Investment companies

Handbook

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Contents

Navigating investment company accounting

From private hedge funds to mutual funds, investment companies come in many different forms. While all investment companies have certain fundamental characteristics like seeking returns through capital appreciation or investment income, the structure and portfolio of each investment company is often unique and can be quite complex.

Investment company accounting involves navigating the intersection of the industry-specific guidance of ASC Topic 946, other applicable US GAAP and various guidance from regulatory authorities and professional associations. Additional complexity is introduced when some, but not all, of that guidance applies to your investment company.

This Handbook provides a roadmap to understand the relevant guidance, explaining when and how to apply that guidance to each type of investment fund. It provides an in-depth look at the broad and often complex issues related to the scope, classification, measurement, presentation and disclosure for investment companies. Further, it includes examples demonstrating how the standards apply to common scenarios faced by the asset management industry.

We hope you will find this Handbook to be a useful tool in applying investment company accounting.

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About this publication

The purpose of this Handbook is to assist you in accounting for investment companies in the scope of *ASC 946, Financial Services – Investment Companies*.

Organization of the text

Each chapter of this Handbook includes excerpts from the FASB's Accounting Standards Codification® and overviews of the relevant requirements. Our in-depth guidance is explained through Q&As that reflect the questions we encounter in practice. We include examples to explain key concepts.

Our commentary is referenced to the Codification and to other literature, where applicable. The following are examples:

- 946-320-35-1 is paragraph 35-1 of ASC Subtopic 946-320
- ASU 2013-08.BC13 is paragraph BC13 in the basis for conclusions of FASB Accounting Standards Update (ASU) No. 2013-08
- FAS 102.20 is paragraph 20 of FASB Statement No. 102
- TRG 11-18.14 is agenda paper No. 14 from the meeting of the FASB's Transition Resource Group for Credit Losses (TRG) held in November 2018
- CON 8.PR20 is paragraph PR20 of FASB Concepts Statement No. 8, Conceptual Framework for Financial Reporting, chapter 7, Presentation
- S-X Rule 6-03(g) is Rule 6-03(g) of SEC Regulation S-X
- SEC Rel 33-10231 sec II.C.6 is section II.C.6 of SEC Release No. 33-10231, Investment Company Reporting Modernization
- SAB Topic 5.T is SEC Staff Accounting Bulletin Topic 5.T
- Form N-1/A Item 13(a) (Instruction 2(b)) is Instruction 2(b) to Item 13(a) of SEC Form N-1/A
- FRR 404.03.a is paragraph 03.a in section 404 of the SEC Financial Reporting Releases
- IM-DCFO 2020-03 is staff position 2020-03 of the SEC's Division of Investment Management Accounting Matters Bibliography
- ICRM FAQ S-X 2 is Regulation S-X Question 2 of the SEC Division of Investment Management Investment Company Reporting Modernization Frequently Asked Questions
- 1940 Act §2(36) is section 2(36) of the Investment Company Act of 1940
- Advisers Act §202(a)(29) is section 202(a)(29) of the Investment Advisers Act of 1940
- CFR 270.18f-3 is Rule 18f-3 of the 1940 Act
- AAG-INV, 7.11 is paragraph 11 of chapter 7 of the AICPA's Audit and Accounting Guide, Investment Companies (Updated as of August 1, 2024)

- TQA 6910.36 is section 6910.36 of the AICPA's Technical Questions and Answers
- AICPA IC EP 2/2018 is the February 2018 meeting of the AICPA Investment Companies Expert Panel
- SOP 95-2.22 is paragraph 22 of AICPA Statement of Position (SOP) 95-2.
- APB 10 (n8) is footnote 8 to APB Opinion No. 10
- AVG-PCI 12.02 is paragraph 2 of chapter 12 of the AICPA's Accounting and Valuation Guide, Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies

Pending content

This edition of our Handbook incorporates amendments to Topic 946 from ASU 2024-02, Codification Improvements—Amendments to Remove References to the Concepts Statements. However, the Codification excerpts containing the amendments from this ASU are reproduced as if the pending content were currently effective for all entities – i.e. the amendments are not labeled as pending content.

Abbreviations

We use the following abbreviations in this Handbook:

1940 Act	Investment Company Act of 1940
Advisers Act	Investment Advisers Act of 1940
ADR	American depositary receipt
AICPA	American Institute of Certified Public Accountants
AOCI	Accumulated other comprehensive income
BDC	Business development company
CDO	Collateralized debt obligations
CDSL	Contingent-deferred sales load
CLO	Collateralized loan obligations
FIFO	First in-first out
GDR	Global depositary receipt
GP	General partner
IRC	Internal Revenue Code
IRR	Internal rate of return
LIFO	Last in-first out
MLP	Master limited partnership
NAV	Net asset value

PIK	Payment-in-kind
OCI	Other comprehensive income
REIT	Real estate investment trust
RIC	Registered investment company
TBA	To-be-announced
USD	US dollars
VIE	Variable interest entity
VOE	Voting interest entity

1. Executive summary

This Handbook discusses the specialized accounting and financial reporting requirements for investment companies that are in the scope of Topic 946. It focuses on the requirements in Topic 946 and Article 6 of Reg S-X. However, other Codification Topics not specific to investment companies also apply but are discussed in other KPMG Handbooks.

Objective and scope

Topic 946 provides incremental industry-specific guidance for investment companies in its scope. To be in the scope, an entity must satisfy either of the following criteria:

- be an entity regulated under the Investment Company Act of 1940 (1940 Act); or
- have the characteristics of an investment company.

The second criterion requires an evaluation of two sets of characteristics.

Fundamental characteristics ALL must be met to be considered an investment company.	• Entity obtains funds from one or more investors and provides the investor(s) with investment management services. • Entity commits to its investor(s) that its business purpose and only substantive activities are investing funds solely for returns from capital appreciation, investment income, or both. • Entity does not obtain or have the objective of obtaining returns or benefits from an investee (or its affiliates) that are not normally attributable to ownership interests or that are other than capital appreciation or investment income (this also applies to an entity's affiliates).
Typical characteristics The absence of one or more does not necessarily preclude being considered an investment company.	• Entity has more than one investment. • Entity has more than one investor. • Entity has investors that are not related parties of its parent (if it has a parent) or its investment manager. • Entity's ownership interests are in the form of equity or partnership interests. • Entity manages substantially all of its investments on a fair value basis.

Read more: Chapter 2

Investments

An investment company's portfolio of investments generally comprises the majority of the company's net assets. Such investments are acquired to achieve the investment objectives of providing returns to investors in the form of investment income and/or capital appreciation. Because of the importance of the values of these investments to investors, investment companies measure their investments at fair value in their financial statements.

Topic 946 contains specialized guidance that investment companies use to recognize, measure and derecognize investments, and to account for investment income. The following table explains how the guidance in Topic 946 is structured based on two broad categories of investments.

Debt and equity securities	Subtopic 946-320 provides guidance on accounting for investments in debt and equity securities, including accounting for related interest and dividend income from investments in such securities.
'Other' investments	Subtopic 946-325 provides guidance on accounting for other investments, which include other asset classes such as loan receivables, derivative instruments, real estate properties, physical commodities and digital assets.

Recognition and measurement

Investment companies typically measure investments initially at the transaction price and subsequently at fair value. When they recognize investments depends on the transaction type.

Transaction type	Recognition date
Conventional channels (i.e. regular-way transactions)	Trade date, which is the date the investment company agrees to purchase or sell the security.
Securities that have not yet been identified or do not yet exist (e.g. TBA securities, when-issued securities)	The date the investment company enters into a commitment to purchase the security or when the commitment has been fixed.
Outside of conventional channels (e.g. private placements, tender offers)	The date the investment company obtains a right to demand the securities purchased (or to collect the proceeds of a sale) and incurs an obligation to pay the price of the securities purchased (or to deliver the securities sold).

Other issues

Other issues investment companies face concerning their investments include how to account for interest and dividends, as well as whether and when to derecognize their investments. Each of these areas has its unique issues, as does accounting for foreign investments.

Read more: Chapter 3

Capital transactions

The principal activities of an investment company include selling its ownership interests to investors. The guidance for capital transactions in Topic 946 considers the specific needs of investors who generally focus on an investment company's NAV. The intention of Topic 946 is to provide investors with a reasonable approximation of the fair value of the net assets of the investment company.

