

Accounting for Private Equity Funds

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Critical concepts, clear direction

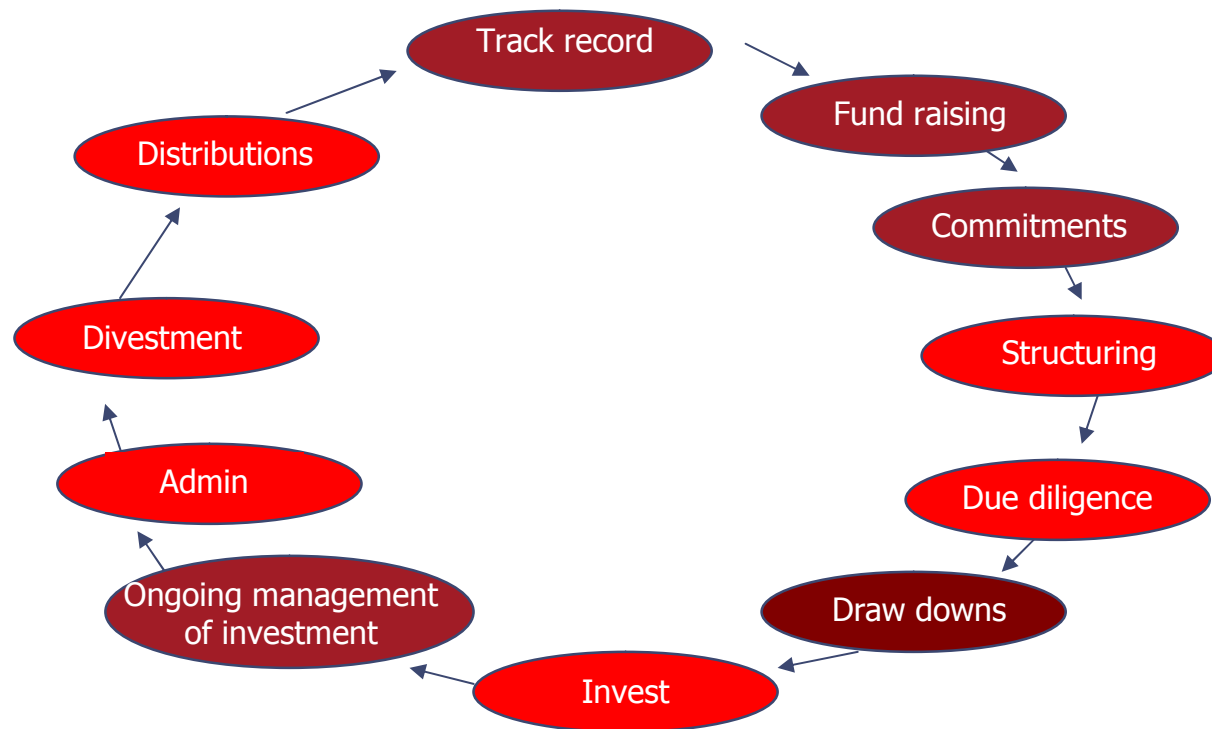


Agenda

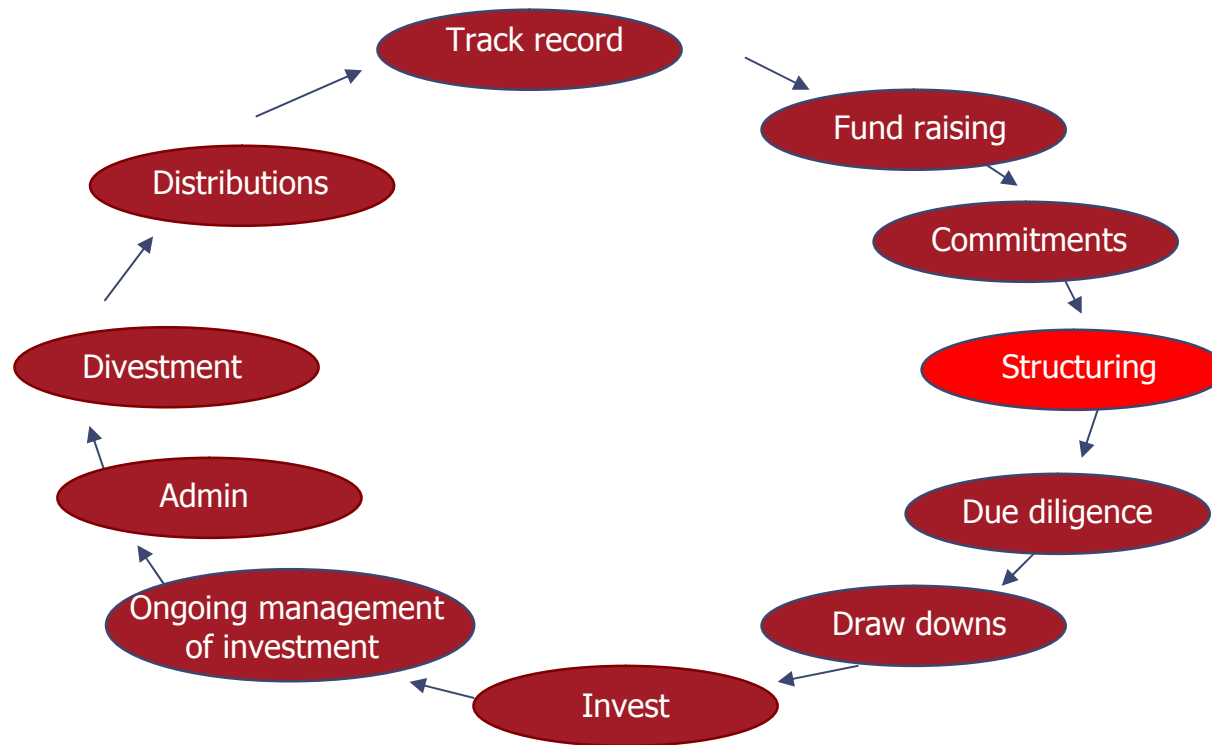
Consider Audit, Accounting and Admin implications of:

1. Structuring
2. Due Diligence
3. Investment
4. Ongoing Admin & Reporting
5. Divestment & Distribution
6. Accounting Update
7. Final thoughts

Investment cycle



Investment cycle - Structuring



Investment cycle – Structuring

The choice of structure

- Generally driven by 4 factors:
 - The needs of the investors
 - The needs of the PE House
 - The Fund's investment strategy
 - The preferences of the Fund's advisors

Investment cycle – Structuring

The choice of structure

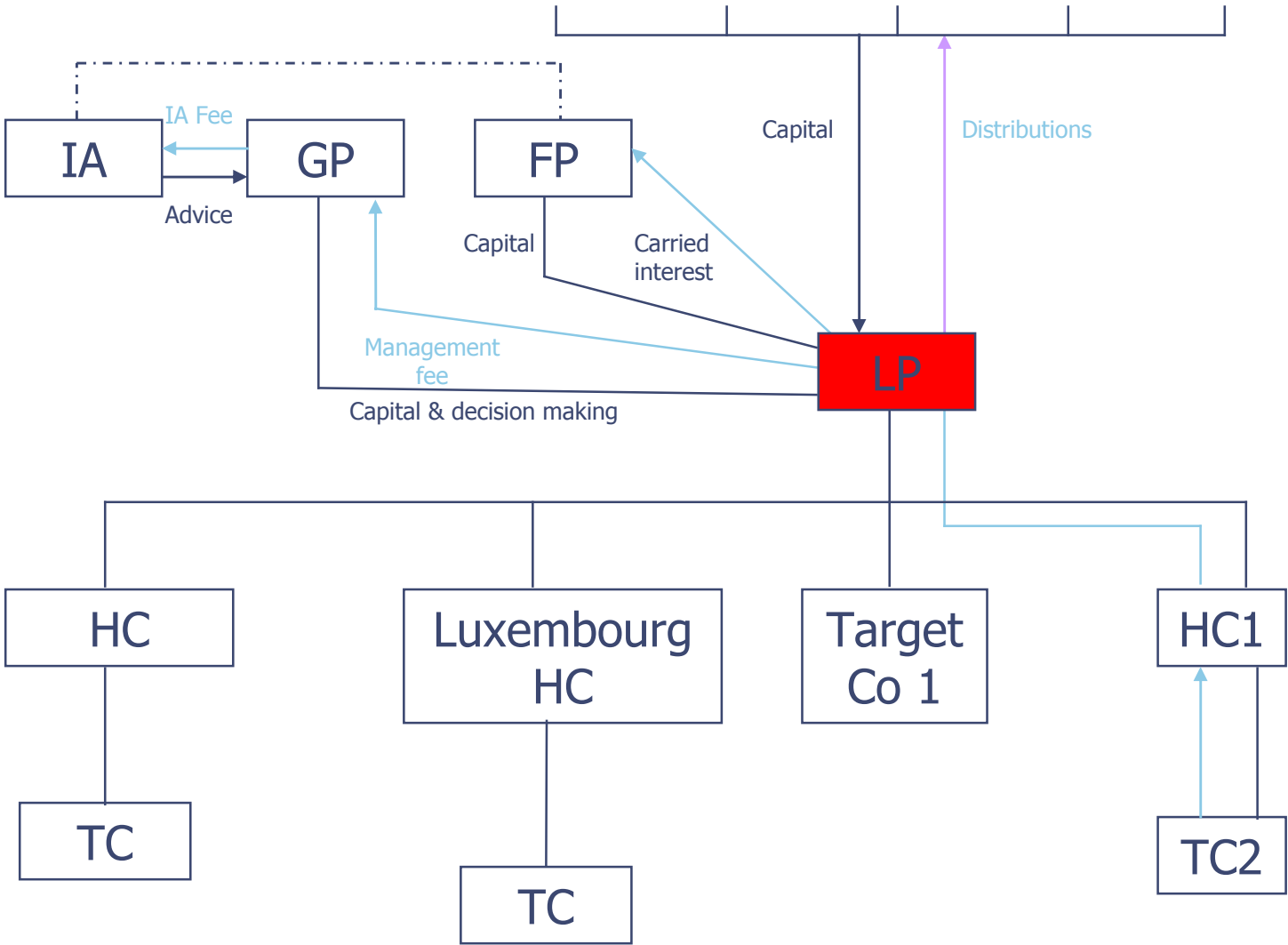
- 3 levels to the structure
 - The management companies [Carried interest, transfer pricing, VAT]
 - The investment portfolios [Use of holding companies depend on investment strategy]
 - The Fund
 - Types of vehicles I have seen:
 - Jersey/Guernsey companies (Often for listed structures)
 - Delaware LLC (Limited liability & tax transparent)
 - Jersey/Guernsey/Delaware/Cayman/UK Limited Partnerships (Most flexible, limited liability for ordinary partners, tax transparent)

