Financial Reporting Center

AICPA Investment Companies Expert Panel
May 7, 2024, meeting highlights

I. **Accounting/Reporting Issues:**

1. The EP continued its discussions from the March 2024 meeting on the newly expanded definition of "as part of a regular business" for dealers and government securities dealers under sections 3(a)(5) and 3(a)(44), respectively, of the Securities Exchange Act of 1934, following its joint call with the Stockbrokerage and Investment Banking Expert Panel. EP members noted that Section III. B.2.c. *Economic Analysis: Number of Affected Parties* of the release mentions a limited number of hedge funds may be affected; however, consistent with prior discussions, the applicability of the rules to hedge funds is a legal determination.

2. The EP discussed "Direct Access" loan investments which involve an upfront fee, sometimes referred to as a "GP Fee," that is charged as a percentage of the committed investment amount and is paid in full to the GP at the time of initial funding of the investment. The fee represents compensation to the GP for its ongoing duties in the administration of the credit facility, including providing information to the investor, such as regular value marks and financial reporting packages. The EP considered whether capitalization of the GP Fee would be appropriate, as the GP Fee is incurred in connection with closing a specific transaction, or whether other treatment would be appropriate, given the GP administers the loan.

The EP has previously discussed the accounting for transaction costs[1] and what constitutes "other charges that are part of the purchase transaction" in ASC 946-320-30-1[2]. In the September 2018 meeting, EP members noted that consideration should be given to whether these costs are direct and incremental to the investment due diligence process and/or if these costs would be incurred regardless of whether the transaction was executed or not. If such expenses were incurred solely to allow closing of the specific transaction, the expense should be included in the transaction price. However, if the expense would be incurred regardless of whether the transaction occurs, then the amounts should be expensed as incurred.

[1] The FASB ASC Master Glossary defines transaction costs as "the costs to sell an asset or transfer a liability in the principal (or most advantageous) market for the asset or liability that are directly attributable to the disposal of the asset or the transfer of the liability and meet both of the following criteria: (A) They result directly from and are essential to that transaction. (B) They would not have been incurred by the entity had the decision to sell the asset or transfer the liability not been made."

[2] ASC 946-320-30-1 states: "An investment company shall initially measure its investments in debt and equity securities at their transaction price. The transaction price shall include commissions and other charges that are part of the purchase transaction."

During the May 2024 meeting, the EP members noted that if the GP is not a lender but rather a facilitator for the loan, then the upfront payment may be to compensate the GP for services and may not be direct or incremental to completing the transaction. In such case, it would not be appropriate to capitalize the GP Fee, since the expense represents a fee for services, and therefore would be expensed as incurred. If the fee is for ongoing services to be performed, EP members noted it would be appropriate to record the upfront payment as a prepaid fee, which would be amortized over the life of the loan.

3. The EP discussed whether it is appropriate for investment companies to apply the provisions of ASC 310-20, which provides guidance on the application of the interest method including how prepayments and nonrefundable fees and costs should be treated in its application, given the scope of ASC 310-20 excludes nonrefundable fees and costs associated with acquiring or originating loans carried at fair value, with changes in fair value reported through earnings. Paragraph 34 from FAS 91 provides the basis for conclusions for excluding the application of the original guidance to loans that are carried at fair value:

"34. The Board concluded that this Statement should not apply to fees and costs and premiums or discounts associated with loans that are carried at market value, because carrying loans at market values obviates the need for accounting guidance for recognition of fees and costs and premiums or discounts associated with those loans."

EP members observed that, given lack of other guidance, it is common for investment companies to apply the provisions of ASC 310-20 by analogy as a method of calculating interest income, given interest income is presented as a separate line item on the statement of operations. Additionally, the EP discussed that ASC 946-320-35-20 requires investment companies to apply the interest method when amortizing premiums and discounts on securities.

The EP members agreed that although the guidance in FASB ASC 310-20, *Nonrefundable Fees and Other Costs*, does not apply to nonrefundable fees and costs associated with originating or acquiring loans that are carried at fair value, some investment companies apply that FASB ASC subtopic by analogy to recognize nonrefundable fees and costs as a yield adjustment over the life of the related investment when applying the interest method to reflect those fees and costs as part of the acquisition cost and income on the investment.

