax purposes and would be required to pay an entity-level tax on ECI.

Additionally, the Feeder Fund limited partnership agreement contains a clause which states that amounts withheld at source are treated as a distribution to the limited partners of the Feeder Fund. If the Feeder Fund has insufficient funds to pay a tax liability, the Feeder Fund may request reimbursement from the limited partners in order to satisfy the liability. Such reimbursement would not be treated as a capital contribution or reduce the unfunded capital commitment of the limited partners.

The offshore limited partners did not want the requirement to file a US income tax return for ECI and requested that the Feeder Fund makes the election to be taxed as a foreign corporation for US tax purposes (i.e., the entity will act as a tax blocker). Therefore, the rationale for including the clause above was to allow for any tax expense incurred to be treated as part of a gross distribution to the offshore limited partners, regardless of the Feeder Fund's tax election.

The EP members discussed the accounting treatment and presentation of the withholding tax expense by the Feeder Fund and whether or not the withholding tax should be presented as a direct expense of the Feeder Fund or an expense at the Master level, which is ultimately allocated to the Feeder Fund through the allocation process. EP members discussed that it's important for entities to distinguish between the tax payer vs. the tax agent (i.e., paying taxes on behalf of owners). Generally, the tax payer would record the withholding tax as an expense, and the tax agent would record it as a distribution. In an instance where a Feeder Fund is determined to be a tax payer and the Master Fund is a tax agent, the Feeder Fund will record an expense and a Master Fund will record a distribution.

Additionally, the EP members discussed whether or not a fund governance document is able to dictate how an expense to a fund should be accounted for. Generally, the EP members agreed that a fund's legal documents would not override GAAP.

4. The EP discussed a scenario where a BDC exercised its call option on its debt and repaid the entire amount owed (including call premiums) with cash. FASB ASC 470-50-40-2 states that the "difference between the reacquisition price of debt and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as losses or gains and identified as a separate item". For an investment company, should the gain/loss be classified in (a) net investment income, (b) net gain/loss on investments, or (c) in a separate income/loss category?

FASB ASC 946-225-45-1 states that “the objective of the statement of operations is to present the increase or decrease in net assets resulting from all of the company's investment activities, by reporting investment income from dividends, interest, and other income less expenses, the amounts of realized gains or losses from investment and foreign currency transactions, and changes in unrealized appreciation or depreciation of investments and foreign-currency-denominated assets and liabilities for the period. That format helps the user understand the contribution of each aspect of investment activity to the company's overall operations.” This guidance focuses on an investment company's investment activities and does not directly address other activities (e.g., financing activities), although ASC 946-225-45-3(i) states that interest expense on debt should be reported separately.

Paragraph 8.36 of the Guide states: Unusual income items, such as amounts recovered from the settlement of litigation, are usually recognized in the financial statements when the investment company acquires an enforceable right, in accordance with the gain contingency provisions of FASB ASC 450-30. For items considered payment in lieu of settlement to make whole for violations by an affiliate, refer to paragraph 7.138 of this guide. Items relating to specific portfolio securities are typically recorded as an adjustment to realized or unrealized gains or losses. Otherwise, the item and a subsequent revaluation should be presented as other income, if any, or a separate income item. If the item is sufficiently material in relation to net investment income, it should be presented as a line item immediately before net investment income, unless the item is clearly identifiable with realized or unrealized gains or losses.

The EP discussed the classification of any gains/losses that arise from a BDC's extinguishment of its debt. Generally, the EP agreed such gains/losses should be accounted for as a separate line item on the income statement, outside of net investment income. Registrants should review their legal documents to determine the impact, if any, on the performance fee calculation.

5. The EP discussed if it was acceptable to combine financial statements of funds managed by the same adviser for the following scenario:

Fact pattern A: An adviser sets up a private fund as a single legal entity with different classes. Each class is set up with a different trading strategy that is separately offered to investors. Each class by itself meets the definition of an investment company and is considered to be a separate reporting entity.

Fact pattern B: Similar to fact pattern A, except instead of a single legal entity, the adviser sets up multiple legal entities, each with a different trading strategy that is separately offered to investors. Each legal entity by itself meets the definition of an investment company and is considered to be a separate reporting entity.

In either of these fact patterns, can combined financial statements be presented?

FASB ASC 946-810-55-1B states “To justify the preparation of consolidated financial statements, the controlling financial interest shall rest directly or indirectly in one of the entities included in the consolidation. There are circumstances, however, in which combined financial statements (as distinguished from consolidated financial statements) of commonly controlled entities are likely to be more meaningful than their separate financial statements. For example, combined financial statements would be useful if one individual owns a controlling financial interest in several entities that are related in their operations. Combined financial statements might also be used to present the financial position and results of operations of entities under common management.”