Investment cycle – Structuring Limited Partnerships

Majority of PE/VC Funds are constituted as Limited Partnerships

- Delaware, UK, Guernsey, Jersey, Cayman etc
- Tax transparent vehicles
- Investors/limited partners assessed to tax in own jurisdiction on apportioned share of gains/losses for the period
- Limited Partnership Agreement provides framework for fund's operations and reporting
- Maximum flexibility
- AIFM – remains to be seen how it will impact fund structuring in the future

LIMITED PARTNERS



Investment cycle – Structuring

The choice of accounting standards

The choice of accounting standards can significantly increase or reduce complexity in the accounting and reporting processes of the fund:

- Although accounting standards are said to be converging, key differences still exist;
- US GAAP convergence to IFRS potentially by 2014
- Limited Partnership Agreements typically allow flexibility as to choice of policies
- Corporate vehicles generally require application of GAAP
- IFRS requires consolidation of investments ‘controlled’ by the fund
- US GAAP has standards tailored to Investment Companies (applies to majority of PE Funds)
- UK GAAP set to transition to IFRS for SMEs in 2012

Investment cycle – Structuring

The choice of accounting standards

The choice of accounting standards can significantly increase or reduce complexity in the accounting and reporting processes of the fund...

Accounting Issue	UK GAAP	IFRS	US GAAP
Overall framework	Nothing fund specific	Nothing fund specific	AICPA Audit and Accounting Guide: Investment Companies
Presentation of financial statements	Driven by the requirements of multiple standards: <ul style="list-style-type: none"> • Profit and Loss Account • Balance Sheet • Cash Flow Statement [unless small' entity] • Statement of Total Recognised Gains and Losses • Notes to the financial statements 	Driven by the requirements of IAS 1: <ul style="list-style-type: none"> • Income Statement (Other Comprehensive Income) • Balance Sheet (Statement of Financial Position) • Cash Flow Statement • Statement of Changes in Net Assets Attributable to Partners • Notes to the financial statements 	Drive by the requirements of Chapter 7 of the Audit and Accounting Guide: <ul style="list-style-type: none"> • Statement of Assets and Liabilities • Schedule of Investments • Statement of Operations • Cash Flow Statement • Notes to the financial statements • Financial Highlights (may be included in the notes)

Investment cycle – Structuring

The choice of accounting standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Consolidation – The Fund	<p>Ability to exercise dominant influence. But...</p> <ul style="list-style-type: none"> • severe long term restrictions; • held exclusively with a view to resale 	<p>Requires consolidation of underlying investments where those structures are controlled.</p>	<p>Does not require consolidation of underlying investments.</p> <p>One exception to this general principle is an investment in an operating company that provides services to the investment company.</p>
Consolidation – General Partner	<p>Ability to exercise dominant influence.</p> <p>Generally less likely to lead to consolidation.</p>	<p>Requires consolidation of the Fund where the GP controls it under the provisions of IAS 27.</p>	<p>Requires consolidation of the Fund where the GP:-</p> <ul style="list-style-type: none"> • Is the primary beneficiary of the Fund under FIN 46(R); or • Controls it under EITF 04-5.
Equity accounting	<p>Generally requires associates to be equity accounted for where the investor holds a participating interest and exercises significant influence.</p> <p>However, PE funds holding such investments as part of their portfolio are exempted.</p>	<p>Requires associates to be equity accounted for except where they have been designated as fair value through profit or loss.</p>	<p>Does not require equity accounting for underlying investments unless those entities are investment companies themselves.</p>

Investment cycle – Structuring

The choice of accounting standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Valuation of investments	Entities required to apply FRS 26 - same as IFRS. Other entities - less prescriptive. May carry investments as cost less any provisions for impairment.	Requires investments (designated as 'fair value through profit or loss' or 'available for sale') to be stated at fair value.	Requires investments to be stated at fair value. FAS 157 requires, amongst other things, new disclosures around the inputs used to determine fair value.
Valuation of quoted securities	Less prescriptive – general practice is to value at quoted prices.	Requires quoted securities in active markets to be stated at bid price multiplied by the number of shares. Marketability discounts are generally not permitted.	Requires quoted securities in active markets to be stated at end of day market prices. Where a legal, contractual or regulatory restriction exists then the market price should be adjusted for the effect of the restriction (requirement of new Fair Value Standard).

Investment cycle – Structuring

The choice of accounting standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Treatment of Partners' Capital	Where the Fund has a finite life, partners' capital is generally treated as debt under FRS 25. Applicable to all entities (not just listed)	Where the Fund has a finite life, partners' capital is generally treated as debt under IAS 32.	Partners' capital is generally treated as equity unless there is an obligation to redeem the capital at a specific date at a specific amount.
Functional Currency	Entities required to apply FRS 26 – same requirements as IFRS. Other entities – not prescriptive.	IFRS and US GAAP requirements are substantially the same: An entity's functional currency is defined as the currency of the primary economic environment in which the entity operates.	
Derecognition of financial assets	Recognise and derecognise based on risks and rewards, focusing on substance rather than just legal form.	De-recognise financial assets based on risks and rewards first; control is secondary test.	Derecognise based on control. Requires legal isolation of assets.

Investment cycle – Structuring

The choice of accounting standards

Creating flexibility in the Limited Partnership Agreement

‘The financial statements shall be prepared in accordance with International Financial Reporting Standards as amended from time to time.’

‘The financial statements shall be prepared in accordance with International Financial Reporting Standards as amended from time to time provided that IAS 27 or subsequent standards requiring consolidation shall not apply.’

‘The financial statements shall be prepared in accordance with accounting policies determined by the General Partner.’

Advice: Consult with your professional advisors – including the auditors – as early as possible

Investment cycle – Structuring

Other key areas of the LPA/Prospectus

Capital contributions → Consider controls over standing data
Don't forget the GP contributions

Capital account allocations → Excel or Accounting Package?
Excel based allocations need careful review processes
Investor transfers need careful review/approval processes

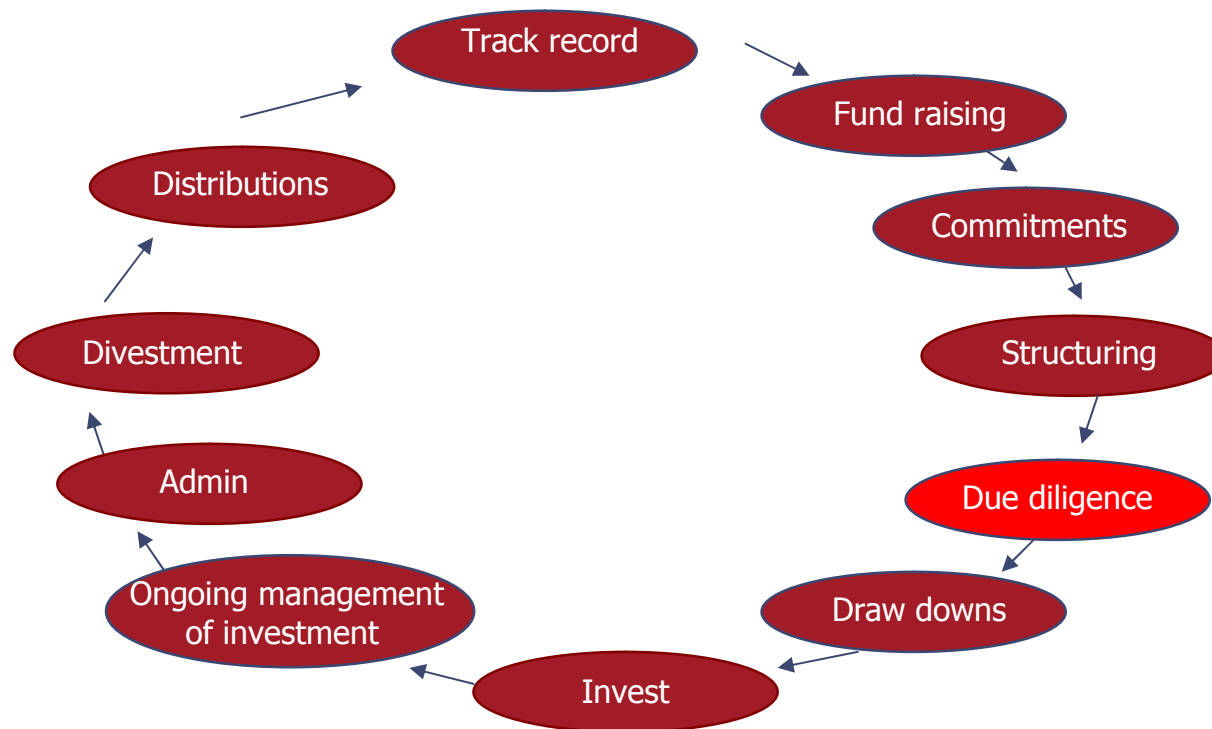
Distributions → Excel based allocations need careful review
In LP's, consider the nature of the distribution (income, gain, capital)
Monitoring of 'catch-up' and 'carried interest' stage is important