4. FASB ASC 230-10-15-4(c) exempts investment companies within the scope of FASB ASC 946 from the requirement to provide a statement of cash flows, provided that all the following conditions are met:

1. During the period, substantially all of the entity's investments were carried at fair value and classified in accordance with Topic 820 as Level 1 or Level 2 measurements or were measured using the practical expedient in paragraph 820-10-35-59 to determine their fair values and are redeemable in the near term at all times.
2. The entity had little or no debt, based on the average debt outstanding during the period, in relation to average total assets. For the purpose of determining average debt outstanding, obligations resulting from redemptions of shares by the entity from unsettled purchases of securities or similar assets, or from covered options written generally may be excluded. However, any extension of credit by the seller that is not in accordance with standard industry practices for redeeming shares or for settling purchases of investments shall be included in average debt outstanding.
3. The entity provides a statement of changes in net assets.

With respect to the first condition, EP members discussed how Securities Sold, Not Yet Purchased (i.e., short securities) are aggregated for purposes of the “substantially all” test.

Several EP members noted it is a reasonable accounting policy election to perform the “substantially all” test using the absolute fair values for the requisite investments in assets and liabilities (assuming Short Securities meet the test to be investments and not debt) versus netting investments in assets and liabilities. EP members noted that when the absolute fair values are used in this test, it should be applied to both the numerator and denominator in the calculation. EP members analogized this absolute value calculation methodology to the absolute value calculation done for derivative notional disclosures, where derivative asset or liability notional amounts are aggregated on an absolute value basis.

EP members noted that consistency of presentation of amounts within the financial statements may be an important qualitative consideration in making judgments on how to apply the “substantially all” test. Securities held long and securities sold short are presented separately within the statement of cash flows, which may support separate, absolute value calculations for long and short securities in determining whether the investments meet the “substantially all” criteria.

An EP member noted that it is important to remember that the “substantially all” test is a period test, and judgment may be involved in how investment averages are determined over a period (e.g., daily, monthly, quarterly, etc.) and how such averages should be considered at period end (e.g., how the average compares to the period end amounts in situations where the concentration of Level 3 assets has increased over the period).

5. The EP discussed access funds during the June 2013 meeting, at which time EP members noted that since the access fund is generally unaffiliated with the investee fund and could be audited by another auditor, the typical master-feeder presentation, which includes attaching the master fund’s financial statements to the feeder’s may not be practical. Given this, EP members had noted that fund-of-funds presentation could be appropriate, with full disclosure of the purpose of the access fund and details about the investee fund’s investment strategy, redemption terms, etc. Regardless of presentation used, the financial statements of the fund need to “stand on their own” and therefore, should contain sufficient information about the access fund’s investment into another fund, especially if the investee fund’s financial statements are not attached.

During the May 2024 EP meeting, the EP discussed reporting considerations for an access fund that has a June 30 fiscal year-end and invests in a single underlying fund that has a December 31 fiscal year-end, in which the access fund does not have permission to attach the underlying fund’s December 31 audited financial statements to its June 30 audited financial statements. In this fact pattern, the access fund uses the NAV practical expedient to value its investment in the underlying fund, which is an investment company that applies ASC 946. The access fund receives capital statements from the underlying fund’s administrator every month. On an annual basis, the access fund receives December 31 audited financial statements of the investee fund. The access fund does not receive any interim (semi-annual or quarterly financial statements) or other information that includes the investment holdings of the underlying fund.

EP members noted that if an access fund applies a fund-of-fund presentation, ASC 946-210-50-9 requires disclosure of the underlying fund’s investees if the access fund’s proportional share of any individual investee owned by the underlying fund exceeds 5 percent of the access fund’s net assets at the reporting date. These disclosures include the name and categories as discussed in ASC 946-210-50-6. ASC 946-210-50-10 requires that if information about the investee's portfolio is not available, that fact should be disclosed. An access fund should also consider additional disclosures to provide transparency over the investee. EP members noted that if the access fund applies the NAV practical expedient at June 30, it may not be appropriate to use the investment holdings information from the underlying fund's audited December 31 financial statements to satisfy the required look-through disclosure regarding the underlying fund's portfolio.