An investment company's accounting and financial reporting for capital transactions differs from that followed by many non-investment companies in several key respects. These differences generally relate to the timing of transactions, accounting for the costs of raising capital and disclosures.

Area	Primary implication of Topic 946
Capital share subscriptions and redemptions	Transactions are recognized at fair value on the trade date (or effective date).
Class of shares	NAVs are determined for each class of shares.
Dividends to investors	Dividends are recognized on the ex-dividend date with tax basis disclosures.
Components of capital	Components of capital are determined on a tax basis.
Offering costs	Certain offering costs are recognized as a deferred charge and amortized to expense.
Distribution costs	Certain distribution costs are recognized as an accrued expense.

Read more: Chapter 4

Investment adviser transactions

Rather than hire employees, investment companies typically engage investment advisers through investment advisory agreements to provide services necessary for their operations. Such services generally include investment management and administrative services. The investment adviser may also use other parties to provide some of these services.

Investment advisers typically charge a management fee or a performance fee.

Management fees	Performance fees
Typically calculated as a percentage of net assets, capital commitments or invested capital at rates set by contractual agreements	Earned based on the performance of the assets under management; may include a normal fee plus a bonus (or less a penalty) if the performance exceeds (or fails to exceed) a preestablished benchmark (e.g. a hurdle rate)

Topic 946 provides guidance on the typical features of such fees.

Feature	Accounting
Loss carryforwards	Loss carryforwards reduce future performance fees for the impact of losses in the current or prior periods. However, an investment company does not recognize an asset for a loss carryforward.
Fee waivers	Fee waivers are arrangements in which the investment adviser (or other service provider) either waives fees owed by the investment company or reimburses other expenses

Feature	Accounting
	of the investment company. They are presented as a reduction of total expenses and their terms are disclosed.
Expense limitation agreements	Expense limitation agreements limit the expenses that can be paid by the investment company. Costs incurred in excess of an expense limitation agreement are carried over to a future period and reimbursed to the investment adviser to the extent that the total expense ratio falls below the permitted maximum. If specified criteria are met, an investment company recognizes a liability for the costs that are carried over.
Expense offset arrangements	Under an expense offset arrangement an investment adviser (or other third party) reduces its fees by a specified or readily ascertainable amount for services provided to the investment company in exchange for use of the investment company's assets. The amount that would have been incurred had the expenses been paid directly in an arm's-length transaction is reflected in the relevant expense caption, with a corresponding reduction in total expenses (e.g. 'fees paid indirectly').

Related party issues

The investment adviser is generally a related party to the investment company and may also be an equity owner of the investment company. Given the unique relationship between an investment company and its investment adviser (including its affiliates), Topic 946 includes specific guidance on how to account for certain transactions between the two parties, such as payments by the investment adviser to the investment company related to investment losses.

We believe the goal of this guidance is to increase comparability of investment company financial statements and to provide transparency about the relationship between the two parties, enabling users of the financial statements to make informed investment decisions.

Read more: Chapter 5

Financial statements: general requirements

Subtopic 946-205 addresses the overall financial statement presentation requirements for investment companies. It provides more detailed requirements specific to investment companies that modify what comprises a full set of financial statements, including financial highlights. The Subtopic also specifies the reporting periods for each of those statements.

There are also specific presentation rules for registered investment companies in SEC Reg S-X.

The following table summarizes the required financial statements, the purpose of each of those statements, and the periods required to be presented for each of those statements when presenting annual financial statements.

Financial statement	Objective	Periods required
Reporting financial position		
Statement of assets and liabilities or **Statement of net assets**	Reports an investment company's financial position as of the reporting date	As of the end of the most recent fiscal year
Schedule of investments	Presents information about an investment company's investment portfolio as of the reporting date	For each statement of assets and liabilities presented
Reporting results of operations		
Statement of operations	Presents the results of the investment company's operating and investment activities including investment income from interest and dividends, expenses, and realized and unrealized gains or losses from investments	For the most recent fiscal year
Financial highlights	Provides information to help understand an investment company's financial performance during the period(s) presented	For the latest five fiscal years (only the most recent fiscal year for nonregistered funds)
Other reporting		
Statement of cash flows	Provides relevant information about the cash inflows and outflows of an investment company during the period	For the most recent fiscal year
Statement of changes in net assets	Summarizes results from operations, dividends and distributions to shareholders, capital share transactions, and capital contributions during the period	For the two most recent fiscal years (only the most recent fiscal year for nonregistered funds)

Read more: Chapter 6

Financial position

The reporting of financial position provides information about an investment company's economic resources and the claims against them. Information about assets, liabilities and equity, and their relationships to one another as of the reporting date, helps users to assess the investment company's liquidity, financial flexibility, net resources available, capability of generating future net cash flows, exposure to risk, and ability to meet long-term financial obligations.

There are two elements to reporting financial position – the primary statement (either a statement of assets and liabilities or a statement of net assets) and a schedule of investments.

Primary statements reporting financial position

There are two types of statements investment companies use to report their financial position.

Statement of assets and liabilities	Statement of net assets
Used unless an investment company elects to use a statement of net assets	• Registered funds: can elect to use if at least 95% of amount of total assets are represented by investments in securities of unaffiliated issuers • Nonregistered funds: election is unrestricted

The main difference between these statements is that a statement of net assets includes a schedule of investments on the face of the statement while the statement of assets and liabilities presents such information in a separate schedule.

Subtopic 946-210 addresses reporting financial position. In addition, Subtopics 946-310 and 946-405 include incremental presentation requirements for receivables and payables when reporting financial position.

For registered funds and BDCs, Rule 6-04 of Reg S-X prescribes more detailed presentation and disclosure requirements for reporting assets, liabilities and net assets.

Schedule of investments

An integral component of reporting an investment company's financial position is providing a schedule of investments, either as a separate schedule or on the face of a statement of net assets. The schedule is deemed integral because of the significance of the investment portfolio to an investment company's economic resources and investment operations.

How a schedule of investments is presented depends on the nature of the investment company.

Nature of investment company	Source of requirements for schedule of investments
Registered funds and BDCs	Reg S-X Article 12
Nonregistered investment partnerships	Section 946-210-50 (Investment Companies That Are Nonregistered Investment Partnerships subsection)
Other nonregistered investment companies	Section 946-210-50 (Investment Companies Other than Nonregistered Investment Partnerships subsection)

Read more: Chapter 7

Results of operations

Investment companies report their results of operations through both a statement of operations and financial highlights.

Statement of operations

A statement of operations provides information about financial performance and the returns on economic resources during the reporting period. Information about an entity's income, expenses, gains and losses helps financial statement users evaluate the ability of an entity to use its assets and other resources and its ability to generate future cash flows.

The primary requirements for presenting a statement of operations and disclosing related items are as follows.

Subtopic 946-220	Applies to investment companies in the scope of Topic 946
Reg S-X Rule 6-07	Provides incremental requirements for registered funds and BDCs

Financial highlights

Financial highlights, presented either as a separate schedule or in the notes to the financial statements, provide information to help users understand an investment company's financial performance during the reporting period.

The primary requirements for presenting financial highlights are as follows.

Subtopic 946-205	Requires financial highlights to include: • per-share information; • ratios to average net assets; and • investment returns.
SEC Forms N-1/A (open-end funds) and N-2 (closed-end funds)	• Applies to registered funds and BDCs. • Provides incremental presentation requirements and instructions on how to calculate certain financial highlights information.

Read more: Chapter 8

Statement of cash flows

The objective of a statement of cash flows is to describe the sources and uses of cash during a period because this information generally is not readily available when reviewing the financial position or results of operations of an investment company.

However, Topic 230 exempts certain investment companies from presenting a statement of cash flows if they meet the following conditions:

- substantially all of the investment company's investments are measured at fair value and meet certain other conditions;

- the investment company has minimal debt; and
- the investment company provides a statement of changes in net assets.

When an investment company provides a statement of cash flows, it applies Topic 230. A few issues arise when applying Topic 230 due to some unique attributes of an investment company's operations.

Read more: Chapter 9

Statement of changes in net assets

A statement of changes in net assets summarizes an investment company's changes in net assets during the reporting period resulting from:

- investment operations;
- net equalization debits or credits;
- distributions to shareholders;
- capital share transactions;
- other contributions of capital (other than from capital share transactions); and
- other equity transactions.

Registered investment companies follow very detailed requirements when presenting a statement of changes in net assets, as summarized in the following table.