Based on the guidance stated above, if funds are under the same adviser, they are technically under common management, and it may be acceptable to present combined financial statements. However, an EP member discussed that if an entity was to present combined financial statements, it should be meaningful to the investors. Generally, the EP members do not believe combined financial statements should be shown in the above scenario.

Additionally, if an RIA is subject to the Custody Rule and is using a private fund's audited financial statements to satisfy its compliance with the audit exemption in the Custody Rule, the RIA should consider whether or not it would be able to use combined financial statements to satisfy the audited financial statement exemption.

6. Accounting for variation margin payments as a legal settlement of the derivative results in entities no longer recognizing a separate receivable or payable for the variation margin paid or received. Instead, those related cash flows are incorporated into the valuation of the derivative contract that effectively approximates zero on a daily basis. After the CME rule change became effective, the CME continues to provide clearing members with the daily changes in the value of centrally cleared derivatives for daily settlement purposes. The CME rule changes generally do not result in a change in the total cash flows related to derivative contracts and entities continue to receive/pay the variation margin. In measuring and recognizing the fair value of centrally cleared derivatives for financial reporting purposes, may an entity rely solely on the values provided by the central clearing organization (i.e. CME) for accounting and disclosure purposes?

The EP members did not believe it was acceptable for entities to rely solely on the values provided by the central clearing organization, when recognizing fair value of centrally cleared derivatives. An EP member questioned how an entity would be comfortable that the price is accurate and whether or not the entity would be able to demonstrate that the value provided by the central clearing organization was a good representation of fair value.

III. Audit and Attest Issues

1. The EP is monitoring potential dual reporting for certain attestation reports. During the September 2017 meeting, the EP discussed whether the accountant's report filed in connection with security counts performed under Rule 17f-1 or 17f-2 should be performed in accordance with AICPA or PCAOB standards. Additionally, the EP discussed which attestation standards should apply to reports issued under Rule 17-Ad13. The EP sought the SEC staff's views on this topic. Please see the SEC staff update section for the staff's views. Included below is additional background on both reports.
 - a. Report on Examinations of Securities Pursuant to Rules 17f-1 and 17f-2 Under the 1940 Investment Company Act is intended to be issued for an SEC registered investment company. An SEC registered investment company is considered an issuer¹. Currently, this report is issued under the PCAOB's standards, however, questions arose whether AICPA standards should apply to these engagements and reports.

An illustrative Report on Examinations of Securities Pursuant to Rule 17f-2 Under the 1940 Investment Company Act is included in chapter 12 of the Guide. The EP members recall that back in 2003-2004, in light of SEC Release No. 34-49708, which states, in part that "references in Commission rules and staff guidance and in the federal securities laws to GAAS or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB plus any applicable rules of the Commission" and the fact that an audit² of a registered investment company is performed under PCAOB standards, it was determined these reports should be performed under PCAOB standards as well.

However, Rules 17f-1 and 17f-2 are silent³ as to which standards to follow. Further, these Rules refer to an independent public accountant. Also, this engagement is not

¹ [Section 3\(a\)\(1\) of the Investment Company Act](#) defines an "investment company" for purposes of the federal securities laws. [Section 3\(a\)\(1\)\(A\) of the Investment Company Act](#) defines an investment company as an issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in "securities."

² Sarbanes-Oxley Act of 2002 states

(2) AUDIT.—The term "audit" means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable rules of the Board under section 103, in accordance with then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements

³ §270.17f-1 Custody of securities with members of national securities exchanges provides, in part, that

(4) Such securities and investments shall be verified by actual examination at the end of each annual and semi-annual fiscal period by an independent public accountant retained by the investment company, and shall be examined by such accountant at least one other time, chosen by the accountant, during each fiscal year. A certificate of such accountant stating that an examination of such securities has been made, and describing the nature and extent of the examination, shall be attached to a completed Form N-17f-1 (17 CFR 274.219) and transmitted to the Commission promptly after each examination.

§ 270.17f-2 Custody of investments by registered management investment company.

(f) Such securities and similar investments shall be verified by actual examination by an independent public accountant retained by the investment company at least three times during each fiscal year, at least two of which shall be chosen by such accountant without prior notice to such company. A certificate of such

considered to be part of an audit of a RIC. EP members are not aware of instances where PCAOB has specifically reviewed this report/engagement as part of an inspection of an issuer investment company's audit. Moreover, another accounting firm other than a RIC's auditor can theoretically be hired for this engagement.

