



**McGladrey & Pullen**

Certified Public Accountants

# Private Equity Accounting Update Presented to the Illinois Venture Capital Association CFO conference

# Agenda

- Common private equity accounting issues 9:15 – 9:40
- Technical updates: 9:40 – 10:00
- Break – 10:00 – 10:15
- Investment valuations – back to the basic's 10:15 – 10:45
- Best practices for your back office 10:45 – 11:00

# Fund formation and start-up issues

- Understand the Limited Partnership Agreement (LPA)
- Accounting for organization and syndication costs
- Admitting new partners after the initial close:
  - True-ups
  - Interest charges, including interest to GP if applicable
  - Refund of excess contributions and allocation to investments
- Set up back-office
- Set up process to track preferred return
- Set up process to track sources and uses of capital

# Capital account maintenance

- Understand the LPA
- Claw-backs concerns (should escrows be released early?)
- Understand the differences between income allocations and distributions
- Special tax distributions and tax withholdings
- Track components of income (loss) items (such as interest income)
- Track waived fees and waiver contributions
- Track sources and uses of capital
- Preferred returns computations – start on day 1
- Carry allocations

# Management fees and expenses

- Understand your LPA
- Management fees:
  - Waived fees – accounting varies between partnership agreements
  - Special allocations of management fees to certain partners
  - Management fee offsets (fee income, placement agent costs – other)
  - Help the GP understand the risks
- Who pays the expense - the management company (GP) or the Fund?
- Broken deal costs
- Insurance, professional fees, bank fees, outsourced accounting fees

# Help GPs understand the implications of Fee Waivers

	No Fee Waiver	Fee Waiver
<b><u>GP cash flows</u></b>		
Contribution	\$ (10,000)	-
Management fee income	10,000	-
Cash flow impact	-	-
<b><u>Capital Account Activity</u></b>		
Contribution	10,000	-
Less expense allocation	(500)	-
GP capital account	\$ 9,500	-

# Revenue recognition

- Sale of portfolio companies
  - Expense of the transaction
  - Escrowed proceeds
  - Other non-cash proceeds
  - Earn-outs
  - Date of agreements
- Accounting for investments in LLCs
  - Flow-through entities still carried at fair value
  - Distribution from flow-through entities are analyzed to determine if they are return of capital or income
  - Generally, tax distributions would be income to the fund when declared

## Revenue recognition – dividends

- From the PEIGG guidelines: *“Paid in-kind dividends should be accrued in accordance with the terms of the underlying security. A valuation discount may be necessary...”*
- From the investment company audit guide: *“Stock dividends and stock splits in the same class as the shares owned are not income to the investment company. However, dividends for which the recipient has the choice to receive cash or stock are usually recognized as investment income in the amount of the cash options.....”*
- From the investment company audit guide: *“Other noncash dividends are recognized as investment income at the fair value of the property received....”*

## Revenue recognition – continued

- PEIGG guidelines: *“Convertible securities are valued at the excess of the value of the underlying security over the conversion price as if the security was converted when the conversion feature is ‘in the money’ (appropriately discounted)...”*
- PEIGG guidelines: *“If deemed determinable beyond a reasonable doubt (virtual certain), escrows from the sale of a portfolio company should be valued at the amount that the manager, using its best estimate, ultimately expects to receive from the buyer in light of the escrows’ various conditions.” (the Virtual Certain comment is not referenced in GAAP)*
- From the investment company guide: *“The fair value for investments is not reduced by estimated brokerage commissions and other costs that would be incurred in selling the investments.”*

## Revenue recognition – continued

- From the investment company audit guide: *“Realized gains and losses are determined, for financial reporting purposes, on the specific identification or average cost methods.” An investment company should use only one method for all securities. Cost includes commissions and other charges.”*
- From the investment company guide: *“Litigation awards should be recorded in accordance with FASB statement 5... if the investment company holds the securities, the award is accounted for as a reduction of cost. If the investment company no longer holds the securities, the proceeds should be accounted for a realized gain.”*