Investment cycle – Structuring

Other key areas of the LPA/Prospectus

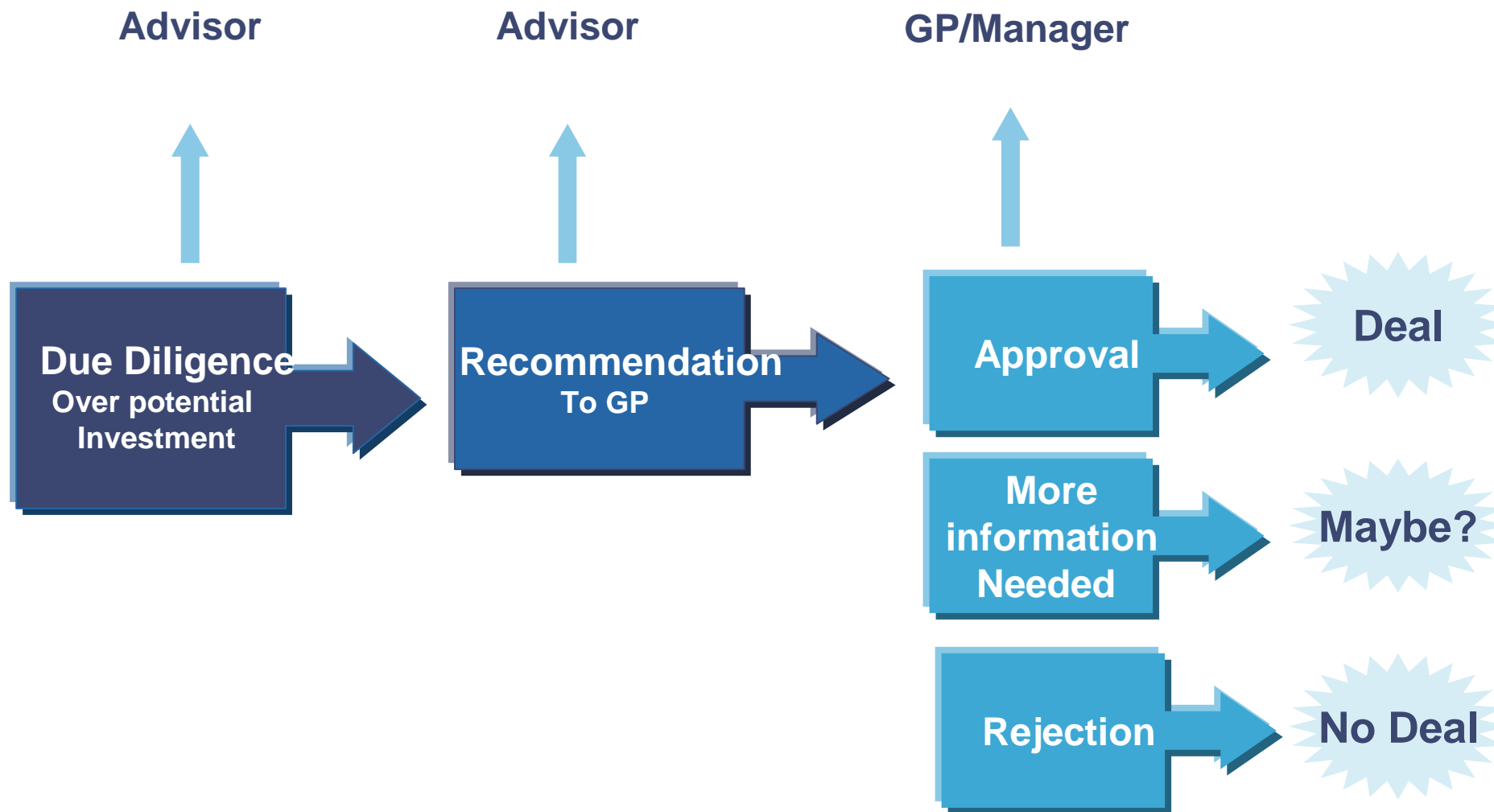
- Management fees → Is the fee a flat % of commitments/NAV
If other fees received by the advisor are 'offset' these need careful monitoring
- GP/Manager kick-out rights → Under most GAAP's, a lack of substantive kick-out rights may lead to a consolidation requirement for the GP
- Fund winding-up procedures → Winding-up procedures may include 'claw-back' provisions of carried interest/performance fee paid to the GP/ Management Company.
- Current valuations lower than historic
 - Claw back provisions starting to apply
- Fund valuation → Important to ensure that the prospectus/LPA does not include valuation requirements that are not GAAP compliant.

Investment cycle – Due Diligence



Investment cycle – Due Diligence

The decision making process



Investment cycle – Due Diligence Points for the Administrator

Themes

- Demonstrating Management & Control
- Retention of documentation
- Accuracy of recording

Actions

- Demonstrate appropriate consideration of transactions
- Documentation should be accurately and timely
- Retain copies of transaction documentation in the relevant jurisdiction
- Maintain control processes that checks the accuracy of the transaction documentation and accounting records

Investment cycle – Due Diligence Points for the Administrator

Typical Points Arising from Documentation Reviews by audit teams

- Time taken for the board to consider investment decisions too short
- Incomplete documentation retained in investment files
- Final signed documentation (eg loan agreements) is inaccurate
- Consideration of revisions to investment decisions are not properly documented
- Where advance board packs are issued, evidence of this should be recorded