Category	Description
Results from operations	The following are presented separately to arrive at the net change in net assets resulting from operations: • net investment income or loss; • net realized gains or losses from investments and foreign currency transactions; and • changes in unrealized appreciation or depreciation on investments and the translation of assets and liabilities in foreign currencies.
Net equalization debits or credits	If equalization accounting is used, the net amount of undistributed investment income included in the price of capital shares issued or reacquired is shown as a separate line item.
Distributions to shareholders	Distributions from net investment income, net realized gain from investment transactions, and other sources are disclosed as a single line item. However, tax return of capital distributions are presented separately.
Capital share transactions	The increase or decrease in net assets derived from the net change in the number of outstanding shares or units is disclosed. The number and value of shares issued in reinvestment of dividends as well as the number and dollar amounts received for shares sold and paid for shares redeemed are disclosed for each share class.

Category	Description
Other contributions of capital	Other contributions of capital resulting from equity transactions that do not involve a change in outstanding units or shares are distinguished by disclosure or separate presentation from capital share transactions presented in a statement of changes in net assets.
Other elements of capital	Changes in net assets resulting from any other elements of capital or residual interests appropriate to the capital structure of the entity are presented separately or disclosed.

For investment companies organized as investment partnerships, a statement of changes in partners' capital is typically presented in lieu of a statement of changes in net assets to provide information about changes in net assets (partners' capital) separately for each ownership class (i.e. the general partner class and the limited partner class).

Read more: Chapter 9

Notes to the financial statements

There are three broad sources of disclosure requirements for investment companies:

- general disclosure requirements in a broad range of Codification Topics that include investment companies in their scope;
- disclosure requirements specific to investment companies in Topic 946 and related Subtopics; and
- incremental disclosure requirements specific to registered funds in Reg S-X and other SEC requirements.

Disclosure items required by Topic 946	Disclosure items required by SEC
• Investment company status • Change in status • Payments by affiliates • Certain distribution costs • General partner advisory services • Expense limitation agreements • Fee waivers • Dividends • Distributable earnings • Financial support to investees • Financial highlights ratios • Total return • Internal rate of return • Capital commitments • Credit enhancements	• Aggregate purchases and sales of investment securities • Remuneration paid • Restricted securities • Tax status • Tax basis disclosures • Issuance and repurchase of a registered fund's own securities • Swing pricing • Restrictions on cash and compensating balances • Unused financing arrangements • Management and service fees • Brokerage commissions • Brokerage service and expense offset arrangements

Disclosure items required by Topic 946	Disclosure items required by SEC
• Net investment income tax provision • Foreign currency gains or losses from foreign investments • Multiple class funds • Master-feeder funds • Fund of funds • NAV per share • Capital share transactions • Difference between net investment income and net realized gain and actual distributions • Foreign currency risk	• Interest and amortization of debt discount and expense • Capital share transactions

Read more: Chapter 9

2. Objective and scope

Detailed contents

2.1 How the standard works

Topic 946 provides incremental industry-specific guidance for investment companies. To be within the scope of Topic 946, an entity must satisfy either of the following criteria:

- be an entity regulated under the Investment Company Act of 1940 (1940 Act); or
- have the characteristics of an investment company.

The second criterion requires an evaluation of two sets of characteristics.

Fundamental characteristics ALL must be met to be considered an investment company.	• Entity obtains funds from one or more investors and provides the investor(s) with investment management services. • Entity commits to its investor(s) that its business purpose and only substantive activities are investing funds solely for returns from capital appreciation, investment income, or both. • Entity does not obtain or have the objective of obtaining returns or benefits from an investee (or its affiliates) that are not normally attributable to ownership interests or that are other than capital appreciation or investment income (this also applies to an entity's affiliates).
Typical characteristics The absence of one or more does not necessarily preclude being considered an investment company.	• Entity has more than one investment. • Entity has more than one investor. • Entity has investors that are not related parties of its parent (if it has a parent) or its investment manager. • Entity's ownership interests are in the form of equity or partnership interests. • Entity manages substantially all of its investments on a fair value basis.

Investment companies in the scope of Topic 946 are not exempt from the scope of other applicable Codification Topics.

2.2 Objective of Topic 946

Excerpt from ASC 946-10

> Overall Guidance

15-1 The Financial Services—Investment Companies Topic only provides incremental industry-specific guidance for the entities that meet the assessment of investment company status described in this Scope Section…Entities within the scope of this Topic also shall comply with the applicable guidance not included in this Topic. The Scope Section of the Overall Subtopic establishes the pervasive scope for all Subtopics of the Financial Services—Investment Companies Topic. Unless explicitly addressed within specific Subtopics, the following scope guidance applies to all Subtopics of the Financial Services—Investment Companies Topic…

Topic 946 applies to entities that satisfy the criteria to be considered investment companies and provides incremental industry-specific guidance for these entities.

Question 2.2.10 Are investment companies under Topic 946 exempt from accounting guidance in other Topics?

Interpretive response: No. While Topic 946 provides accounting and reporting guidance specific to investment companies in its scope, these entities also are required to apply other Codification Topics to the extent applicable. [946-10-15-1]

2.3 Industry background

Excerpt from ASC 946-20

> Background Information about Investment Company Activities

05-1A Typically, an investment company sells its ownership interests, invests the proceeds to achieve its investment objectives, and provides returns to its investors from the net income earned on its investments and net gains realized on the disposal of its investments.

05-1B Several kinds of investment companies exist: management investment companies, unit investment trusts, common (collective) trust funds, exchange-traded funds, investment partnerships, certain separate accounts of life insurance companies, and offshore funds. Management investment companies may be open-end funds (commonly known as mutual funds), **closed-end funds**, special purpose funds, venture capital investment companies, small business investment companies, and business development companies. Investment companies are organized as corporations (in the case of mutual funds, under the laws of certain states that authorize the issuance of common shares redeemable on demand of individual shareholders), common law trusts (sometimes called business trusts), limited partnerships, limited liability investment partnerships and companies, and other more specialized entities, such as separate accounts of insurance companies that are not in themselves legal entities.

05-1C Once an investment company has been organized to do business, it usually engages immediately in its planned principal operations, that is, the sale of capital stock and investment of funds. Employee training, development of markets for the sale of capital stock, and similar activities are usually performed by the investment adviser or other agent, and the costs of these activities are not borne directly by the investment company. However, an investment company, particularly one not engaging an agent to manage its portfolio and to perform other essential functions, may engage in such activities and may bear those costs directly during its development stage.

05-1E Venture capital investment companies, including most small business investment companies and private equity investment companies, differ from other types of investment companies. The typical open-end or closed-end investment company is a more passive investor, whereas a venture capital investment company is more actively involved with its investees. In addition to providing funds, whether in the form of loans or equity, a venture capital investment company often provides technical and management assistance to its investees as needed and requested. That assistance is provided for maximizing the overall value of the investment rather than for other benefits. The portfolio of a venture capital investment company may be illiquid by the very nature of the investments, which are usually securities with no public market. Often, gains on those investments are realized over a relatively long holding period. The nature of the investments therefore requires valuation procedures that may differ from those used by the typical investment company primarily addressed by this Subtopic. Venture capital investment companies also may incur liabilities not generally found in other investment companies.

20 Glossary

Closed-End Funds

Closed-end funds are investment companies that issue a fixed number of shares (that generally trade on an open market) to raise capital, similar to the way in which an entity sells stock in an initial public offering.

Question 2.3.10 What are the principal activities of an investment company?

Interpretive response: The principal activities of an investment company typically include:

- selling its ownership interests to investors (see chapter 4);
- investing the proceeds to achieve its investment objectives and providing returns to investors (see chapter 3); and
- managing its operations either through an investment adviser/manager or through its own functions (see chapter 5).

While the scope of Topic 946 includes many kinds of investment companies with varying investment objectives, they generally all have these principal activities. [946-20-05-1A – 1C, 05-1E]

Question 2.3.20 What are the different kinds of investment companies?

Interpretive response: Investment companies are generally either registered or nonregistered funds. [946-20-05-1A – 1C, 05-1E]

Category	Description
Registered fund	Public funds that are regulated under the 1940 Act, such as: • mutual funds; • BDCs; • exchange-traded funds; • interval funds; and • certain separate accounts of life insurance companies.
Nonregistered fund	Private funds that meet certain registration exemptions under the 1940 Act, such as: • hedge funds; • offshore funds; • private debt/equity funds; • venture capital funds; and • other investment partnerships.