## Income recognition – continued

- From the investment company guide: *“Workout expenses that are incurred as part of negotiations of the terms and requirements of capital infusions... are recorded as a realized loss. Ongoing expenses to protect or enhance an investment... should be treated as operating expenses.”*

# Recent publications and pronouncements

- Codification changes GAAP references
- International
  - Convergence – will it happen?
  - New publication on International valuation standards
- ILPA – Principles for Private Equity (Best practices, wish list or a trend?)
- Fair value updates
- Uncertain tax positions– to be covered in tax updates
- Audit of the General Partner –Is consolidation required?
- When do you follow the Investment company audit guide? (real estate and other investment funds)
- Allocation of unrealized gain (loss) recognition of carried interest and clawback obligations. (TIS 6910.29)
- Detailed list of new pronouncements follows

105	Generally Principles	<b>400 Liabilities</b>	815	Derivatives and Hedging	960	Plan Accounting - Defined Benefit Pension Plans	
<b>200 Presentation</b>		405	<b>820 Fair Value Measurements and Disclosures</b>		962	Plan Accounting - Defined Contribution Pension Plans	
205	Presentation of Financial Statements	410	825	Financial Instruments		965	Plan Accounting - Health and Welfare Benefit Plans
210	Balance Sheet		830	Foreign Currency Matters		970	Real Estate - General
215	Statement of Shareholder Equity	420	835	Interest		972	Real Estate - Common Interest Realty Associations
220	Comprehensive Income	430	840	Leases		974	Real Estate - Real Estate Investment Trusts
225	Income Statement	440	845	Nonmonetary Transactions		976	Real Estate - Retail Land
230	Statement of Cash Flows	450	850	Related Party Disclosures		978	Real Estate - Time-Sharing Activities
		460	852	Reorganizations		980	Regulated Operations
235	Notes of Financial Statements	470	855	Subsequent Events		985	Software
250	Accounting Changes and Error Corrections	480	860	Transfers and Servicing		995	U.S. Steamship Entities
255	Changing Prices		<b>900 Industry</b>				ASC Section List (within each section)
260	Earnings Per Share	<b>500 Equity</b>	905	Agriculture		00	Status
270	Interim Reporting	505	908	Airlines		5	Overview and Background
272	Limited Liability Entities		910	Contractors - Construction		10	Objectives
274	Personal Financial Statements	<b>600 Revenue</b>	912	Contractors - Federal Government		15	Scope and Scope Exceptions
275	Risks and Uncertainties	605	915	Development Stage Entities		20	Glossary
280	Segment Reporting		920	Entertainment - Broadcasters		25	Recognition
		<b>700 Expenses</b>	922	Entertainment - Cable Television		30	Initial Measurement
<b>300 Assets</b>		705	924	Entertainment - Casinos		35	Subsequent Measurement
305	Cash and Cash Equivalents		926	Entertainment - Films		40	Derecognition
310	Receivables			Postemployment Benefits		45	Other Presentation Matters
320	Investments - Debt and Equity Securities		928	Entertainment - Music		50	Disclosure
323	Investments - Equity Method and Joint Ventures	715	930	Extractive Activities - Mining		55	Implementation Guidance and Illustrations
			932	Extractive Activities - Oil and Gas		60	Relationships
325	Investments - Other	718	940	Financial Services - Brokers and Dealers		65	Transition and Open Effective Date Information
330	Inventory	720	942	Financial Services - Depository and Lending		70	Grandfathered Guidance
340	Other Assets and Deferred Costs		944	Financial Services - Insurance		75	XBRL Definitions
		730	<b>946 Financial Services - Investment Companies</b>			S99	SEC Materials
350	Intangibles - Goodwill and Other	740	948	Financial Services - Mortgage Banking			
360	Property, Plant and Equipment						
		<b>800 Broad Transactions</b>	950	Financial Service - Title Plant			
		805	952	Franchisors			
		808	954	Health Care Entities			
		810	958	Not-for-Profit Entities			