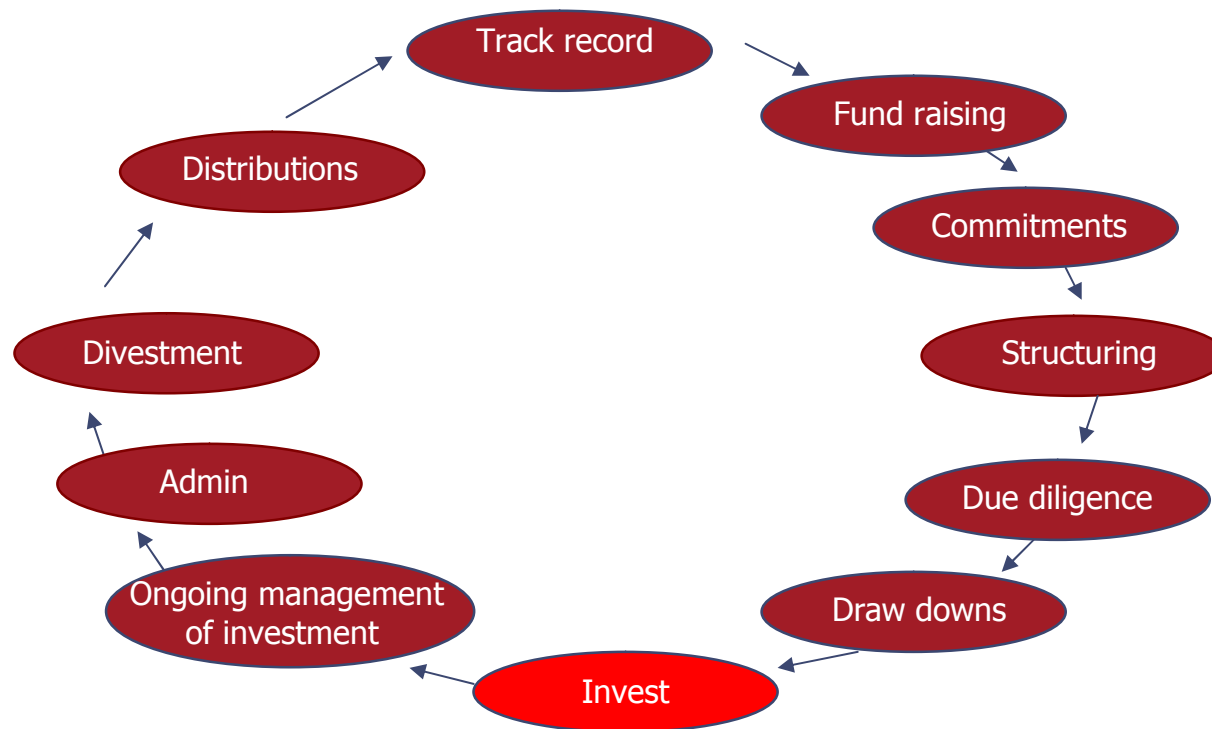
Investment cycle – Due Diligence

Audit risk

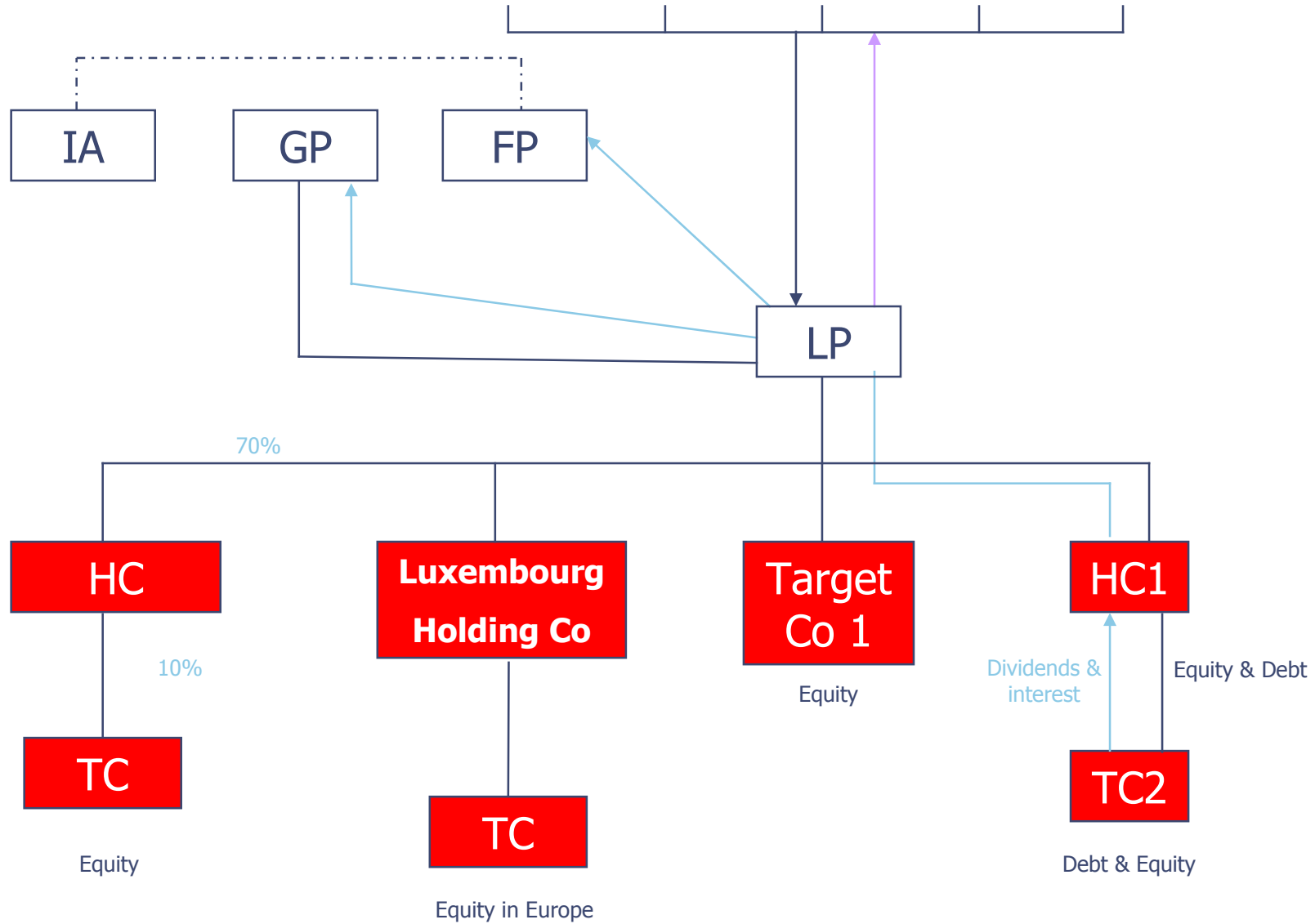
Our audit review will typically include testing of 100% of investment transactions. The testing will include reference to:

- Investment Advisors' Recommendations
- Minutes of General Partner/Manager Approvals
- Transaction documentation
 - What instruments are being bought and sold
 - The price of the transaction
 - Any ongoing commitments or contingencies
- Consistency of all the above with the Fund's accounting records

Investment cycle – Invest



LIMITED PARTNERS



Investment cycle – Invest Structuring the deal

- Legal and tax advice considering
 - Tax efficiency
 - Mechanisms to facilitate exit rights
 - Who the other investors are
 - Level of control taken
- Accurate implementation of advice
- Ongoing monitoring to ensure that structure is still appropriate
- Update legal and tax advice for each exit event

Investment cycle – Invest

Implications of deal structuring

- Admin
 - Need to ensure that shares are issued/loan agreements are signed
 - Also be careful to accurately process any changes that may occur down the line
 - Relevant minutes and records of each holding company need to be maintained
 - Demonstration of substance/management of control needs to be monitored closely since a mistake may invalidate the structure.
- Accounting
 - Transactions at the holding company level need to be considered at the fund level [Valuation of investments, unrecorded liabilities, disclosures]
 - The capital structure of the holding company will affect the nature of the returns received by the Fund. (eg if the Fund has provided debt only to the holding company then returns will be income or return of capital)

Investment cycle – Invest

Audit risk: Investments - existence

- We typically test 100% of investments held by the fund
- Need to consider holding companies/SPV's used in each investment structure [and confirm existence with each party involved]
- What are the other considerations for the confirmation process
 - Type of security held by the fund
 - Derivatives issued that may dilute the value of the fund's holding
 - Related party disclosures
 - Fees received by the GP that are offset off the management fee
 - Dividends and interest declared/paid but not recorded at the fund level

Investment cycle – Invest Consolidation

Accounting Standards	Control eg 50% +	Influential minority eg 20-49%
UK GAAP	Consolidation can be avoided (see exclusions).	Equity accounting can be avoided if held within a 'basket of investments'.
IFRS	Consolidation required.	Equity accounting not required for 'venture capital organisations' who fair value through P&L
US GAAP	Consolidation not required.	Equity accounting not required.

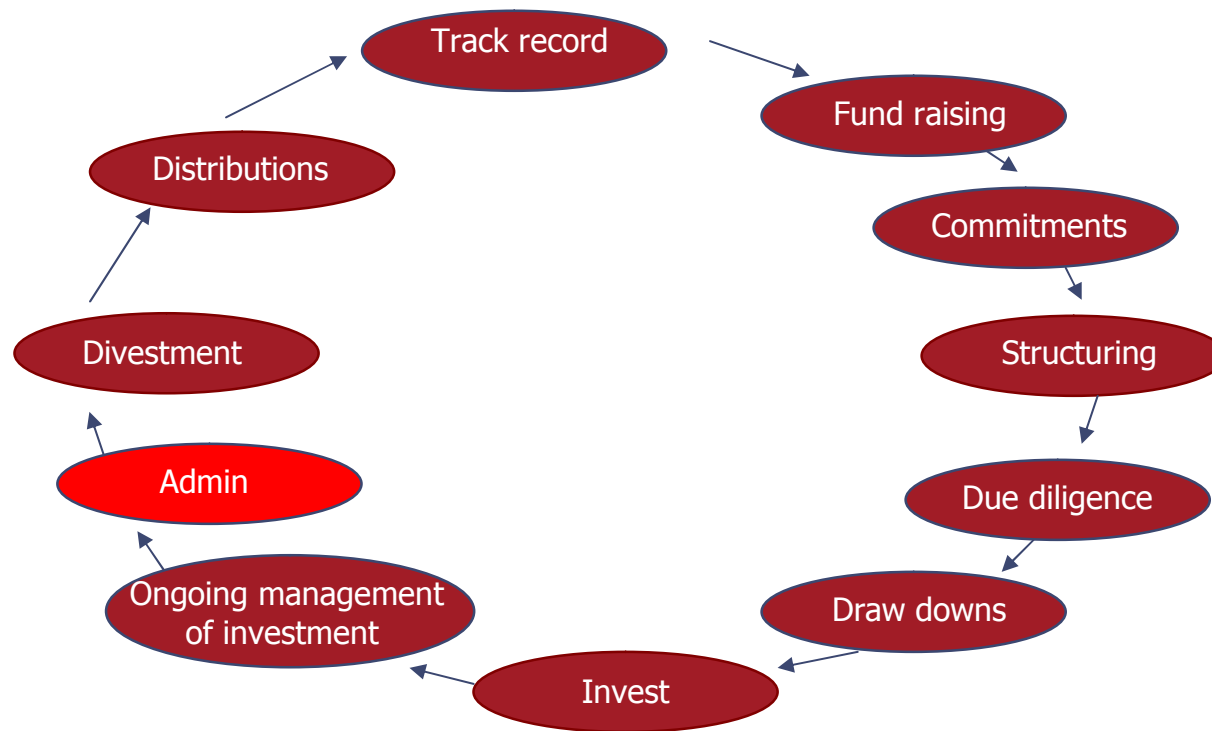
Investment cycle – Invest

Tax risk

Tax is a big issue....for all of us

- Private Equity Funds often enter into transactions involving complex investment structures designed to be tax efficient.
- There is a risk that a structure put in place:
 - Does not reflect the advice given by the lawyers and tax advisers
 - Reflects an untested interpretation of tax legislation in a particular country
 - Is not updated for changing legislation or interpretations
- Our approach is therefore to:
 - Consult with our tax department on the level of risk associated with a particular fund structure
 - Discuss processes and controls in place at the client surrounding tax risk
 - Assess the adequacy of processes and controls in place
 - Obtain representations from management

Investment cycle – Admin & Reporting



Investment cycle – Admin & Reporting Administration

High quality ongoing administration is obviously important but where have mistakes been found in the past?