The EP acknowledges that subject matter of these engagements could be considered in performing an audit of a RIC, which may support PCAOB standards reporting for these engagements. However, since the PCAOB has an oversight of the audits of issuers and brokers and dealers registered with the SEC, the PCAOB's inspections cover only audits of RICs, and not engagements performed Pursuant to Rules 17f-1 and 17f-2 Under the 1940 Investment Company Act.

Moreover, if these reports continue to be issued under PCAOB standards, the questions may arise whether dual standards (AICPA and PCAOB) would need to be followed. Currently, per AICPA Council Resolution, audit and attestation engagements of entities other than issuers or SEC-registered broker-dealers continue to be subject to AICPA standards, even though regulators may require audits of such entities to be conducted under PCAOB standards.

- b. Report on Management's Assertion Regarding XYZ Transfer Agent's Annual Study and Evaluation of Internal Control in Accordance with Rule 17Ad-13 of the Securities Exchange Act of 1934:

The Guide's illustrative report pursuant to Rule 17Ad-13⁴ of the Securities Exchange Act of 1934 regarding evaluation of internal controls of a transfer agent follows GAAS (in accordance with AT-C section 205) reporting.

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

1. Standards Applicable to Attestation Reports Related to Rules 17f-1, 17f-2, and 17Ad-13: During the September 2017 meeting, the EP sought the SEC staff's clarification on the applicability of PCAOB standards to attestation reports required by rules 17f-1(b)(4), 17f-2(f), and 17Ad-13(a).⁵

accountant stating that an examination of such securities and investments has been made, and describing the nature and extent of the examination, shall be attached to a completed Form N-17f-2 (17 CFR 274.220) and transmitted to the Commission promptly after each examination.

⁴ §240.17Ad-13 Annual study and evaluation of internal accounting control.

(a) *Accountant's report.* Every registered transfer agent, except as provided in paragraph (d) of this section, shall file annually with the Commission and the transfer agent's appropriate regulatory agency in accordance with §240.17Ad-2(h), a report specified in paragraph (a)(1) of this section prepared by an independent accountant concerning the transfer agent's system of internal accounting control and related procedures for the transfer of record ownership and the safeguarding of related securities and funds. That report shall be filed within 90 calendar days of the date of the study and evaluation set forth in paragraph (a)(1).

(1) The accountant's report shall:

- (i) State whether the study and evaluation was made in accordance with generally accepted auditing standards using the criteria set forth in paragraph (a)(3) of this section;

⁵ Related to the illustrative reports included within the AICPA Audit and Accounting Guide for Investment Companies in Chapter 12 under the headings "Report on Examinations of Securities Pursuant to Rules 17f-1 and 17f-2 under the 1940 Act" and "Report on Management's Assertion Regarding XYZ Transfer Agent's Annual Study and Evaluation of Internal Control in Accordance with Rule 17Ad-13 of the Securities Exchange Act of 1934 as of October 31, 2018"

- a. The SEC staff stated that security counts performed for compliance with rules 17f-1 and 17f-2 are attestation exams and not audits and the SEC staff sees no basis for performance in accordance with the standards of the PCAOB, and therefore the attestation standards of the AICPA alone may be appropriate. The staff advised that auditors should consider whether the attestation exam is performed in conjunction with an audit, and whether there are differences in the AICPA attestation standards compared to the PCAOB attestation standards. While the attestation report does not need to be in accordance with PCAOB standards, auditors should be conscious of the manner in which the attestation exam is performed if, for example, the auditor is leveraging the testing performed for a 17f-2 count for purposes of an audit, as audit engagements for registrants must meet PCAOB auditing standards. The staff also expressed its views that the attestation report could be issued under dual standards (i.e., both PCAOB and AICPA attestation standards).
- b. The SEC staff noted that where a transfer agent is not an issuer and does not file audited financial statements with the SEC, PCAOB standards do not generally apply. With respect to attestation reports filed pursuant to rule 17Ad-13, the SEC staff sees no basis for performance in accordance with the standards of the PCAOB.

2. Loan Provision of Auditor Independence Rules: The staff noted the upcoming expiration in December 2017 of the no action letter issued to Fidelity Management & Research Company et al. in June 2016. Subsequent to the September meeting, the staff issued an [extension of the no action letter](#) on September 22, 2017.