# International Financial Accounting Standards

- Principles based vs. rules based
- Roadmap to convergence with US GAAP
  - Delays encountered
- Current differences of IFRS vs. US GAAP
  - Determination of fair value of financial instruments
  - Consolidation policy
  - Shareholder capital
  - Business combinations
- Impact and challenges of conversion

# Effective Date Reminder

- Effective for fiscal years beginning after November 15, 2008
  - FAS 157, *Fair Value Measurements*, for nonfinancial assets and nonfinancial liabilities recognized or disclosed at fair value on a nonrecurring basis (codified in ASC 820) - **Already effective for Investment Funds**
  - FAS 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* (codified in ASC 815)
  - FSP FAS 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (codified in ASC 860)
- Effective for fiscal years beginning after December 15, 2008
  - **FAS 141(R), *Business Combinations* (codified in ASC 805)**
  - FAS 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of ARB No. 51* (codified in ASC 810)
  - FAS 163, *Accounting for Financial Guarantee Insurance Contracts - an interpretation of FASB Statement No. 60* (codified in ASC 944)
  - **FIN 48, *Accounting for Uncertainty in Income Taxes*, for nonpublic entities (codified in ASC 740)**

## Effective Date Reminder, Cont.

- Effective for fiscal years beginning after December 15, 2008
  - FSP FAS 140-4 and FIN-46R-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities* (codified in ASC 810 and 860)
  - FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* (codified in ASC 275 and 350)
  - FSP APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* (codified in ASC 470 and 825)
  - FSP FAS 141(R)-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies* (codified in ASC 805)
  - FSP FAS 117-1, "Endowments of Not-for-Profit Organizations: Net Asset Classification of Funds Subject to an Enacted Version of the Uniform Prudent Management of Institutional Funds Act, and Enhanced Disclosures for All Endowment Funds" (codified in ASC 958)

## Effective Date Reminder, Cont.

- Effective for fiscal years beginning after December 15, 2008
  - FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (codified in FASB ASC 260)
  - FSP EITF 99-20-1, *Amendments to the Impairment Guidance of EITF Issue No. 99-20* (codified in ASC 325-20)
  - EITF Issue No. 07-1, "Accounting for Collaborative Arrangements" (codified in ASC 808-10)
  - EITF Issue No. 07-4, "Application of the Two-Class Method under FASB Statement No. 128, "Earnings per Share," to Master Limited Partnerships" (codified in FASB ASC 260)
  - EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" (codified in ASC 815-40)
  - EITF Issue No. 08-3, "Accounting by Lessees for Maintenance Deposits" (codified in ASC 840-10)

## Effective Date Reminder, Cont.

- Effective for fiscal years beginning after December 15, 2008
  - EITF Issue No. 08-4, "EITF Issue No. 08-4, "Transition Guidance for Conforming Changes to EITF Issue No. 98-5, 'Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios'" (codified in ASC 470)
  - EITF Issue No. 08-5, "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement" (codified in ASC 820)
  - EITF Issue No. 08-6, "Equity Method Investment Accounting Considerations" (as codified in ASC 323)
  - EITF Issue No. 08-7, "Accounting for Defensive Intangible Assets" (codified in FASB ASC 350-30)
  - EITF Issue No. 08-8, 'Accounting for an Instrument (or an Embedded Feature) with a Settlement Amount That Is Based on the Stock of an Entity's Consolidated Subsidiary" (codified in ASC 815-10 and 815-40)

## Effective Date Reminder, Cont.

- Effective for periods ending after June 15, 2009
  - FAS 165, *Subsequent Events* (codified in ASC 855)
  - FSP 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* (codified in ASC 820)
  - FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (codified in ASC 320)
  - FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* (codified in ASC 825)
- Effective for periods ending after August 26, 2009
  - ASC Update 2009-05, *Measuring Liabilities at Fair Value*