Investment companies are also generally either open-end or closed-end funds. [946-20-05-1A – 1C, 05-1E, 946-20 Glossary]

Category	Description
Open-end fund	• Redeems investor ownership interests based on NAVs determined at regular intervals (e.g. daily, monthly or quarterly). • Typically invests in public companies or other investments that are highly liquid.
Closed-end fund	• Raises capital by issuing a fixed number of shares. • Investor ownership interests generally cannot be redeemed. • Investors either trade their interests on the open market (e.g. on an exchange or a secondary market), receive periodic distributions from the investment company as investments are sold, or redeem interests on a periodic basis in limited quantities (e.g. an interval fund). • Typically invests in less liquid investments such as private debt/equity and venture capital.

2.4 Investment company status: Overview

2.4.10 Entities

Excerpt from ASC 946-10

> Entities

15-2 The accounting principles discussed in this Topic apply to all investment companies. An investment company as discussed in this Topic is an entity that meets the assessment described in paragraphs 946-10-15-4 through 15-9.

15-3 The guidance in this Topic does not apply to real estate investment trusts.

• > Assessment of Investment Company Status

15-4 An entity regulated under the Investment Company Act of 1940 is an investment company under this Topic.

15-5 An entity that is not regulated under the Investment Company Act of 1940 shall assess all the characteristics of an investment company in paragraphs 946-10-15-6 through 15-7 to determine whether it is an investment company. The entity shall consider its purpose and design when making that assessment.

Two types of entities are in the scope of Topic 946, those that: [946-10-15-4 – 15-5]

- are regulated entities under the Investment Company Act of 1940 (1940 Act); and
- have the Topic 946 characteristics of an investment company.

Determining whether an entity has the characteristics of an investment company requires an assessment of two sets of characteristics: fundamental characteristics and typical characteristics.

Question 2.4.10 Are all entities required to assess whether they are investment companies under Topic 946?

Interpretive response: Yes, with two exceptions.

- **Entities regulated under the 1940 Act.** An entity that meets the definition of an investment company under the 1940 Act is subject to its regulations, and therefore is automatically subject to the requirements of Topic 946. Since the definition of an investment company under the 1940 Act differs from Topic 946, an entity that is regulated under the 1940 Act may not possess all of the fundamental and typical characteristics of an investment company in Topic 946 (see sections 2.5 and 2.6).

- **Real estate investment trusts (REITs).** REITs are specifically excluded from the scope of Topic 946.

All other entities must assess whether they have the characteristics of an investment company under Topic 946 (see section 2.4.20). [946-10-15-2 – 15-5]

Question 2.4.20 Can an entity that is excluded from the definition of an investment company under the 1940 Act be an investment company under Topic 946?

Background: The 1940 Act provides several exclusions from the definition of an investment company, including those for a 'private fund' that otherwise meets the definition, but is limited in the number or type of investors as specified in Section 3(c)(1) or 3(c)(7). An entity that is excluded from the definition of an investment company under the 1940 Act is not subject to its regulations, and therefore is not automatically subject to the requirements of Topic 946.

Interpretive response: Yes. Except for REITs (see Question 2.4.10), entities that are excluded from or do not otherwise meet the definition of an investment company under the 1940 Act need to assess whether they have the characteristics of an investment company under Topic 946 (see section 2.4.20). [946-10-15-4, 1940 Act §§3(a), 3(c), Advisers Act §202(a)(29)]

Question 2.4.30 Is a BDC automatically subject to the requirements of Topic 946?

Interpretive response: It depends. A BDC is defined in the 1940 Act as a closed-end company that is operated for the purpose of making investments in securities and making available significant managerial assistance with respect to the issuers of such securities. A BDC is not registered as an investment company under the 1940 Act but elects to be regulated under the 1940 Act pursuant to Section 54(a). A company that elects to be regulated under the 1940 Act is automatically subject to the requirements of Topic 946. A company that does not elect to be regulated under the 1940 Act must assess whether it has the characteristics of an investment company under Topic 946 (see section 2.4.20). [946-10-15-4, 1940 Act §§2(a)(48), 54(a)]

Question 2.4.40 Can an entity that has the characteristics of an investment company elect not to apply Topic 946?

Interpretive response: No. An entity that has the characteristics of an investment company under Topic 946 is subject to the requirements of Topic 946 unless it is explicitly excluded from its scope (i.e. REITs). This determination requires judgment if the entity does not have all of the typical characteristics listed in Topic 946. See sections 2.4.20 and 2.6. Conversely, entities that do not meet the characteristics of an investment company in Topic

946 are not permitted to apply its guidance. Application of Topic 946 is not an accounting policy election. [946-10-15-2 – 15-5]

Question 2.4.50 Are all REITs precluded from applying Topic 946?

Background: The FASB considered issuing separate specialized accounting guidance for real estate entities, including REITs. However, because of the complexity of issues and concerns raised by stakeholders, the FASB never finalized that guidance and included a scope exception in Topic 946 for REITs.

Interpretive response: Not necessarily. We believe it is acceptable for nonpublic REITs that otherwise meet the Topic 946 characteristics of an investment company to apply Topic 946 by analogy, subject to the considerations discussed in the remainder of this response, but we believe it is not acceptable for public REITs to do so.

Some nonpublic REITs apply investment company accounting and financial reporting by analogy even though they are excluded from the scope of Topic 946. These nonpublic entities elect REIT status for tax purposes, but otherwise typically have the attributes of an investment company. Alternatively, a nonpublic REIT may be formed as a blocker entity or a feeder fund in a master-feeder structure. In addition, some real estate entities may measure their real estate investments at fair value by analogy to Topic 946 because:

- they have determined that they are investment companies;
- they are controlled by pension plans that are required to measure their investments at fair value; or
- industry practices have developed such that real estate investments are measured at fair value without regard to investment company attributes or pension plan ownership.

The FASB has not changed industry practice for REITs and other real estate entities that issue financial statements that are consistent with the measurement principles in Topic 946.

Multiple nonpublic REITs

We believe reporting entities that sponsor or have investments in multiple nonpublic REITs with similar characteristics generally should elect as an accounting policy to account for all of those similar entities as investment companies or non-investment companies. Therefore, we believe it generally is not appropriate for a reporting entity to selectively account for some nonpublic REITs with which it is involved as a sponsor or investor as investment companies but account for other similar nonpublic REITs as non-investment companies. [946-10-15-3, ASU 2013-08.BC53, BC57, BC58]

2.4.20 Assessment for entities not regulated under the 1940 Act

Excerpt from ASC 946-10

• > Assessment of Investment Company Status

15-6 An investment company has the following fundamental characteristics:

a. It is an entity that does both of the following:
   1. Obtains funds from one or more investors and provides the investor(s) with investment management services
   2. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both.
b. The entity or its **affiliates** do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

15-7 An investment company also has the following typical characteristics:

a. It has more than one investment.
b. It has more than one investor.
c. It has investors that are not **related parties** of the **parent** (if there is a parent) or the investment manager.
d. It has ownership interests in the form of equity or partnership interests.
e. It manages substantially all of its investments on a **fair value** basis.

15-8 To be an investment company, an entity shall possess the fundamental characteristics in paragraph 946-10-15-6. Typically, an investment company also has all of the characteristics in paragraph 946-10-15-7. However, the absence of one or more of those typical characteristics does not necessarily preclude an entity from being an investment company. If an entity does not possess one or more of the typical characteristics, it shall apply judgment and determine, considering all facts and circumstances, how its activities continue to be consistent (or are not consistent) with those of an investment company.

15-9 The implementation guidance in Section 946-10-55 is an integral part of assessing investment company status and provides additional guidance for that assessment.

> Implementation Guidance

55-1 This Section provides additional guidance for the assessment in paragraphs 946-10-15-5 through 15-9 to determine whether an entity that is not regulated under the Investment Company Act of 1940 is an investment company under this Topic.

55-2 This Section is organized as follows:

a. Fundamental characteristics of an investment company
b. Typical characteristics of an investment company
c. Illustrative examples.

• > Fundamental Characteristics of an Investment Company

55-3 To be an investment company, an entity shall possess the fundamental characteristics in paragraph 946-10-15-6. Paragraphs 946-10-55-4 through 55-10 provide additional guidance for determining whether an entity has the fundamental characteristics of an investment company.