- Resolutions not signed
- Share registers and directors' registers not kept up to date
- Permit conditions regarding filing of financial statements with the regulator not complied with
- AGM's of GP's and SPV's not held
- Annual financial statements of SPV's not prepared
- No evidence of investors reports being sent to investors

Investment cycle – Admin & Reporting

Investor reporting

A growing set of standards driving consistent reporting:

- EVCA Investor Reporting Guidelines
 - Fund reporting
 - Portfolio reporting
 - Capital accounts
 - Fees and carried interest
- International Private Equity and Venture Capital Valuation Guidelines (Revised guidelines issued 6 September 2009)
- PEIGG Guidelines
- US GAAP/UK GAAP/IFRS

Investment cycle – Admin & Reporting

Reporting fair value

- Ultimately investors are focused on realised value;
- The advisor needs to be able to measure unrealised value for three important reasons:
 - Underlying investors often need to report at fair value. Asset allocation models also require fair values
 - Market practice is now to report at fair value in the financial statements
 - It is an important part of his own internal monitoring mechanisms

Investment cycle – Admin & Reporting

International Private Equity & Venture Capital Valuation Guidelines

FRS 26/IAS 39/ FAS 157 all....

- Require fair value accounting
- Increasing guidance on how to reach fair value issued over past 12 months

The International Private Equity and Venture Capital Valuation Guidelines were developed by the British, European and French Venture Capital Associations.

The guidelines are intended to provide a framework for arriving at a fair value for private equity and venture capital investments. The guidelines define fair value as:

‘the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction.’

This is basically consistent with the definition contained within accounting standards.

Investment cycle – Admin & Reporting

Valuation methodologies unquoted companies

‘The Valuer should exercise his or her judgement to select the methodology that is the most appropriate for a particular investment’:

- Price of recent investment - consider the background to the transaction
- Earnings multiple - an established investment with maintainable earnings
- Net assets – value derived from assets rather than earnings [eg property holding or investment business]
- Discounted cash flow – flexible but subjective since many assumptions are used. Useful as a cross-check.
- Industry valuation benchmarks - limited situations. Useful as a cross-check.
- Milestone analysis – given more recognition in the 2009 revision

Investment cycle – Admin & Reporting

Valuation methodologies unquoted companies

• Multiple Based Valuation		2007		2008
Earnings		100		90*
Multiple		10		5
		<hr/>		<hr/>
Enterprise Value		1,000		450
External Debt		(400)		(400)
Gross Attributable Ent Value		<hr/> 600		<hr/> 50
Discount (fn1)	20%	(120)	10%	(5)
Net Attributable Ent Value		<hr/> 480		<hr/> 45
Shareholder Debt		(20)		(20)
Equity Value (100%)		<hr/> 460		<hr/> 25
Percentage ownership	90%		90%	
		<hr/>		<hr/>
Carrying Value		414		22.5
		<hr/>		<hr/>

* Earnings have been normalised

Fn1 No separate marketability discount under 2009 revision of the guidelines

Investment cycle – Admin & Reporting

Valuation methodologies unquoted companies

‘What are the key issues?’

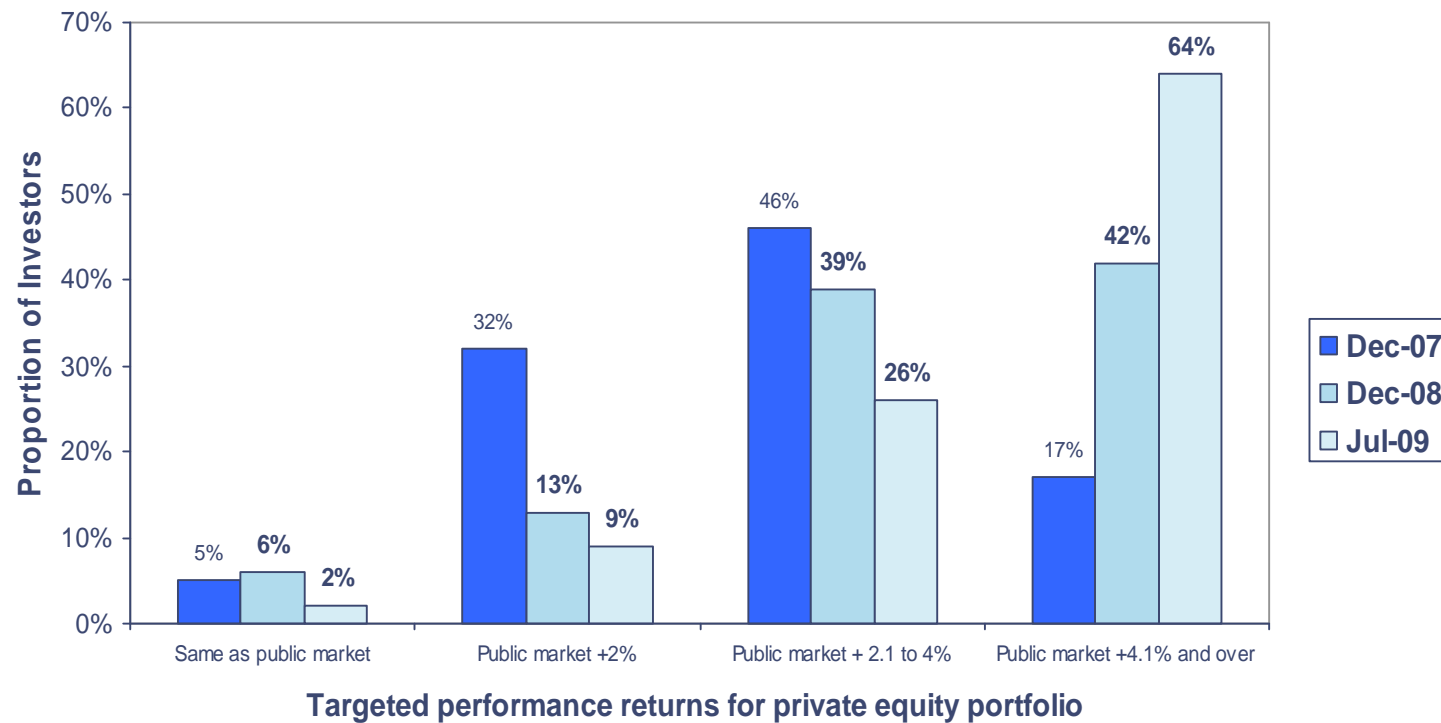
- Selection of an appropriate multiple
- Estimation of “maintainable earnings”
- Selection of a reasonable (comparable company) multiple
 - Criteria for choosing comparable companies
 - Same industry/product/revenue stream
 - Similar profit record
 - Close in terms of size, turnover, dividend cover etc
 - Not be in a special situation
 - Have similar prospects

Investment cycle – Admin & Reporting

Valuation methodologies unquoted companies

Growth potential and returns

- What returns do investors expect from their private equity portfolios?