## Effective Date Reminder, Cont.

- Effective for periods ending after September 15, 2009
  - FAS 168, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting* (ASC 105)
  - ASC Update 2009-06, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*
- Effective for fiscal years ending after December 15, 2009
  - FSP FAS 132(R)-1, "Employers' Disclosures about Postretirement Benefit Plan Assets"(codified in ASC 715-20)
- Effective for fiscal years beginning after November 15, 2009
  - FAS 166, *Accounting for Transfers of Financial Assets*
  - FAS 167, *Amendments to FASB Interpretation No. 46(R)*

## Effective Date Reminder, Cont.

- Effective for fiscal years beginning after December 15, 2009
  - FAS 164, *Not-for-Profit Entities: Mergers and Acquisitions* (not yet in ASC)
  - EITF 09-1, "Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance" (not yet in ASC)
  - ASC Update 2009-12 - *Fair Value Measurements and Disclosures (Topic 820) - Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
- Effective for fiscal years beginning after June 15, 2010
  - ASU 2009-14 - *Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*
  - ASU 2009-13 - *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*

# Private Equity Accounting Issues

- New fund start up issues
- Capital account maintenance
- Fund expenses
- Revenue recognition
- Valuations (to be covered separately)

# Investment Valuations

*Valuation professionals get us back to  
the basics*



# Best Practices for Private Equity Valuations

- Internal controls around inputs, review and overall processes
  - Valuation policy
  - Valuation committee
  - Documentation requirements
  - Decision flow-chart or checklist
  - Approval process
  - Consistent application of process
- Real involvement from the General Partner
- Use of a valuation specialist to help you develop your models, provide access to comparable information and provide related guidance.
- Understand way your LPs need fair value reporting



# Best Practices for Private Equity Valuations - Continued

Detailed investment narratives to explain:

- An overview of the company – describe the past performance and expectations for the future
- What is the principle or most advantageous market
- Identify the valuation techniques used
- Why a specific valuation technique was used or given a greater weight.
- Why specific public or M & A multiples were used and why they are valid comparisons
- Explain the reasons for the selection of a specific multiple
- EBITDA add-backs
- Unusual items in the waterfall (preferences etc)



# Best Practices for Private Equity Valuations - Continued

- Use of multiple methodologies (Income and market approaches)
- Determine a range of values before reaching a conclusion
- Build up an internal database of M & A transactions (wins and losses)
- Don't automatically add back cash without considering working capital
- Additional documentation and support when the most recent financing is considered the best evidence of fair value.
- Provide documentation that can be audited to support your inputs
- Do not consider the cost to sell in the valuation
- Day one gains or losses are possible.
- Public stock:
  - Discounts only if trading is restricted.
  - Some public stock is not traded in an active market



# Valuation of early stage portfolio companies

- Transaction (entry) price may equal exit price and therefore represents fair value at initial recognition, unless: The transaction is with related parties, the transaction occurs under duress for either party or the transaction occurs outside the principal or most advantageous market
- *What can't we just keep the investment at cost? If you are burning cash and the company continues to be valued at the original purchase price then the valuation is increasing.*
- Investment narratives documenting actual performance and potential.
- Monitoring of budgets and milestones
- DCF need to be considered
- Questions to consider:
  - When the investment was initially made – how was the valuation determined?
  - If you were to sell the investment – how would you determine if an offer is acceptable?

# Best Practices – back office operations

- Accounting manual to document procedures
- Standardized forms and templates
  - Investments summary (cap table – other key investment issues)
  - Investment activity schedules
  - Cash management
  - Capital accounts and related computations including waterfalls, preferred return computations, income tracked by type on a cumulative and annual basis
  - Investor reporting, capital calls, distribution notices, quarterly reports.
  - Tax worksheets
  - Investment deal flow tracking
  - Portfolio company Investment monitoring

# Best Practices – back office operations

- Review procedures and checklists
  - Closing checklists with reviewer sign-offs
  - Audit preparation checklist
  - Due dates monitoring (tax, LP reporting, expense reports, portfolio company reporting, others)
- Portfolio company monitoring
  - Financial reporting
  - Insurance coverage
  - Board meetings
- Custody of assets
- Outsourcing (SAS 70 reports)