• • > Typical Characteristics of an Investment Company

55-11 As required by paragraph 946-10-15-5, an entity shall assess all the typical characteristics in paragraph 946-10-15-7 to determine whether it is an investment company. If an entity does not possess one or more of the typical characteristics, it should apply judgment and determine, considering all facts and circumstances, how its activities continue to be consistent (or are not consistent) with those of an investment company. Paragraphs 946-10-55-12 through 55-29 provide additional guidance for determining whether an entity has a certain typical characteristic of an investment company.

If an entity is not regulated under the 1940 Act, to qualify as an investment company under Topic 946, it must possess certain characteristics that are fundamental to investment companies. It also must have certain characteristics that are typical of investment companies. Whether an entity has these characteristics depends in large part on its purpose and design, as explained throughout this chapter. [946-10-15-5]

Question 2.4.60 What are the characteristics of an investment company?

Interpretive response: An investment company's business purpose, design and activities differentiate it from other types of entities. The fundamental and typical characteristics in Topic 946 are based on these unique features. [946-10-15-5]

Fundamental characteristics

While there are many types of investment companies, all investment companies have the following fundamental characteristics (see section 2.5): [946-10-15-6]

- **Investment management services:** obtains funds from one or more investors and provides the investor(s) with investment management services;
- **Business purpose:** commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both; and
- **Investment returns:** does not obtain or have the objective of obtaining returns or benefits from an investee (or its affiliates) that are not normally attributable to ownership interests or that are other than capital appreciation or investment income (this also applies to an entity's affiliates).

Typical characteristics

An investment company also has the following typical characteristics (see section 2.6): [946-10-15-7]

- more than one investment;
- more than one investor;
- investors that are not related parties of the parent (if there is a parent) or the investment manager of the entity;
- ownership interests in the form of equity or partnership interests; and
- substantially all of its investments are managed on a fair value basis.

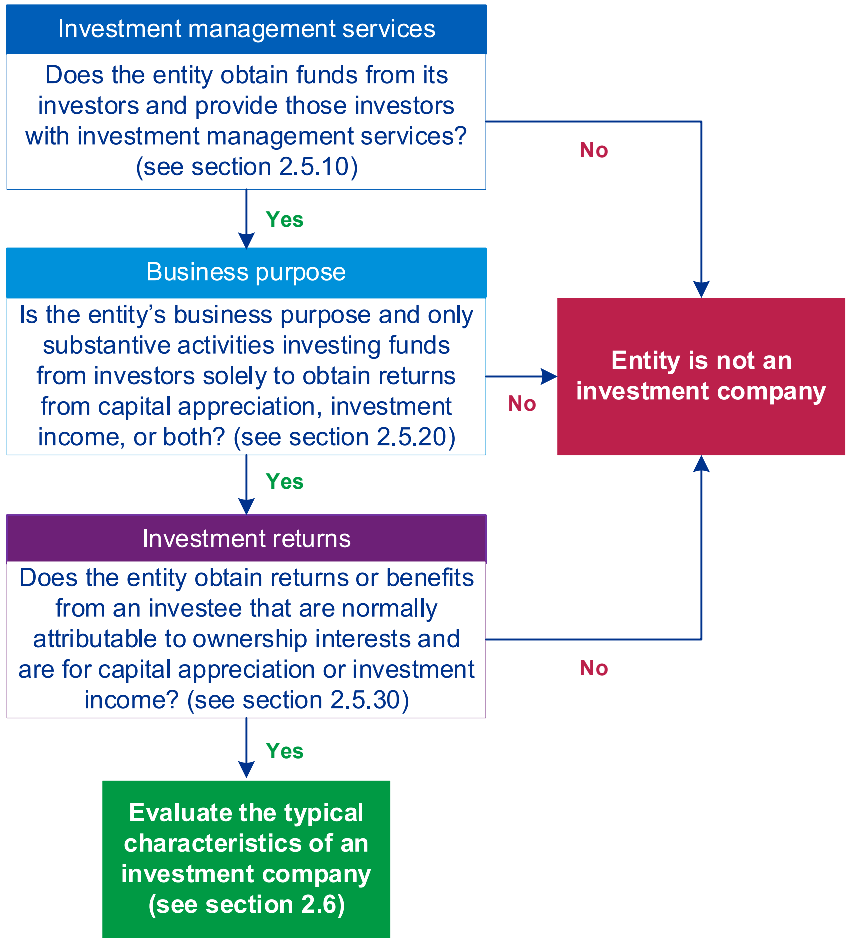
Question 2.4.70 Is an investment company other than an entity regulated under the 1940 Act required to have all of the fundamental characteristics?

Interpretive response: Yes. An entity that does not have all of the fundamental characteristics of an investment company is precluded from applying investment company accounting and financial reporting unless it is regulated under the 1940 Act. [946-10-15-5]

Question 2.4.80 If an entity does not meet all of the fundamental characteristics, does it evaluate whether it meets the typical characteristics?

Interpretive response: No. An entity is required to possess all of the fundamental characteristics to be an investment company (see Question 2.4.70). The existence of typical characteristics would not compensate for the absence of any fundamental characteristics. However, the typical characteristics are relevant in determining whether an entity has all of the fundamental characteristics. This means, for practical purposes, that the typical characteristics are considered in conjunction with the fundamental characteristics (see Question 2.4.90). [946-10-15-8, ASU 2013-08.BC13]

If an entity meets all of the fundamental characteristics, it then determines whether it has the typical characteristics.



Question 2.4.90 What should be considered in assessing whether an entity has sufficient typical characteristics to be considered an investment company?

Interpretive response: There are no bright lines in performing the evaluation and it is necessary to consider all relevant facts and circumstances, including both positive and negative indicators, and exercise judgment in the assessment. The FASB did not require a minimum number of typical characteristics to be present for an entity to be within the scope of Topic 946, but indicated that the Board believes it is very unlikely that an entity that does not possess any of the typical characteristics is an investment company. Although the Board did not rule out the possibility, we are not aware of fact patterns in practice in which an entity is considered to be within the scope of Topic 946 notwithstanding that it has none of the typical characteristics of an investment company. [946-10-15-8, ASU 2013-08.BC13]

While the evaluation of typical characteristics is separate and distinct from the evaluation of fundamental characteristics, the facts and circumstances that affect the evaluation of the concepts usually are interrelated. For example, an entity managing investments on a fair value basis (one of the typical characteristics) may do so because of its business purpose and activities (i.e. investing funds for returns from capital appreciation, which is the business purpose fundamental characteristic). An entity that is not managing its investments on a fair value basis might not possess this fundamental characteristic. However, there may be circumstances in which managing investments on a basis other than fair value would not cause an entity to fail the business purpose fundamental characteristic (see Question 2.6.140).

Entities must ensure that one or more fundamental characteristics are not missing as a result of the absence of one or more typical characteristics.

Question 2.4.100 When does an entity determine whether it has the characteristics of an investment company?

Interpretive response: An entity determines whether it has the characteristics of an investment company upon its formation. After this initial determination, it reassesses its investment company status only if one of the following events occur. [946-10-15-5, 25-1]

Event	Action
There is a subsequent change in the entity's purpose and design.	Reassess whether it has the characteristics of an investment company.
The entity ceases to be a regulated entity under the 1940 Act.	Assess whether it has the characteristics of an investment company.
The entity becomes a regulated entity under the 1940 Act.	Begin applying Topic 946 if the initial determination was that the entity did not have the characteristics of an investment company.

For further detail about reassessments, see section 2.8.

Question 2.4.110 What factors are relevant in evaluating whether a structured investment vehicle qualifies as an investment company?

Background: Structured investment vehicles (such as CDOs or CLOs) are pools of investment assets that are often financed primarily with debt. Structured investment vehicles may be sponsored by an investment company (or its investment manager) or a non-investment company (e.g. bank or its affiliate).

Topic 946 does not require an entity to have ownership interests in the form of shares of stock or partnership interests to be an investment company (see section 2.6.40). As a result, structured investment vehicles may meet the definition of an investment company in some cases.

Interpretive response: The list of considerations below and the chart that follows may indicate whether a structured investment vehicle is more or less like an investment company.