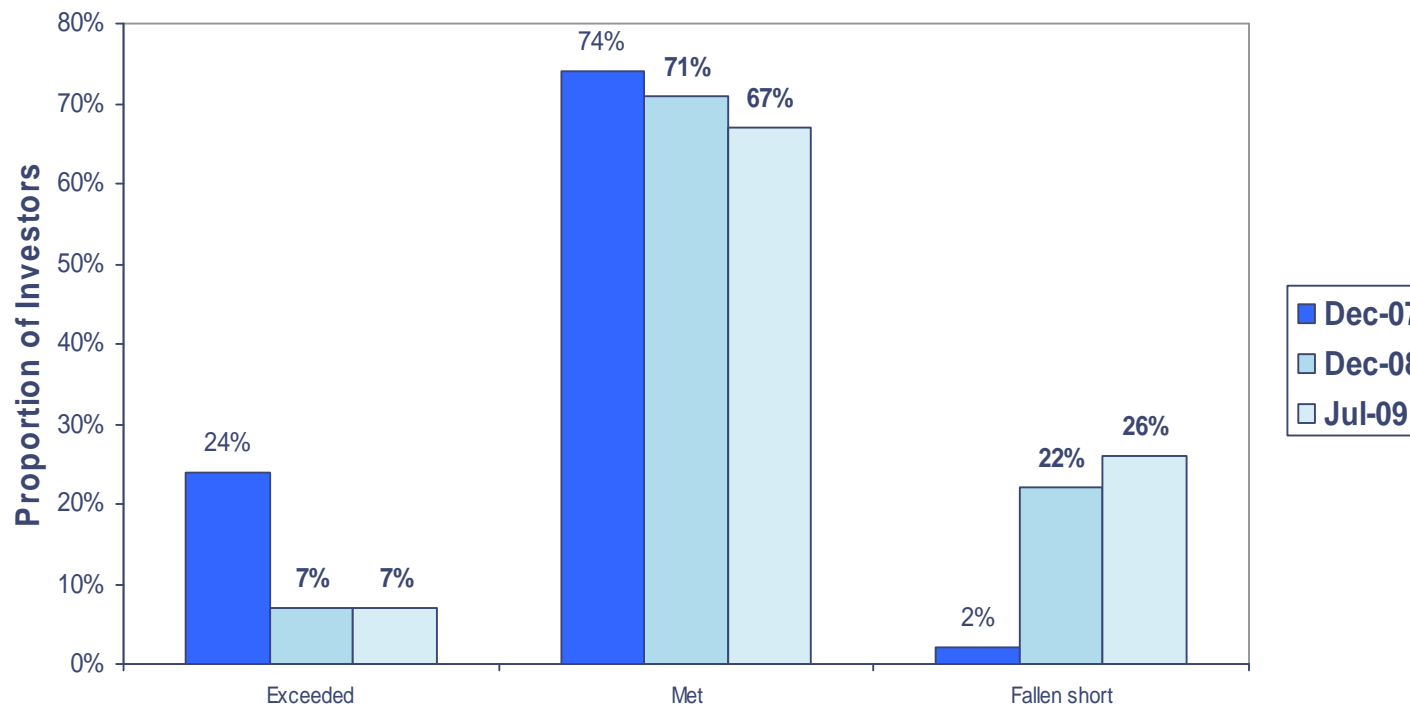
Source: Preqin Research report: Private equity investor survey

Investment cycle – Admin & Reporting

Valuation methodologies unquoted companies

Growth potential and returns

- Have investors' private equity fund investments lived up to expectations?



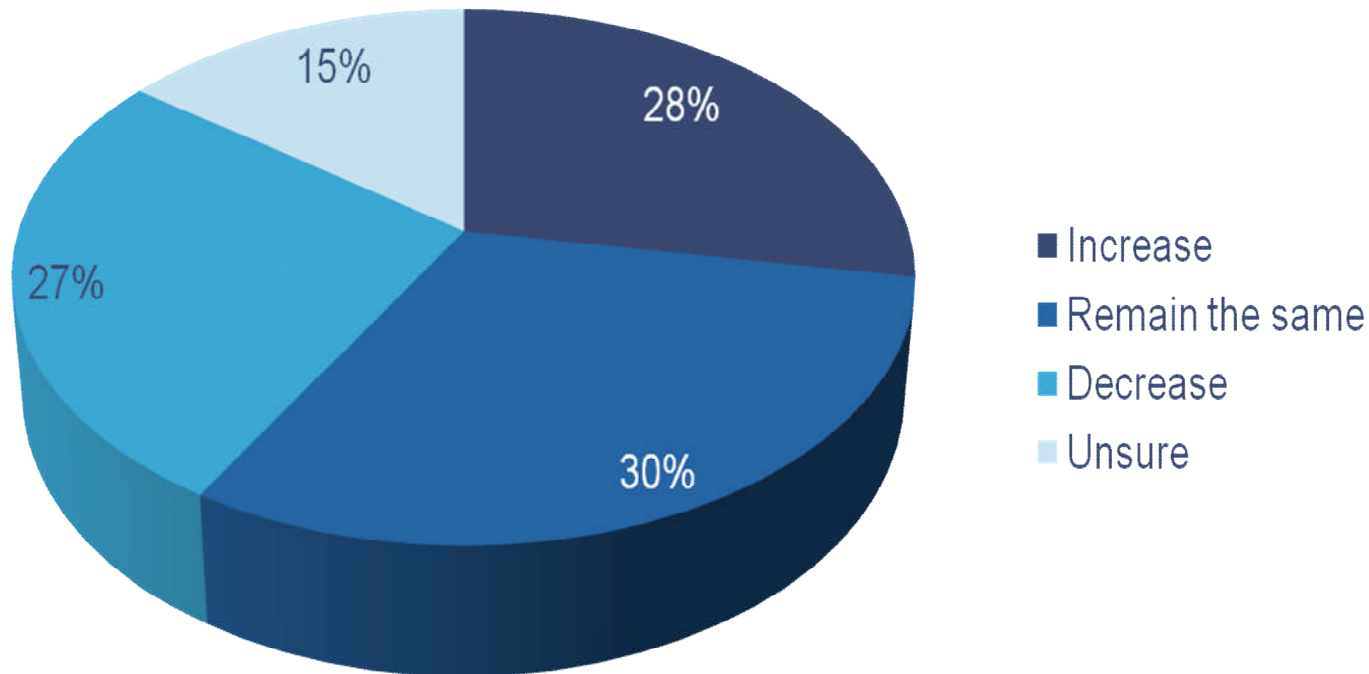
Source: Preqin Research report: Private equity investor survey

Investment cycle – Admin & Reporting

Valuation methodologies unquoted companies

Growth potential and returns

- Investors' expectations for valuations of private equity portfolios in next six months



Source: Preqin Research report: Private equity investor survey

Investment cycle – Admin & Reporting

Valuation methodologies quoted companies

Use of Bid-Prices

‘Instruments quoted on a stock market should be valued at the bid prices on the reporting date....although the use of the mid-market price will not usually result in a material overstatement of value’.

NB. This is consistent with IFRS which requires the use of bid prices. US GAAP permits the use of prices within the bid-offer spread where appropriate.

Marketability discounts/Control premiums

‘Marketability discounts should generally not be applied to prices quoted on an active market, unless there is some contractual, governmental or other legally enforceable restrictions preventing realisation at the reporting date.....

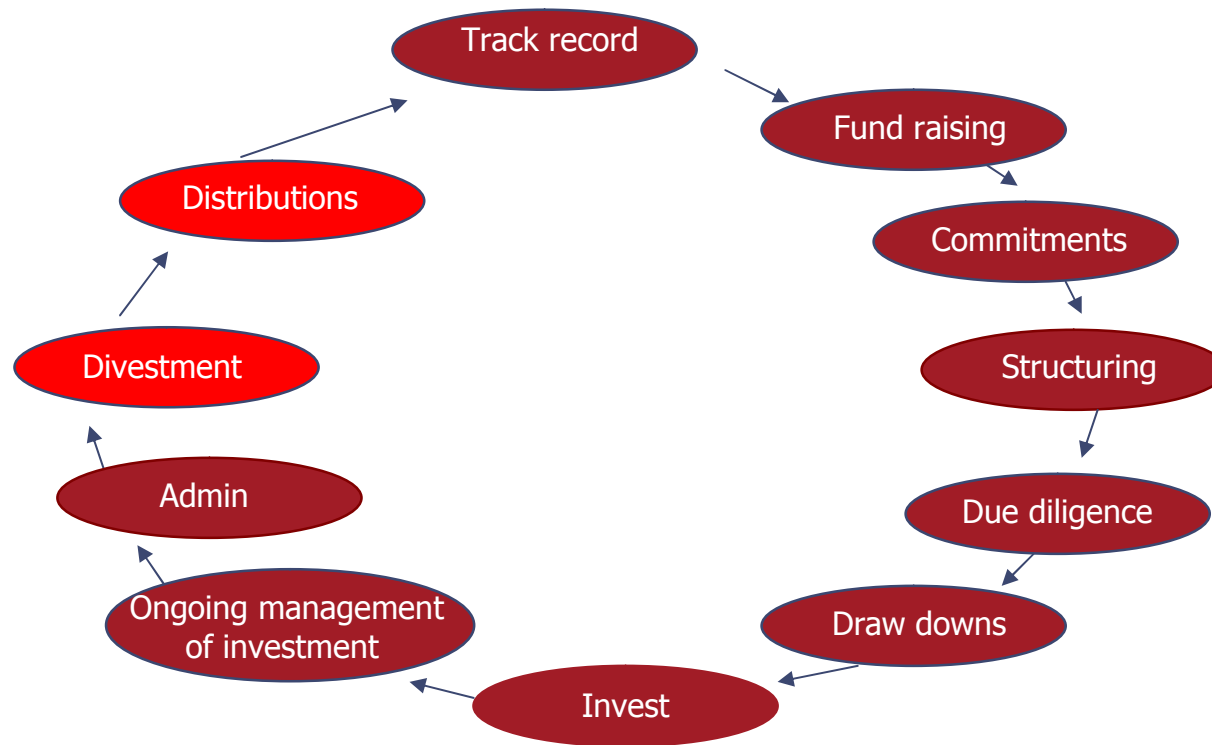
In the case of a six-month lock-up period, in practice a discount of 20% to the market price is often used at the beginning of the period, reducing to zero at the end of the period.’