An EP member shared that in the FASB's 2012-2013 deliberations on Accounting Standards Update No. 2013-08, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*, the Board discussed that an investment company should disclose the following about its investments in another investment company (investee fund) whose fair values exceed 5 percent of the reporting investment company's net assets at the reporting date[3]:

1. A description of the investee fund (name and category) consistent with the requirements for the schedule of investments
2. The percentage of the reporting investment company's net assets invested in the investee fund
3. The total assets of the investee fund
4. The total debt outstanding of the investee fund
5. The net assets of the investee fund
6. The expense ratio of the investee fund
7. The proportionate ownership interest in the investee fund.

Further, the Board noted that the items which should be disclosed above should be as of the investee fund's most recently audited financial statements, including a disclosure of that date.[4] Though such disclosure requirements were not codified in the final ASU, the FASB noted transparency may be lacking when disclosures on the risks, obligations and expenses of an investee fund are not provided.[5] The EP member noted that these could be relevant factors to consider including in an access fund's financial statements.

The EP members agreed that for a material single investee fund held by an access fund that is so significant to the access fund, a best practice is for the access fund to have audited financial statements or financial information of the single investee fund as of the same date of the access fund's audited financial statements. One EP member noted this this would not be a substitute for the required fund of fund disclosures. If the access fund is applying fund of fund accounting and cannot attach the financial statements of the investee fund, it should use this information to provide transparent disclosures around the financial information of the investee fund in the access fund's audited financial statements . If the access fund is applying master-feeder accounting and cannot attach the financial statements of the investee fund, it should ensure that the access fund's financial statements contain all the necessary disclosures to allow it to stand on its own.

6. In connection with recently launched digital assets ETFs, the EP members discussed considerations for determining the "principal market" for valuing crypto assets in accordance with ASC 820. The EP members also discussed disclosure matters when US GAAP prices differ from the prices used to calculate transaction NAVs based on differences between the valuation methods used to value crypto assets included in the ETF's registration statement and valuation methods that comply with US GAAP.

EP members noted that the AICPA Practice Aid "Accounting for and auditing of digital assets" Q&A #16 offers useful guidance on how to determine the principal market for crypto assets. An excerpt from this Q&A states:

"The determination of the principal market should be based on the market with the greatest volume and

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[3] See FASB August 29, 2012 "Investment Companies" minutes at https://www.fasb.org/page/ShowPdf?path=INVCO-bmmin-20120829.pdf&title=Investment

[4] See FASB January 23, 2013 "Investment Companies" minutes at https://www.fasb.org/page/ShowPdf?path=1-23-13+Board+meeting+minutes+INVCO+FINAL.pdf&title=Investment

[5] See ASU No. 2013-08, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements*, basis of conclusions paragraph 65.

level of activity that the reporting entity can access and not on the entity's own level of activity in a particular market. In that regard, it is important for an entity to assess whether there are any regulatory or other restrictions that prevent it from accessing a particular market.

When identifying the principal market — or in the absence of a principal market, the most advantageous market — an entity is not required to undertake an exhaustive search of all possible markets for the asset, but it should consider all information that is reasonably available. In accordance with FASB ASC 820-10-35-5A, the market in which an entity normally transacts for the crypto asset is presumed to be the principal market, unless contrary evidence exists."

EP members noted that in cases where a US GAAP ASC 820-determined NAV for a crypto asset ETF differs from a transaction NAV determined based on the valuation methods stated in the registration statement due to crypto asset pricing differences, such differences could be disclosed to investors in the fund's registration statement and differences between the methods could also be disclosed within the fund's financial statements.

II. Audit and Attest

1. The EP discussed whether an audit would be required under the SEC custody rule in a scenario in which a nonregistered unitized fund in liquidation has no remaining units or assets except for one sanctioned security which cannot be transferred or sold by the fund until an undetermined future date when the sanction is lifted. The sanctioned security has been deemed to be worthless by the valuation committee. The fund has ceased operations/tracking by the administrator, but the custodian is paid a small monthly fee by the trustee of the fund.

EP members agreed that whether audits would still be required for the entity under the SEC custody rule is a legal and compliance matter.

III. SEC Staff Update

Disclaimer

The following comments and observations were compiled by the AICPA Investment Companies Expert Panel and AICPA staff and are not authoritative positions or interpretations issued by the SEC or its staff. The comments and observations were not transcribed by the SEC or its staff and have not been considered or acted upon by the SEC or its staff. Accordingly, these comments and observations do not constitute a statement of the views of the SEC or its staff.