- How is the vehicle marketed and presented to current and potential investors? How does the investor view the vehicle? How is the entity being reported to investors currently, including in unaudited financial statements (i.e. on a fair-value or amortized cost basis)? See section 2.5.
- Did the sponsor or another affiliate of the entity originate the loans or other assets held by the entity or were those loans or other assets acquired on the open market? If the sponsor is an affiliate of the entity and originated the entity's loans or other assets, does origination represent a substantive business activity of the entity (including activities of its affiliates)? The greater the extent of origination activities performed by the entity or its affiliates for investments held by the entity, the more likely it is that the entity is not an investment company. See section 2.5.
- How does the entity manage and evaluate the performance of its investments (fair value or amortized cost basis)? On what basis does it transact with its investors (fair value versus amortized cost)? How are asset-based fees calculated? See section 2.6.50.
- Is the sponsor's or adviser's retained risk in the vehicle (e.g. in the form of a residual interest or derivatives such as credit default swaps) significant in relation to the entity's entire capital structure? If a sponsor holds an investment interest in the entity (e.g. a beneficial interest), consider the amount of that interest and its level of subordination in relation to the entire capital structure to evaluate the significance of the retained risk. See section 2.6.30.

Factor	More indicative of an investment company	Less indicative of an investment company
Origination	• Entity/affiliate does not originate investments. • If entity/affiliate does originate investments, the origination activities are not a substantive portion of the business activities of the entity/affiliate (see Question 2.5.160).	• Entity/affiliate originates investments and origination activities are a substantive portion of the business activities of the entity/affiliate.
Fair value management	• Fair value is the primary measurement attribute used to evaluate the entity's financial performance and to make investment decisions for substantially all of the entity's investments.	• Fair value of investments is not used to evaluate the entity's financial performance or to make investment decisions. • Entity does not transact with its investors on the basis of NAV per share

Factor	More indicative of an investment company	Less indicative of an investment company
	• Entity transacts with its investors on the basis of NAV per share determined using the fair value of investments. • Entity/affiliate earns fees based on the fair value of the entity's assets or net assets determined using the fair value of assets or investments.	determined using the fair value of investments. • Entity/affiliate does not earn fees based on the fair value of the entity's assets or net assets determined using the fair value of assets or investments.
Retained risk	• Insignificant.	• Significant.

2.5 Fundamental characteristics

This section explains each of the three fundamental characteristics and how they interrelate. An entity that is not regulated under the 1940 Act cannot be an investment company within the scope of Topic 946 unless it possesses all three of these characteristics.

2.5.10 Investment management services

Excerpt from ASC 946-10

• > Assessment of Investment Company Status

15-6 An investment company has the following fundamental characteristics:

a. It is an entity that does both of the following:
   1. Obtains funds from one or more investors and provides the investor(s) with investment management services....

A traditional function of an investment company is to obtain funds from one or more investors and to provide the investor(s) with professional investment management services. This is one of the fundamental characteristics of an investment company. [946-10-15-6(a)(1), ASU 2013-08.BC16]

Question 2.5.10 What are investment management services?

Interpretive response: While not defined in Topic 946, investment management services are generally services provided to investors that support the principal activities of an investment company (see Question 2.3.10). We believe these services should be consistent with the other fundamental characteristics of an investment company. Specifically, these services should be related to the objective of obtaining returns or benefits from capital appreciation, investment income or both (which is the business purpose fundamental characteristic – see section 2.5.20).

Examples of investment management services include:

- investment selection (i.e. acquisition and disposition of investments);
- investment due diligence services;
- research services; and
- monitoring the performance of investments.

Some entities (or their investment managers) also provide related services to investees as part of their principal activities, such as financial support to investees (see Question 2.5.120) and assistance with day-to-day management of the investees' operations (see Question 2.5.130). While these services may be related to the objective of obtaining returns or benefits from capital appreciation or investment income, they are not investment management services because those services are provided to an entity's investees, not to the entity's investors. Instead, such services are evaluated under the investment returns fundamental characteristic (see section 2.5.30).

Question 2.5.20 Can an investment company use an investment manager to provide investment management services to investors?

Interpretive response: Yes. Investment companies may be either externally managed by an investment manager through an investment advisory agreement or internally managed through their own investment management professionals. These investment managers act on behalf of the investment companies that are responsible for providing investment management services to investors.

Question 2.5.30 Is a corporate treasury function considered investment management services?

Interpretive response: No. A corporate treasury function may involve investing in securities to generate investment income and capital appreciation. However, these investments are typically short-term in nature and made with the primary objective of managing the entity's cash reserves, liquidity risks and funding of operations that the entity was designed for, instead of providing investment returns to investors. Therefore, we believe the activities of a corporate treasury function are related to the entity's strategic operating purposes, not to investment management services. [946-10-15-6, ASU 2013-08.BC16]

Question 2.5.40 Can an entity meet the investment management services fundamental characteristic if it obtains in-kind contributions from investors instead of cash?

Interpretive response: Generally yes. An element of the investment management services fundamental characteristic is that an investment company receives funds from investors. Investment companies typically obtain cash from investors in exchange for ownership interests and provide professional investment management services over the pooled funds. However, some investment companies may permit certain investors to contribute in-kind consideration (e.g. securities or other investments) in lieu of cash contributions.

The investments contributed in-kind are typically included as part of the investment company's portfolio along with other investments obtained from investing pooled funds, where the investors participate in the returns from the investments contributed in-kind in the same manner as the returns generated by other investments held by the investment company.

However, certain circumstances may indicate the nature and purpose of the in-kind contribution is for the entity to hold the investment for operating or strategic benefits, which is contrary to other fundamental characteristics (see sections 2.5.20 and 2.5.30), rather than to provide investors with investment management services. Examples of such circumstances include the following.

- The investments contributed in-kind represent a substantial portion of the assets held by the entity, or the entity does not have a plan to acquire additional investments.
- The type, characteristics or expected returns of the investments contributed in-kind are inconsistent with the stated investment objectives or strategies of the entity.
- The investments contributed in-kind represent a substantial level of the ownership interests in the investee.
- An affiliate of the entity contributes its own investments or those of another affiliate as the in-kind contribution.
- Participation in the investment income or gains from the investments contributed in-kind is for the benefit of a disproportionately few investors or affiliated investors.

When any of these circumstances are present, determining whether the in-kind contribution is consistent with the investment management services characteristic requires careful consideration of the relevant facts and circumstances.

2.5.20 Business purpose and substantive activities

Excerpt from ASC 946-10

• > Assessment of Investment Company Status

15-6 An investment company has the following fundamental characteristics:

a. It is an entity that does both of the following:…
   2. Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both.

• • > Business Purpose and Substantive Activities

55-4 An investment company should have no substantive activities other than its investing activities and should not have significant assets or liabilities other than those relating to its investing activities, subject to the exception in the following paragraph.

55-5 An investment company may provide investing-related services (for example, investment advisory or transfer agent services) to other entities, directly or indirectly through an investment in an entity that provides those services, as long as those services are not substantive. However, an investment company may provide substantive investing-related services, directly or indirectly through an investment in an entity that provides those services, if the substantive services are provided to the investment company only.

• • • > Evidence of an Entity's Business Purpose and Substantive Activities

55-6 Evidence of the entity's business purpose and substantive activities may be included in the entity's offering memorandum, publications distributed by the entity, and other corporate or partnership documents that indicate the investment objectives of the entity. Evidence of the entity's business purpose and substantive activities also may include the manner in which the entity presents itself to other parties (such as potential investors or potential investees). For example, an entity that presents its business to its investors as having the objective of investing for capital appreciation has characteristics that are consistent with the business purpose and substantive activities of an investment company. Alternatively, an entity that presents itself as an investor whose objective is jointly developing, producing, or marketing products with its investees has characteristics that are inconsistent with the business purpose and substantive activities of an investment company.

55-7 An entity's investment plans also provide evidence of its business purpose and substantive activities. Accordingly, an investment company whose business purpose and substantive activities include realizing capital appreciation should have an exit strategy for how it plans to realize the capital appreciation of its investments. Although the entity may not yet have determined the specific method or timing of disposing of an investment, the fact that it has identified potential exit strategies through which it can realize capital appreciation provides evidence that its business purpose and substantive activities are consistent with those of an investment company. The entity need not document specific exit strategies for each individual investment held for the purpose of realizing capital appreciation but should identify potential exit strategies for different types or portfolios of investments held with the purpose of realizing capital appreciation. Disposal of investments only during liquidation or to satisfy investor redemptions are not exit strategies. Therefore, an entity should have a plan to dispose of its investments before liquidation when its business purpose and substantive activities include realizing capital appreciation. An investment company whose business purpose and substantive activities are to invest for returns only from investment income does not require an exit strategy for its investments.