Control premiums - Would generally not expect to see them rise in distressed market conditions

Investment cycle – Admin & Reporting Investments – Valuation and audit process

- Broad concepts of valuation already discussed.
- As auditors we focus on:
 - Understanding the procedures and controls surrounding valuation
 - The assumptions used by the GP
 - The supporting documentation explaining why the methodologies and assumptions used are appropriate (particularly where changes have taken place).
 - Consistency of approach
 - The audit evidence available to support the GP's representations (eg sale agreements, entity financial statements, valuation reports)
 - Whether we need a valuation specialist to help us with our work.

Investment cycle – Divestment & Distribution



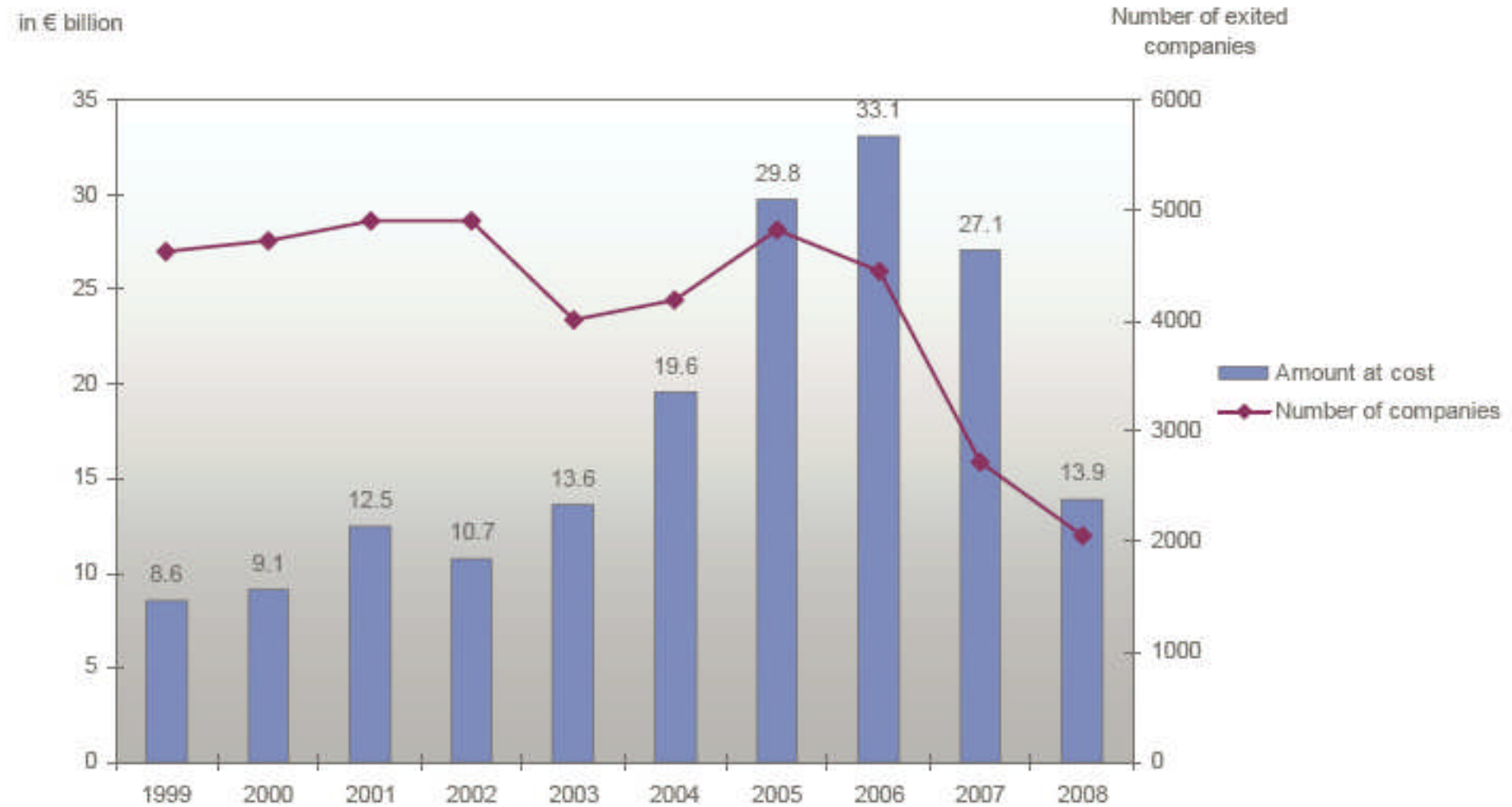
Investment cycle – Divestment & Distribution

Exit strategy – at least in theory!

- Initial view must be taken on investment
- Remain flexible throughout ownership period
- Typical exit options are:
 - IPO
 - “The Holy Grail”
 - Beware of Lock-ins
 - Not common
- Trade sale
 - Most common
 - Must be business synergies to make it work
- MBO/MBI
 - Current management team (MBO) or
 - External management team (MBI)
- Secondary Fund
 - Not common at an investment level (i.e typically acquire portfolios)

Investment cycle – Divestment & Distribution

EVCA Statistics – Divestments at cost

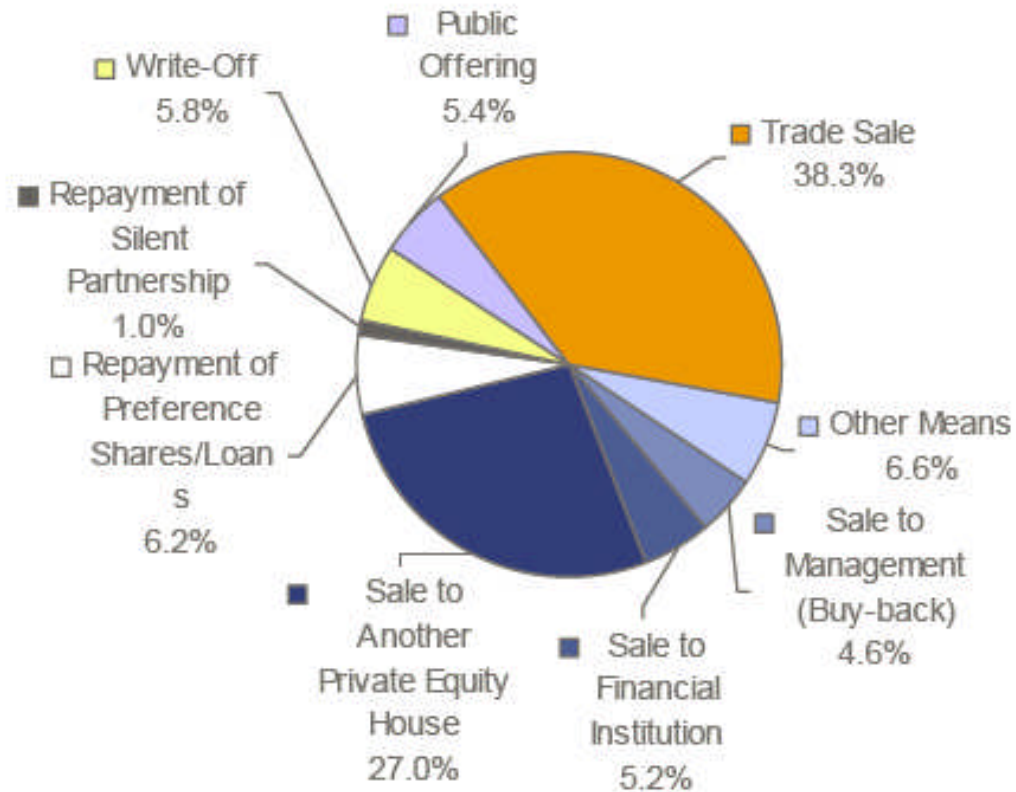


Source: PEREP_Analytics for 2007 & 2008;
Thomson Reuters/PwC for previous years

Investment cycle – Divestment & Distribution

EVCA Statistics – Divestment by exit route in 2008

All private equity - % of amount at cost



Investment cycle – Divestment & Distribution

Things to think about on distribution

- Order defined in LPA/Articles of Association
- A typical waterfall may be as follows:
 - Return of Capital to investors
 - Payment of a Preferred Return of 8% to investors
 - A 'Catch Up' payment of 80% to the GP; 20% to the investors until 20% of profits paid to GP; then
 - 20% paid to GP and 80% to investors.
- Allocation versus Distribution – Portfolio level Vs Investment level basis
- Classification as income/capital is important to investor. Consider:
 - The nature of the instrument paying the returns;
 - The accuracy of the interest calculations for debt instruments;
 - Whether the instrument has changed since the initial investment;
 - The accuracy of the information transferred to the distribution notice from the underlying calculations.

