



# Hot Topic: Coronavirus

## Potential accounting and reporting impacts for investment funds

July 9, 2020



### KPMG highlights potential accounting and reporting implications for investment funds as a result of COVID-19.



#### Background

This Hot Topic discusses some of the potential accounting and reporting impacts that operational, financial and regulatory challenges resulting from COVID-19 may have on investment funds, including:

- repurchases of debt securities and preferred shares;
- defaulted capital commitments;
- payments by affiliates for reimbursements of investment losses;
- financial support arrangements; and
- SEC regulatory relief.



#### Repurchases of debt securities and preferred shares

In light of the current market conditions, certain investment funds may consider repurchasing their public debt at values below their redemption amounts. In particular, some closed-end management investment companies and business development companies (BDCs) may be motivated to repurchase their own debt securities and preferred shares to maintain their asset coverage requirements for senior securities under Section 18 or Section 61 of the Investment Company Act of 1940 (Investment Company Act). These repurchases may include (1) securities, which are in legal form preferred shares, but are classified as debt under Topic 480 when the preferred shares contain mandatory redemption requirements, and (2) preferred shares classified as temporary equity (when redemption is outside the control of the investment fund) or permanent equity. [480-10-25-4, 480-10-S99-3A(4)]

#### Debt securities

The reacquisition of an investment fund's own outstanding debt securities (including preferred shares that are classified as debt under Topic 480) results in an extinguishment of debt, whether the securities are cancelled or held as treasury bonds (i.e. bonds repurchased that are not legally retired and therefore may be subsequently reissued). Under Subtopic 405-20, when an investment fund is released from its obligation debt extinguishment accounting applies, and a gain or loss is recognized

for the difference between the amount paid to repurchase the debt and the carrying amount of the debt (including unamortized premiums, discounts, or issuance costs related to the debt issuance). [405-20-40-1, 470-50-40-2]

When an investment fund's own debt securities are reacquired in the open market, the extinguishment of debt is generally recorded on the delivery of cash (i.e. settlement date). We believe the timing of the extinguishment is a legal determination that may not be consistent with the trade date convention for recognizing purchases of securities in connection with investing activities. However, we do not believe it is appropriate to record the acquisition of an investment fund's own debt securities as an investment prior to extinguishment. [405-20-40-1]

We believe investment funds should classify gains or losses from extinguishment of debt as a separate line item apart from net investment income and net realized and unrealized gains (losses) from investments in the statement of operations and the financial highlights disclosures.

## Redeemable preferred shares

On the reacquisition of an investment fund's own redeemable preferred shares classified in equity, the difference between the amount paid to reacquire the preferred shares and the carrying amount of the preferred shares should be recorded as an adjustment to the distributable earnings of the investment fund. For investment funds that report earnings per share (such as BDCs and commodity ETFs), the difference between the reacquisition amount and the carrying amount should also be recorded as an adjustment to the net increase in net assets resulting from operations available to common shareholders in the calculation of earnings per share. [260-10-S99-2]

## Defaulted capital commitments

Private equity and venture capital funds typically obtain capital commitments from investors and periodically call capital under those commitments as needed to make investments or to pay operating expenses. Topic 505 states that receivables for issuances of equity should not be recorded as an asset and should be recorded as a deduction from equity, except in very limited circumstances in which there is substantial evidence of ability and intent to pay within a reasonably short period of time. We believe that similar treatment as a deduction from equity also applies to capital call receivables. [505-10-45-2]

When market conditions decline, there may be increased instances of investors defaulting on their capital commitments. An investment fund's legal documents typically include contractual remedies when an investor is in default of its capital commitments. Examples of contractual remedies available to the investment fund may include:

- facilitating a secondary market sale of the defaulting investor's existing capital account to other investors or a third-party;
- charging interest on the defaulted capital call;
- withholding future distributions to cover unpaid commitments;
- forfeiting a portion or all of the capital account of the defaulting investor; and
- accelerating payment of the investor's remaining capital commitment.

Typically, forfeitures of the defaulting investor's capital account under enforced contractual remedies are reallocated to the other investors of the investment fund in proportion to their capital commitments in accordance with the governing documents of the investment fund. When the investment fund's governing documents state that the forfeiture of the defaulting investor's capital account results in a transfer of equity interests between the defaulting investor to the other investors, the forfeiture of capital should be recorded as a capital redemption from the defaulting investor with a corresponding

capital contribution to the other investors rather than as income to the investment fund. Similarly, when the governing documents state that interest received for defaulted capital calls reduces the outstanding capital call amount, the receipt of such interest should be recorded as a capital contribution to the defaulting investor's capital account rather than interest income. A secondary market sale by the defaulting investor of its investment is a transaction between investors and therefore is not a recognized transaction to the investment fund. [\[505-10-25-2\]](#)

We believe that legal fees and other expenses incurred to resolve defaulted capital commitments should be recorded as an expense rather than as a charge against equity because such costs are not analogous to an offering of equity interests.