3. Investment Company Reporting Modernization FAQs: The staff offered clarification on some of the questions answered in the [FAQs](#) on the Investment Company Reporting Modernization, specific to the amendments to Regulation S-X:

- a. With respect to collateral held, Rule 6-04.6 states:

Deposits for securities sold short and other investments. State separately amounts held by others in connection with: (a) Short sales; (b) open options contracts; (c) futures contracts; (d) forward foreign currency contracts; (e) swap contracts; and (f) investments-other than those presented in 12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B and 12-13C.

The FAQ specifically addressed that a fund may provide the amounts held by others in connection with derivative contracts by counterparty in the notes to the financial statements when it is impracticable to obtain collateral by derivative type, provided that the disclosure also includes the rights of setoff associated with the investments and the effect of the arrangements with counterparties on the fund's balance sheet. The staff highlighted that if a fund is utilizing different counterparties for each derivative type, they would expect the collateral held in connection with these investments to be shown separately on the balance sheet.

- b. With respect to identifying restricted derivatives, the FAQ states:

Rules 12-13 through 12-13D require funds to "[i]ndicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment." Certain derivatives transactions may be subject to limitations such that they cannot be "sold," but the fund would be able to exit the transaction through other means, such as through the execution of an offsetting transaction. For example, a fund would exit a futures transaction by entering into an offsetting transaction. How should the fund treat these types of transactions for the purposes of rules 12-13 to 12-13D?

The Commission staff recognizes that a fund may exit derivatives transactions through means other than sale, such as through a negotiated agreement with the fund's counterparty, a transfer to another party, or close out of the position through execution of an offsetting transaction. The staff believes that a fund should identify a derivatives transaction as restricted if, as of the balance sheet date, the fund would not have been able to exit the transaction.

The staff clarified that a derivative is considered restricted if it is not allowed to exit the derivative, regardless of whether the fund is able to identify a counterparty willing to enable the fund to exit the derivative. The staff encouraged registrants to consult them if such situations exist.

- c. Though the FAQs did not specifically prescribe how a registrant should calculate notional amount for derivative instruments, it did guide registrants to Table 1 on page 69 of the Derivatives Proposing Release for common examples to calculate notional amounts. With respect to notional amounts for options contracts, the FAQ specifically stated that *“funds would not delta-adjust the notional amount for options, as reflected in Table 1, because Form N-PORT separately requires delta and Article 12 of Regulation S-X specifically requires notional amount without a delta adjustment.”* The staff encouraged registrants to consult them if they wish to disclose the delta-adjusted notional in the financial statements.

Investment Companies Expert Panel

Highlights of the November 13, 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) May and September 2017 meetings and July 2017 call 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 EP discussed potential updates to the AICPA Audit and Accounting Guide *Investment Companies* (the Guide), including summary schedule of investments in securities of unaffiliated issuers and reporting circumstances described in chapter 12 that could be addressed by either AICPA or PCAOB attestation standards (or both).

II. Accounting/Reporting Issues:

1. During the May 2017 EP meeting, an EP member noted that they believe investment companies will be impacted by guidance in [FASB ASU 2016-13](#) *Financial Instruments: Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (CECL)* and have highlighted several broad areas for investment companies as potentially being affected by this ASU. One of the topics discussed at July EP conference call was beneficial interests accounted for under FASB ASC 325-40 - creation and release of allowance account for all future expected credit losses. During the November EP conference call, the EP considered guidance in FASB 325-40-35-2 that was superseded by FASB ASU 2016-13:

The method used for recognizing and measuring the amount of interest income on a beneficial interest shall not differ based on whether that beneficial interest is classified as held to maturity, available for sale, or trading debt security. The same amount of interest income shall be recognized each period regardless of whether the beneficial interest is classified as held to maturity, available for sale, or trading debt security.

The EP noted that generally an investment company would record interest income based on the interest method and would update the effective yield based on expectations of timing and amount of cash flows to be collected. The EP will continue discussing this topic at the January EP meeting.

2. 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 (“settled to market”). At the time of the EP meeting, the LCH rulebook was amended such that counterparties could elect whether and to apply the change. However, subsequent to the EP meeting, the LCH announced that it will be changing its rules to make it clear that variation margin payments associated with certain derivative contracts represent settlements of the contracts’ exposures, rather than collateral against the exposures. The changes will be effective 16 January 2018.