Investment cycle – Divestment & Distribution

Things to think about on distribution

Admin processes and controls

- Recording and updating of standing data
- Accurate recording of the disposal transaction [Cost, income, gain]
- Accurate allocation of proceeds available for distribution amongst the partners
- Focus on calculations for preferred return and carried interest
- Accurate cash payments to investors/general partner

Audit approach

- Testing of disposal to transaction documentation
- Verification of allocation methodology in accordance with the LPA/Prospectus
- Verification of the preferred return and carried interest calculations
- Sample testing of cash payments

Accounting thoughts

- Should the Fund make a provision for carried interest on unrealised gains? - **Yes**
- How should carried interest be accounted for in the fund? – **A topic for debate**
- Should the manager/GP recognise the carried interest in its accounts? - **Maybe**

Accounting update

Amendments to IFRS 7 - Applicable for annual periods beginning on or after 1 January 2009.
(Comparatives not required in first year of application)

Classification within the Fair Value Hierarchy

Level 1

- Observable
- Quoted prices for identical assets or liabilities in active market at the measurement date

- Fair value = Price * Quantity
- Should be used whenever available

Level 2

- Quoted; similar items in active markets
- Quoted, identical/similar, not active
- Must be observable at the measurement date

- Valuation may include factors such as adjustments for liquidity
- Adjustments suggest Level 3 if measurement may be affected by a significant amount

Level 3

- Unobservable inputs (e.g., a company's own data)
- Market perspective still required

- Requires significant judgment and disclosure

Accounting update

Amendments to IFRS 7 - Disclosure

For assets and liabilities measured at fair value the client shall disclose the following:

- The methods, and when a valuation technique is used, the assumptions applied in determining fair value
- The level within the hierarchy in which the instruments' fall
- Any significant transfers between level 1 and level 2
- A roll-forward of Level 3 measurements
- Total gains or losses in the Level 3 roll-forward that were included in earnings due to assets and liabilities held at the reporting date

A roll-forward of level 3 measurements shall include:

- Opening fair value
- Total gains or losses for the period,
- Separate disclosures for purchases, sales, issues and settlements,
- Transfers into and out of level 3 (where significant each shall be disclosed separately).
- Closing fair value
- ***There will be an example of these disclosures in the 2009 illustrative financial statements which are due to be out by the end of November 2009.***

Accounting update

IAS 12 – Income tax

- The proposals in the Exposure Draft are intended to align more closely the accounting for Income Taxes under IFRS with US GAAP (FIN 48) and to clarify aspects of accounting under IAS 12.
- The IASB's proposals mean that uncertainties about whether the tax authorities will accept the position taken is included in the measurement of the tax assets and liabilities themselves.
- In March 2009 the IASB issued an Exposure draft on 'Income Tax'
- This approach can be expected to increase the tax liability where a company has tax uncertainties that it had not previously recognised on the basis that these uncertainties were not likely to crystallise as tax payable.
- The proposals also introduce specific disclosure requirements in relation to areas of estimation uncertainty relating to tax, (for example, the effects of unresolved disputes with the tax authorities).
- The proposals do not include any exemption from disclosing the information required on the basis that such disclosure may prejudice the position of the entity in a dispute.

Accounting update

IAS 39 – Financial Instruments: Classification and measurement

- The IASB ED proposes a fundamentally new model for the classification and measurement of financial instruments. This ED is the first phase in a longer process to replace IAS 39 in its entirety.
- The objective is to improve the ability of users of financial statements to assess the amounts, timing and uncertainty of future cash flows by replacing the many financial instrument classification categories and associated impairment methods in IAS 39 *Financial Instruments: Recognition and Measurement*.
- In this phase, the IASB is proposing that financial instruments will be classified into two measurement categories: fair value or amortised cost.
- Financial instruments will be available for classification into the amortised cost category if they meet both of the following criteria: a) they contain only basic loan features; and b) they are managed on a contractual yield basis.

Accounting update

IAS 39 – Financial Instruments: Classification and measurement

All other financial instruments will be measured at fair value.

- The recent financial crisis has highlighted problems for both users and preparers in understanding the existing reporting requirements for financial instruments and the data provided.
- The changes proposed in the ED are fundamental and are likely to have far-reaching implications for Investment Funds.
- We note that the proposals are likely to result in reclassifications between measurement categories in both directions: from amortised cost to fair value and from fair value to amortised cost. The extent of any net impact on the income statement will depend largely on the complexity of the financial instruments that each entity holds and the way in which they are managed.
- The proposed effective date is not until January 2012.

Accounting update

Codification

- On July 1, 2009, the FASB Accounting Standards Codification became the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP).
- The Codification will become effective for financial statements that cover interim and annual periods ending after September 15, 2009.
- All content in the Codification carries the same level of authority under GAAP.
- With certain extremely limited "grandfathering" exceptions, the Codification supersedes and makes non-authoritative existing FASB, American Institute of Certified Public Accountants (AICPA), FASB Emerging Issues Task Force (EITF), and related literature.

Accounting update Codification

- Financial statement preparers accordingly need to update financial statement disclosures, accounting policies and procedures, accounting memoranda and education processes (internal finance and business users as well as external financial statement users) to reflect the adoption of the Codification.
- The FASB codification can be accessed via the FASB website, <http://asc.fasb.org/home> (registration is required). Refer to PwC's DataLine 2008-04 FASB Codification of US GAAP, and, DataLine 2009-12 for further details.

Accounting update FSP FAS 157-4

- Clarifies the approach to, and provides additional factors to consider in, measuring fair value when there has been a significant decrease in market activity for an asset or liability and quoted prices are associated with transactions that are not orderly.
- Retains existing “exit price” concept under FAS 157 (ASC 820) – does not change the objective of fair value measurement.
- Continues emphasis on the need for entities to apply judgment and provides them with a framework to use in determining whether markets are not active.
- Does not apply to the requirements of FAS 157 (ASC 820) that relate to the use of quoted prices for an identical asset or liability in an active market (that is, a Level 1 input).

Accounting update FSP FAS 157-4

- FSP 157-4 indicates that even when an entity determines that there has been a significant decrease in the volume and level of activity for an asset or liability, it is not appropriate to conclude that all transactions (in the market for the asset or liability) are not orderly.
 - The determination of whether transactions are distressed should be based on the weight of available evidence.
- FSP 157-4 provides guidance to be considered when evaluating observable transaction prices.
- Paragraph 16 provides a list of circumstances that may indicate that a transaction is not orderly.

Accounting update

FAS 157 (ASC 820) Disclosure Improvement Project

- Guidance for level of disaggregation for disclosures – what is a “class”?
 - A subset of a line item, apply judgment in determination
- Qualitative information regarding significant inputs and valuation techniques for both level 2 and 3 estimates
 - Clarifies they are required for BOTH level 2 and 3
- Sensitivity of level 3 estimates to changes in one or more significant inputs
 - Very controversial, consistent with changes to IFRS 7
- Quantitative and qualitative disclosures regarding transfers between levels
 - Amounts and reasons for transfers
- Gross rather than net presentation of changes in Level 3 fair value measures

Accounting update

FASB: Uncertain tax positions (FIN 48)

In July 2006, the FASB released an Interpretation that is intended to reduce diversity:

Accounting for Uncertainty in Income Taxes (FIN 48) Under the interpretation, companies' financial statements will reflect expected future tax consequences of uncertain tax positions.

It appears that investment companies will need to:

- List all tax positions that they currently have within their structures
- Ensure there is current support for positions taken
- Assume that they are going to be audited by the relevant tax authorities - would the position be sustained?
- Ensure documented policy and procedures in place for addressing and monitoring tax risk

FIN 48 will become effective for non-public entities at 31 December 2009.

Other entities should already have adopted the standard.

Accounting update

FAS 161 (ASC 815)

- FAS 161, Disclosures about Derivative Instruments & Hedging Activities (ASC 815-10) was issued by the FASB in March 2008 and is effective for fiscal years AND interim periods beginning AFTER November 15, 2008, with early adoption encouraged.
 - Encourages, but does not require, comparative disclosures for earlier periods at initial adoption.
- Amends and expands disclosure requirements previously set forth under FASB Statement No. 133 (ASC 815), Accounting for Derivative Instruments & Hedging Activities.
- Requires that an entity prepare additional disclosures, highlighting underlying “risk” for derivatives and usage.
- FAS 161 (ASC 815) does not change the accounting for derivatives.

Accounting update

FAS 161(ASC 815) - Derivatives

Included in scope of FAS 161 (ASC 815):

- Written options
- Purchased options
- Swaptions
- CDS, IRS, TRS, & other swaps
- Futures contracts
- Forward contracts
- Interest rate cap / floor
- Credit support agreements
- Money Funds
- (Most) warrants/rights

Excluded from scope (for Investment Funds) of FAS 161 (ASC 815):

- Structured notes*
- Convertible preferred stock*
- Inverse floaters
- IO / PO
- Securities lending transactions
- When issued / delayed delivery
- Short sales
- Inflation indexed interest payments

*Embedded derivatives within structured notes and convertibles are in scope of FAS 161 (ASC 815) unless entire instruments marked to market through earnings (FAS 161, Para. A6)

Final thoughts....

- Think about accounting issues at the set up of the Fund (give the auditors a call)
- Accurate documentation is key
- Ensure that board meetings are effectively structured and documented
- Discuss the audit process with the audit team so that you understand their priorities and are well prepared

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