1. The SEC staff announced that the second annual Conference on Emerging Trends in Asset Management will take place on May 16; in-person and virtual participation are available.

2. Recent rulemaking and other related matters:
    a. As a result of the U.S. Court of Appeals for the Fifth Circuit vacating the Share Repurchase Disclosure Modernization rule, the disclosure requirements revert to those in effect prior to the rule's effective date. Therefore, the Code of Federal Regulations was revised to reflect the court's vacatur of the rule.
    b. The Exemption for Certain Investment Advisers Operating Through the Internet rule makes amendments under the Investment Advisers Act of 1940 to exempt certain investment advisers that provide advisory services through the internet from the prohibition on Commission registration. Further, Chair Gensler mentioned in his statement regarding the adoption of the rule that a 2021 risk alert highlighted that almost half of the examined advisers that availed themselves of this exemption did not qualify for it. Current

amendments intend to narrow the exemption from the prohibition on registration for the advisers that qualify.

c. The [Fall 2023 Regulatory Flexibility Agenda] includes many projects that may be of interest to investment companies, registered investment advisers and their auditors.

d. On April 8, 2024, the Investment Company Institute (ICI) and ICI Southwest submitted a supplemental joint [comment letter] to the SEC on the proposed [Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices rule], in light of the recent adoption and subsequent stay of [The Enhancement and Standardization of Climate-Related Disclosures for Investors rule] for public companies.

3. Recent speeches:

a. ["U.S. Capital Markets and the Public Good" Prepared Remarks before SEC Speaks] – Chair Gary Gensler, April 2, 2024

b. [At the SEC: Nothing but Crickets Remarks at SEC Speaks] – Commissioner Hester M. Peirce, April 2, 2024

c. [Remarks at SEC Speaks 2024 – Director Gurbir S. Grewal, Division of Enforcement, April 3, 2024]

4. The SEC staff observed that certain private funds which received modified audit opinions have taken the position that their audited financial statements satisfy the custody rule. The SEC staff noted that the custody rule requires that audited financial statements must be prepared in accordance with US GAAP. Therefore, a modified opinion (i.e., qualified opinion, adverse opinion, or disclaimer of opinion) would not meet the requirements set forth in the rule. If there are questions on whether audited financial statements would satisfy the audit exception of the custody rule, the SEC staff encourages advisers to consult with the staff.

5. Financial statement review comments and reminders:

a. The SEC staff observed that certain funds with outstanding borrowings included disclosures in the notes to their financial statements indicating that the lender has a lien over eligible securities. However, the funds did not identify which securities in their portfolios were subject to a lien by the lender, which is required by Rule 4-08(b) of Regulation S-X. Rule 4-08(b) states that assets mortgaged, pledged, or otherwise subject to lien, and the approximate amounts thereof, shall be designated and the obligations collateralized briefly identified.

b. The SEC staff has issued comments to registrants when a fund has investments in securities in foreign jurisdictions subject to foreign currency controls, but does not include a policy in the footnotes regarding the translation of the foreign currency into USD. To the extent that there are questions on this topic, the SEC staff encourages registrants to consult with the staff.

c. The SEC staff has issued comments to registrants when a fund invests in a money market fund and fails to disclose the money market fund yield on its schedule of investments. The staff noted that these disclosures are comparable to those required by Rule 12-12 of Regulation S-X and Rule 480 under the Securities Act of 1933 (1933 Act). The staff reminded the EP that Rule 12-12 – "Investments in securities of unaffiliated issuers" – requires the name of issuer and title of issue to be listed separately on the schedule of investments. Additionally, Rule 480 – "Title of securities" – states:

> If a registration statement is prepared on a form available solely to investment companies registered under the Investment Company Act of 1940, or a business development company which is selling or proposing to sell its securities pursuant to a

registration statement which has been filed under the Act, wherever the title of securities is required to be stated there shall be given such information as will indicate the type and general character of the securities, including the following:

(a) In the case of shares, the par or stated value, if any; the rate of dividends, if fixed, and whether cumulative or non-cumulative; a brief indication of the preference, if any; and, if convertible, a statement to that effect.