An investment company commits to its investors that its sole purpose is to make investments on their behalf to provide returns in the form of capital appreciation, investment income, or both. While non-investment company entities also have a business purpose of providing returns to shareholders, their objective is to provide returns from activities other than capital appreciation and investment income. Given this, an investment company's only substantive activities should be its investing activities, which is the business purpose fundamental characteristic of an investment company. [946-10-15-6(a)(2)]

Question 2.5.50 Can an investment company have substantive non-investment company activities?

Interpretive response: Generally no. An investment company cannot have any substantive activities other than investing for returns from investment income, capital appreciation, or both. [946-10-55-4]

However, some investment companies perform investing-related services either directly or indirectly through an investee that provides those services. Such investing-related services may include investment advisory, transfer agent, or broker-dealer services. These are not in and of themselves investing activities, but instead support the investing activities of an investment company.

An investment company is not precluded from providing substantive investing-related services that are provided only to itself because the services are performed as an extension of its activities as an investment company. Conversely, an investment company is precluded from providing substantive investing-related services to other entities. [946-10-55-5, ASU 2013-08.BC19]

See Question 2.3.130 in KPMG Handbook, Consolidation, for guidance on consolidating an operating entity that provides services to an investment company.

Question 2.5.60 Can an investment company have any significant assets or liabilities unrelated to its investing activities?

Interpretive response: Generally no. The existence of significant assets or liabilities other than those relating to investing activities may be indicative of substantive activities that are inconsistent with the activities of an investment company. [946-10-55-4]

For example, an entity that has significant trade receivables, trade payables, inventories and fixed assets may be engaged in sales of retail or manufactured goods that are inconsistent with investing activities, and therefore would not be an investment company.

However, an investment company is not precluded from having significant assets or liabilities that are associated with investing-related services that are not provided to other entities (see Question 2.5.50). [946-10-55-5]

In addition, an investment company may obtain non-investment assets from the seizure of collateral for a defaulted investment. We do not believe the status of an investment company would be impacted if: [SOP 07-1.13]

- collateral is obtained on a temporary basis to recover losses on the defaulted investment; and
- the investment company does not use the assets to perform any substantive activities that are inconsistent with investing activities.

Question 2.5.70 Can an investment company have an investment in an entity that provides investment advisory services?

Interpretive response: Yes, provided that either:

- the sole business purpose of that investment is obtaining returns from capital appreciation, investment income, or both; or
- that entity is providing investment advisory services only to the investment company (see Question 2.5.50).

However, we believe an investment company that has a controlling financial interest in an entity that provides investment advisory services is indirectly providing investing-related services. In that situation, an investment company would not be able to hold this investment if those services are substantive and are being provided to other entities. [946-10-55-5]

Question 2.5.80 Is an investment company required to have evidence of its business purpose and substantive activities?

Interpretive response: Yes. An entity must have evidence of its business purpose and substantive activities when assessing its investment company status. Sources of information that are relevant in supporting the entity's assessment include, but are not limited to: [946-10-55-6 – 55-7]

- the entity's offering memorandum;
- marketing materials or publications distributed by the entity;
- organizational documents such as partnership, trust, or LLC agreements;
- entity structure charts;
- the manner in which the entity presents itself to third parties, including the entity's potential investors and potential investees;
- the entity's investment plans, which may be described in the offering memorandum or investment committee meeting minutes; and
- information about the entity's potential exit strategies for investments held for capital appreciation.

Question 2.5.90 Does an investment company need to have an exit strategy for its investments?

Interpretive response: It depends on the business purpose for holding the investments.

Capital appreciation

An investment company whose business purpose is to obtain returns from capital appreciation must have an exit strategy for those investments (see section 2.7.30 for Subtopic 946-10's Example 2). Having an exit strategy is an important distinction between an investment company and a non-investment company (e.g. a holding company) that may own an operating subsidiary indefinitely. This exit strategy is the basis for recognizing capital appreciation in an investment company's financial statements by measuring investments at fair value (see chapter 3). [946-10-55-7]

Identification of the specific method and timing of each investment disposal is not required. Further, the investment company does not need to document an investment-by-investment realization strategy. However, it should identify potential exit strategies for different types of investments held for capital appreciation. These strategies should include plans to dispose of its investments without regard to investor redemptions or liquidation of the investment company. [946-10-55-7]

Investment income

An investment company whose business purpose is to obtain returns from investment income is not required to have an exit strategy for those investments. For example, an investment company may have an investment in an operating entity that has significant recurring dividends. The investment company does not necessarily need to have a strategy to dispose of that investment.

2.5.30 Returns or benefits from investments

Excerpt from ASC 946-10

• > Assessment of Investment Company Status

15-6 An investment company has the following fundamental characteristics:…

b. The entity or its **affiliates** do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

• • > Returns or Benefits from Investments

55-8 An entity would not be an investment company if the entity or its **affiliates** obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income. Examples of relationships and activities that would be inconsistent with the characteristics of an investment company include any of the following:

a. The entity or its affiliates acquire, use, exchange, or exploit the processes, assets, or technology of an investee or its affiliates. This includes the entity or its affiliates having disproportionate or exclusive rights to acquire assets, technology, products, or services of an investee or its affiliates (for example, by holding an option to purchase an asset from an investee if the asset's development is deemed successful).
b. There are other arrangements between the entity or its affiliates and an investee or its affiliates to jointly develop, produce, market, or provide products or services.
c. An investee or its affiliates provide financing guarantees or assets to serve as collateral for borrowing arrangements of the entity or its affiliates to provide returns or with the objective of providing returns other than capital appreciation or investment income. The guidance in this paragraph does not prohibit an investment company from using its investments in its investees as collateral for any of its borrowings.
d. An affiliate of the entity holds an option to purchase from the entity ownership interests in an investee at an amount other than **fair value**.
e. There are transactions between the entity or its affiliates and an investee or its affiliates that meet any of the following:
   1. They are on terms that are unavailable to entities that are not affiliates of the investee.
   2. They are not at fair value or are not conducted at arm's length.
   3. They represent a substantive portion of the investee's or the entity's business activities, including business activities of affiliates of the entity or affiliates of the investee.

55-9 An investment company may have a strategy to invest in more than one investee in the same industry, market, or geographical area to benefit from synergies that increase the returns from capital appreciation and investment income from those investments. Transactions between an entity's investees should not affect the entity's assessment of whether it is an investment company unless those transactions result in the entity obtaining returns or benefits other than capital appreciation or investment income.

55-10 An investment company may provide both of the following services to an investee, either directly or through an investment in an entity that provides those services, only if those services are provided for the purpose of maximizing returns from capital appreciation, investment income, or both (rather than other benefits) and do not represent a separate substantial business activity or separate substantial source of income for the investment company:

a. Assistance with day-to-day management of the operations of an investee
b. Financial support, such as a loan, capital commitment, or guarantee.

20 Glossary

Affiliate

A party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity. See **Control**.

Control

The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract, or otherwise.

To prohibit corporations or conglomerates from structuring entities to achieve a particular accounting outcome, an investment company (or its affiliates) cannot obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests, or that are other than capital appreciation or investment income. This restriction is the investment returns fundamental characteristic and is intended to prevent inappropriate application of Topic 946 to operating entities whose objectives are to hold investments for operating or strategic benefits. [946-10-15-6(b), ASU 2013-08.BC23 – BC24]

Restricting benefits to those normally attributable to ownership interests further emphasizes the importance of the business purpose fundamental characteristic discussed in section 2.5.20. This also introduces an element of judgment into the evaluation. The guidance requires consideration of what is 'normal' for the industry when evaluating whether an entity meets the fundamental characteristics. This concept is dynamic, not static, as the industry may change over time. Therefore, an entity should consider the specifics of its business activities, as well as the broader industry, when evaluating whether it meets the fundamental characteristics of an investment company.

Question 2.5.100 Do affiliates of an entity impact the investment company assessment under Topic 946?

Interpretive response: Yes. An entity would not be an investment company if its affiliates obtain or have the objective of obtaining returns or benefits from the entity's investees (or their affiliates) that are not normally attributable to ownership interests or that are other than capital appreciation or investment income. As a result, an entity and its affiliates must assess whether their investments are held for operating or strategic benefits that are not consistent with the business purpose and substantive activities of an investment company. [946-10-55-8]

An affiliate of an entity is any party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the entity. Control is the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of an entity through ownership, by contract or otherwise. See section 8.3 of KPMG Handbook, Financial statement presentation, for guidance on the definitions of affiliate and control. [946-10 Glossary]

The FASB was concerned that an investment company could be inserted into a larger corporate structure to achieve a particular accounting outcome. For example, a parent could use an 'internal' investment company subsidiary to invest in operating entities that may be incurring losses (e.g. R&D activities on behalf of the overall group) and record its investments at fair value, rather than reflecting the underlying activities of the investee. [ASU 2013-08.BC23]

Question 2.5.110 Can an investee provide financing guarantees or assets to serve as collateral for debt of the investment company?