Some clearing members do not report the variation margin payments for each individual derivative contract, but on an aggregate basis. During the November EP conference call, the EP discussed how nonregistered investment companies have been presenting these variation margin payments in the condensed schedule of investments: reporting it separately from the cumulative appreciation (depreciation), similar to open futures contracts or allocating it to each contract as a component of fair value. The EP considered guidance from FASB ASC 946-210-50-6, which states, in part, the following for derivatives:

50-6 The financial statements of an investment partnership meeting the condition in paragraph 946-210-50-4 shall, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule shall do all of the following:

....

e. Disclose the number of contracts, range of expiration dates, and ***cumulative appreciation (depreciation) for open futures contracts*** of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets. In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

f. Disclose the range of expiration dates and ***fair value for all other derivative instruments*** of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets. In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

The EP members discussed the presentation of the condensed schedule of investments for centrally cleared derivatives, given the changes in the CME and LCH rulebooks. The changes would now require the fair value of the derivative and the related variation margin payments to be viewed as a single unit of account for settled to market transactions. The EP members noted that when a variation margin payment is made, the entity does not have transparency into the breakdown of variation margin payment by instrument, which may result in challenges for the entity’s condensed schedule of investments reporting.

The EP members discussed the guidance in FASB ASC 946-210-50-6, and suggested that the guidance provided in the ASC with respect to the cumulative appreciation (depreciation) presentation of futures contracts in the condensed schedule of investments can be analogized for other centrally cleared derivatives. One EP member noted that for some contracts included in the condensed schedule of investments, an entity may show fair values for each type of derivative contract in total, then apply cumulative variation margin, to arrive at net fair value (to be able to tie to the balance sheet).

3. The EP members discussed whether the Guide should be expanded to include real estate investment company concepts, including presentation, but generally agreed that the current scope of the Guide is appropriate.
4. The EP considered guidance in FASB ASC 946-205-50-3, which states “Nonregistered investment partnerships shall disclose per-share data for all common classes in general-purpose financial statements. However, it is permissible for financial highlights to be presented only for those classes of shares that are included in reports to those classes.” The EP members generally noted that they have not seen this permissible guidance (nonregistered investment companies issue separate financial statements for different common classes) applied in practice.

5. The EP considered the following scenario. A private equity fund may be required by the limited partnership agreement to distribute proceeds of the sale of a portfolio company as soon as reasonably practicable but at the discretion of the general partner. The EP discussed the following views on whether the undistributed cash should be recorded as a liability to the partners if the general partner has not determined a distribution date:

View A: Yes. The distribution should be accrued as a liability since the amount is probable and estimable. FASB Concepts Statement No. 6 defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

View B: No. The distribution should not be accrued until the “ex-dividend date”. ASC 946-20-25-9 states “Both closed-end and open-end investment companies record distribution liabilities on the ex-dividend date rather than the declaration date. For closed-end investment companies, a purchaser typically is not entitled to a dividend for shares purchased on the ex-dividend date. Open-end investment companies record the liability on the ex-dividend date to properly state the net asset value at which sales and redemptions are made. When large (in excess of 15 percent of a closed-end fund’s net asset value) dividends or distributions are declared, it is the policy of some exchanges to postpone the ex-dividend date until the dividend has been paid. In such circumstances, the liability for the dividend distribution would be recorded on the books of the fund on the payment date.”

An EP member noted that entities should review their offering documents and consider the information disseminated to investors about the timing of distributions, whether or not there are other items that will affect the distribution amount, or if the general partner has the ability to set distribution amounts, etc. The EP members generally noted that the distribution can only be recorded when the amount of the liability is known.

6. During the July 2015 EP meeting, the EP discussed a scenario in which a company owned 65% of a public company which was traded on the NYSE. The majority of the EP members believed that under US GAAP, it would be inappropriate to apply a control premium to securities where there is a Level 1 input available. During November 2017 EP conference call, the EP considered whether the company would be able to apply a discount or control premium (to the exchange price) if (1) it owned restricted securities which would result in a Level 2 or 3 measurement, (2) it believed that its principal market was outside the exchange, and (3) believed a market participant would value the entire position rather than individual shares (i.e., the entire position would be a single unit of account).

In November 2017, the EP reaffirmed its views previously expressed in July 2015 and noted that a company needs to consider the market participants and market for each transaction, and, generally, under US GAAP, it would be inappropriate to apply a control premium to securities where there is a Level 1 input available. Please refer to the July 2015 EP minutes for considerations for investment companies under the Investment Company Act of 1940.

III. Audit and Attest Issues

1. The AICPA staff informed the EP that the AICPA task force will resume updating the AICPA Alternative Investments Practice Aid in upcoming months.
2. The EP considered potential updates to the AICPA Investment Companies Expert Panel and staff [FAQs on the Custody Rule](#) and will revisit this topic during future EP meetings.