## Payments by affiliates for reimbursements of investment losses

During volatile market conditions, an affiliate (typically an investment adviser, a trustee, or a sponsor of an investment fund) may voluntarily compensate an investment fund for losses incurred on certain of its portfolio investments. Payments by affiliates may be in the form of a cash contribution to the investment fund or a purchase of securities from the investment fund in excess of their current fair values.

Subtopic 946-20 specifically discusses circumstances where an affiliate may make payments to reimburse an investment fund related to investment losses for either of the following reasons:

- losses from a portfolio investment resulting from events outside the control of the investment fund or its affiliate (such as a sudden default by an issuer); or
- losses from a portfolio investment that violated the investment guidelines of the investment fund (such as investment guideline violations resulting from style drift). [\[946-20-05-2\]](#)

Because the payments by affiliates for those two reasons are ordinarily made to preserve the affiliate's service relationship with the investment fund, Subtopic 946-20 states that such payments are reported as a separate line item in the statement of operations as part of the net realized and unrealized gains (losses) from investments and foreign currency. [\[946-20-45-1, AAG-INV 7.139-7.140\]](#)

An investment fund may receive other payments by affiliates for reasons other than those described in Subtopic 946-20. The classification of other types of payments by affiliates in the statement of operations or the statement of changes in net assets (i.e. as a capital transaction) requires a careful evaluation, which includes consideration of the reasons for the payment and the nature of the relationship of the affiliate to the investment fund. When the reason for the payment and the nature of the relationship indicates that the payment benefits the affiliate's shareholder relationship with the investment fund by enhancing or maintaining the value of the its investment, such payments are in substance a capital contribution to the investment fund. [\[AAG-INV 7.139 and 7.143, SAB Topic 5T\]](#)

Regardless of the classification of payments by affiliates, the amounts and the circumstances for the payments should be disclosed in the notes to the financial statements. In addition, the impact of such payments to the investment fund's total return should be presented in the financial highlights disclosures in a manner similar to the disclosure of voluntary waivers of fees and expenses on expense ratios. [\[946-20-50-2\]](#)



## Financial support arrangements

During times of economic uncertainty, there may be increasing motivations for an investment fund to provide financial support to its investees. Some investment funds provide financial support to investees, either because of contractual obligations negotiated as part of the acquisition of the investment, or for the objective to enhance or preserve the value of the investment. An investment fund may provide various forms of financial support (such as loans, capital commitments or guarantees) directly to an investee, or an investment fund may assist an investee with obtaining financial support.

Under Topic 946, an investment fund is permitted to provide financial support to an investee without jeopardizing its status as an investment company if the financial support is provided for the purpose of maximizing returns from capital appreciation, investment income, or both, and does not represent a separate substantial business activity or separate substantial source of income for the investment fund. An entity is precluded from being an investment company if the entity (or its affiliates) obtains 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. Therefore, an investment fund should consider whether a financial support arrangement with an investee provides any substantial returns or benefits that are not consistent with the business purpose and objectives of an investment company. For example, if financial support is provided to an investee in exchange for a service fee (such as a loan origination fee) that represents a separate substantial source of income to the investment fund, such service fee provides the investment fund with returns or benefits that are not normally attributable to ownership interests that are from sources other than capital appreciation or investment income, and therefore would result in the investment fund no longer being an investment company. [\[946-10-55-8, 55-10\]](#)

The classification of payments for financial support provided to an investee depends on whether the financial support results in the acquisition of additional securities or represents a capital infusion related to an existing investment. Payments that result in the acquisition of additional securities should be recognized as the cost basis for those additional investments. *Capital infusions*, which are expenditures made directly to an investee to ensure the completion of the investee's operations and to enhance or preserve the fair value of the investment fund's investment in the investee, should be recorded as an addition to the cost basis of the existing investment. [\[946-320-20, 946-320-35-14\]](#)

An investment fund may incur expenditures in connection with providing financial support to investees. These may include *workout expenditures*, which are professional fees (such as legal, accounting and appraisal fees) paid to unaffiliated entities in connection with:

- capital infusions;
- restructurings or plans of reorganization;
- ongoing efforts to protect or enhance an investment; or
- pursuit of other claims or legal actions. [\[946-320-20\]](#)

Under Topic 946, workout expenditures incurred to negotiate the terms and requirements of capital infusions or in connection with the restructuring of, or a plan of reorganization for, an investment should be recorded as realized losses. Other ongoing expenditures to protect or enhance an investment or to pursue other claims or legal actions should be recorded as operating expenses. [\[946-320-35-15, 35-16\]](#)

## SEC regulatory relief

The SEC has issued several orders and guidance providing temporary relief to registered investment companies and BDCs affected by COVID-19. KPMG Hot Topics, [SEC extends regulatory relief for companies impacted by coronavirus](#) and [SEC issues update on COVID-19 regulatory relief](#), provide additional information on the SEC's relief orders and other reporting considerations related to the COVID-19 outbreak.

In addition, the staff of the SEC's Division of Investment Management has prepared responses to questions about investment funds and advisers affected by COVID-19, which can be found [here](#).

### Temporary relief for BDCs

On April 8, 2020, the SEC issued an [order](#) providing additional flexibility for BDCs to issue and sell senior securities and participate in certain joint enterprises or joint arrangements that would otherwise be prohibited by the Investment Company Act and its promulgated rules<sup>1</sup>. Subject to certain conditions in the order, the following temporary relief is provided.

- Prior to the issuance or sale of a covered senior security, a BDC may rely on a new asset-coverage test (Adjusted Asset Coverage Ratio) using portfolio values calculated as of December 31, 2019 for investments the BDC continues to hold as of the measurement date<sup>2</sup> (Adjusted Portfolio Value). The Adjusted Asset Coverage Ratio is calculated by reducing the asset coverage ratio calculated using the Adjusted Portfolio Value by 25% of the difference between (1) the asset coverage ratio calculated using the Adjusted Portfolio Value, and (2) the asset coverage ratio calculated in accordance with Section 18(d) of the Investment Company Act as of the measurement date.
- A BDC operating under an existing order permitting it to enter into co-investment transactions in portfolio companies with certain affiliated persons may participate in follow-on investments with one or more Regulated Funds and/or Affiliated Funds (as defined in the BDC's existing co-investment order).

This temporary relief is available until the earlier of December 31, 2020 or the date by which the BDC ceases to rely on the order.

### Custody rule requirements

The staff of the SEC's Division of Investment Management (the Division) issued several new and updated [FAQs](#) on the requirements under Rule 206(4)-2 of the Investment Advisers Act of 1940 (the Custody Rule) for investment advisers affected by COVID-19 addressing the following topics.

- **Inadvertent receipt of client securities when an adviser's personnel may be unable to access mail or deliveries:** In such circumstances, the Division would not consider the adviser to have received client assets at that office location until the adviser's personnel are able to access the mail or deliveries at that office location.
- **Compliance when a pooled investment vehicle is unable to distribute its audited financial statements by the applicable deadline due to certain unforeseeable circumstances:** The Division would not recommend enforcement action against an adviser that is relying on the audit provision and that reasonably believed that the pool's audited financial statements would be

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<sup>1</sup> Investment Company Act Release No. 33837 (April 8, 2020)

<sup>2</sup> Values of portfolio company investments that have become permanently impaired subsequent to December 31, 2019 are excluded from the Adjusted Asset Coverage Ratio

- distributed within the applicable deadlines, but failed to have them distributed in time under certain unforeseeable circumstances.
- **Inability to complete surprise examinations:** The Division would not recommend enforcement action against an adviser that reasonably believed that its independent public accountant would complete its examination and submit Form ADV-E to file its certificate of accounting by the 120-day deadline, but failed to do so due to logistical disruptions resulting from COVID-19, as long as the independent public accountant files such report as soon as practicable, but not later than 45 days after the original due date.
- **Custody of certain privately issued securities that are evidenced by physical certificates:** The Division would not recommend enforcement action if an adviser does not maintain the certificates with a qualified custodian for the duration of closures of qualified custodians due to COVID-19 and until such time as physical certificates can reasonably be placed with a qualified custodian, or similar securities can reasonably be issued using an approach that complies with the privately offered securities exception, provided certain other conditions are met.

## Evolving information

The potential global and economic impacts of the coronavirus continue to evolve rapidly, and companies should monitor the situation. Investment funds are encouraged to maintain close communications with their board of directors, external auditors, legal counsel and other service providers as the circumstances progress. Stay informed at [read.kpmg.us/coronavirus](https://read.kpmg.us/coronavirus)

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