(b) In the case of funded debt, the rate of interest; the date of maturity, or, if the issue matures serially, a brief indication of the serial maturities, such as "maturing serially from 1950 to 1960"; if the payment of principal or interest is contingent, an appropriate indication of such contingency; a brief indication of the priority of the issue; and, if convertible, a statement to that effect.

(c) In the case of any other kind of security, appropriate information of comparable character.

d. The SEC staff noted that certain BDCs have not disclosed accrued noncash payment-in-kind (PIK) income separately and instead aggregated it within another line item in the statement of cash flows. The SEC staff reminded the EP that BDCs should disclose the accrued PIK income as a separate line item in the statement of cash flows.

e. The SEC staff noted that seed financial statements are required when registering under the 1933 Act. The SEC staff noted that Item 26 of Schedule A under the 1933 Act, which requires a profit and loss statement for multiple fiscal years, uses the phrase "year by year" which indicates a fiscal year cannot exceed 12 months. In addition, ASC 210-10-45-3 references a one-year time period when segregating current assets provided the operating cycle does not exceed 12 months. Also, Rule 3-06 of Regulation S-X indicates that where there is a requirement for filing financial statements for a time period exceeding one year but not exceeding three consecutive years, not more than 12 months should be included in any period reported upon. If more than 12 months are presented, the SEC staff will comment that financial statement presentation must align with the requirements of both the 1933 Act and Regulation S-X.

f. The SEC staff noted that when financial statements containing certifications are amended, the certifications need to be updated for the date of amendments each time financial statements are amended. If financial statements are amended multiple times, the certification dates would need to be updated each time financial statements are amended.

g. The SEC staff shared that growth in technology has enabled the Division of IM to review registrants' filings and identify certain issues related to certifications, including instances where (1) the date of the certification preceded the audit opinion date and (2) the certification was for Form 10-Q whereas it was supposed to be for Form 10-K. The staff noted that a filing with a missing certification will require refiling, and certifications must be signed by the Principal Executive Officer or the Principal Financial Officer.

h. The SEC staff highlighted the following material weaknesses identified since the last meeting:

    1. A registrant did not design proper controls around valuation and disclosures under US GAAP and concluded that a material weakness existed. In this scenario, it was identified that an investment valuation required adjustment as of the balance sheet date due to information that was available to the registrant

at the balance sheet date. The SEC staff noted that when an error results in an adjustment to the fair value of an investment, generally this would require a registrant to perform a NAV error analysis from the date the error was known or knowable and the registrant's NAV error correction policy should be applied from that date as well. After the SEC staff inquired with the registrant regarding the application of its NAV error policy, the registrant performed a NAV error analysis related to the error.

2. The SEC staff shared that a registrant presented a "little r" restatement related to tax footnote disclosures (i.e., a correction in the current year's financial statements of an immaterial misstatement in a prior year's financial statements). The entity did not meet the requirements to be treated as a RIC under subchapter M of the Internal Revenue Code during the prior year even though it had intended to be a RIC and presented the required RIC tax disclosures. Prior periods were restated because the fund determined it was a C corporation and not a RIC under subchapter M. After discussions with the SEC staff, the registrant ultimately concluded it had a material weakness in internal control over financial reporting and determined that a restatement of previously issued financial statements was appropriate. The SEC staff reminded the EP that registrants should consider reaching out to the staff when they have these scenarios to discuss their conclusions on whether the prior year's financial statements need to be restated.

6. Exams:

a. Risk Alert: Shortening the Securities Transaction Settlement Cycle, March 27, 2024
b. Risk Alert: Initial Observations Regarding Advisers Act Marketing Rule Compliance, April 17, 2024

7. Enforcement:

a. The SEC charged two investment advisers for making false and misleading statements about their purported use of artificial intelligence.
b. The SEC charged a registered investment adviser for widespread and longstanding failures to maintain and preserve certain electronic communications and with failing to enforce its code of ethics.
c. The SEC charged five registered investment advisers for Marketing Rule violations.
d. The SEC charged a registered investment adviser for violations of the Commission's "pay-to-play" rule. Commissioner Hester M. Peirce's statement of dissent is available here.
e. The SEC charged an accounting firm and its owner for systemic failures to comply with Public Company Accounting Oversight Board (PCAOB) standards in its audits and reviews incorporated in more than 1,500 SEC filings from January 2021 through June 2023.