Interpretive response: Generally no. If an investee (or its affiliates) provides financing guarantees or assets to serve as collateral for borrowing arrangements of the investment company (or its affiliates), the investment company would likely receive benefits under the arrangement that are not attributable to ownership interests and would not be consistent with the fundamental characteristics of an investment company. However, an investment company may use its investments in investees as collateral for its debt arrangements without impacting its status as an investment company. [946-10-55-8]

Question 2.5.120 Can an investment company provide financial support to its investees?

Interpretive response: It depends. An investment company (or its affiliates) may provide financial support to its investees, including loans, capital commitments or guarantees, provided that: [946-10-55-10]

- the purpose of the financial support is to maximize the overall value from the investment rather than to obtain other benefits; and
- the financial support does not represent a separate substantial business activity or a separate substantial source of income for the investment company.

See Question 2.9.40.

However, the terms or circumstances for providing financial support could indicate that the relationship with the investee is for strategic operating purposes. We believe the following facts may be relevant when determining whether providing financial support represents a separate substantial business activity or a separate substantial source of income. [SOP 07-1.27]

- Loan terms are not at fair value.
- Financial support arrangements were entered into as a required condition of the investment.
- Financial support is regularly provided to investees (or their affiliates), such as to finance day-to-day operations.
- Lending is not the usual business activity of an affiliate that provides financial support to investees.

Question 2.5.130 Can an investment company provide services to its investees?

Interpretive response: Generally yes. An investment company (or its affiliates) may provide certain services to its investees, including assistance with day-to-day management of the operations of an investee, provided that: [946-10-55-10]

- the purpose of the service is to maximize the overall value from the investment, not to obtain other benefits; and
- the service does not represent a separate substantial business activity or a separate substantial source of income for the investment company.

Question 2.5.140 Can an investment company's unaffiliated investees have transactions with one other?

Interpretive response: Yes. Transactions between and among an entity's unaffiliated investees generally should not affect the conclusion about whether the entity is an investment company. For example, an investment company may have a strategy to invest in more than one investee in the same industry, market or geographical area to benefit from synergies that increase the returns from capital appreciation and investment income from those investments. Those transactions would be consistent with the investment returns fundamental characteristic. However, transactions that are structured to result in the entity obtaining operating or strategic benefits or returns other than capital appreciation or investment income would be inconsistent with this fundamental characteristic. [946-10-55-9]

Question 2.5.150 What are examples of activities that are inconsistent with the investment returns fundamental characteristic?

Interpretive response: The following are examples of relationships and activities that are inconsistent with the investment returns fundamental characteristic. [946-10-55-8]

General examples

- The entity (or its affiliates) acquires, uses, exchanges or exploits the processes, assets or technology of an investee (or its affiliates).
- The entity (or its affiliates) has disproportionate or exclusive rights to acquire assets, technology, products or services of an investee (or its affiliates). For example, the entity holds an option to purchase an asset from an investee if the asset's development is deemed successful (see section 2.7.30 for Subtopic 946-10's Example 2).
- Arrangements exist between the entity (or its affiliates) and an investee (or its affiliates) to jointly develop, produce, market or provide products or services.
- An affiliate of the entity holds an option to purchase from the entity ownership interests in an investee for an amount that is not equal to fair value (see section 2.7.30 for Subtopic 946-10's Example 2).
- There are transactions between the entity (or its affiliates) and an investee (or its affiliates) that meet any of the following conditions.
  - They are on terms that are unavailable to non-affiliate entities.
  - They are not at fair value.
  - They are not conducted at arm's length.
  - They represent a substantive portion of the business activities of the entity (including its affiliates) or the investee (including its affiliates).

Specific examples

An entity would not meet the investment returns fundamental characteristic if the activities or sources of income in the table below represent:

- a separate substantial business activity or a separate substantial source of income for the entity; or
- a substantive activity of the entity (including those of its affiliates).

These activities or sources of income are inconsistent with the investment returns fundamental characteristic because they relate to obtaining returns or benefits from an investee (or its affiliates) other than capital appreciation or investment income.

Type of entity	Activity or income source
Activities inconsistent with investment returns fundamental characteristic	
Structured investment vehicle (e.g. CDOs and CLOs)	Loan (or investment) origination

Type of entity	Activity or income source
Activities inconsistent with investment returns fundamental characteristic	
Private equity	Management consulting
Real estate	Construction and development or property management

In many cases, the key to the evaluation is determining whether the activities involve services or other transactions between investees (or their affiliates) and the entity (or its affiliates). For example, loan origination involves providing an underwriting service to an investee borrower. If services or other transactions are involved, it is necessary to determine the significance of those activities to the entity.

We believe activities such as real estate development, operation of hotels and assisted living facilities, and harvesting or extracting resources produced by real estate (e.g. timber) result in returns or benefits other than capital appreciation or investment income. Whether engaging in those activities would cause an entity not to meet the business purpose and investment returns fundamental characteristics depends on the significance of those activities to the entity.

Question 2.5.160 What factors are relevant in evaluating whether an entity with loan origination activities qualifies as an investment company?

Interpretive response: The AICPA provides guidance to evaluate whether loan origination represents a substantive activity that precludes an entity from qualifying as an investment company. This evaluation generally includes a quantitative and qualitative assessment of the significance of those activities relative to the entity's investing activities, including consideration of the following factors. [TQA 6910.36]

Factor	More indicative of an investment company	Less indicative of an investment company
Fees	Fee income generated from the entity's loan origination activities is insignificant relative to total income.	Fee income generated from the entity's loan origination activities is significant to total income.
Investing activity	The entity's purchases and sales of non-originated securities are significant in relation to its origination of loans.	The entity may originate loans and sell them primarily for the purpose of generating origination fees. Loans originated by the entity are its primary investments.
Regulatory considerations	The party that manages the entity is registered with the SEC or a state as an investment adviser.	The entity is required to operate as a bank by a banking authority, e.g. licensing and capital requirements.

Factor	More indicative of an investment company	Less indicative of an investment company
Entity ownership and management	The entity is managed by an investment adviser, and substantially all investors are unrelated third parties.	The entity is a bank, an entity owned by a bank, or a captive finance company.
Customization of the loans	Loans are originated with unique features specific to each individual loan.	Loans are originated using standard terms and agreements (generally in higher volumes).
Loan retention	Loans are created and held as part of the investment portfolio to match the investment horizon of the entity.	Loans are sold shortly after origination through securitizations or otherwise.
Embedded features	Originated loans include embedded features that are more akin to equity.	Originated loans do not include equity-like features.

Example 2.5.10 Structured investment vehicle

Bank forms a structured investment vehicle (Vehicle) and immediately transfers a portfolio of loans that it originated to Vehicle. Loan origination activities conducted by Bank are a substantive portion of Vehicle's business activities. Bank retains approximately 11% of the total beneficial interest in Vehicle's junior mezzanine tranche. Bank's subsidiary, Manager, performs the collateral management and is charged with monitoring Vehicle's portfolio of assets, including default mitigation activities.

In exchange for the collateral management services, Manager receives an annual fee based on the fair value of assets under management. The annual fee is consistent with the fee for similar collateral management services. Manager's sole business and source of income is serving as collateral manager for Vehicle and similar investment entities.

Vehicle is organized as a limited liability company in which Bank is the sole member, representing 100% of the equity. Potential investors receive offering documents and marketing materials, which represent that Vehicle's business purpose is generating returns for its investors in the form of investment income.

Vehicle is capitalized by the issuance of multiple classes (senior, mezzanine, and junior mezzanine) of beneficial interests to 50 investors, including Bank's retained beneficial interest. The beneficial interests collectively represent 99.9% of Vehicle's total capital (the remaining capital is comprised of the equity interest held by Bank). No investor, other than Bank, is an affiliate of Vehicle. As a subsidiary of Bank, Manager is also an affiliate of Vehicle even though it does not hold an investment interest in Vehicle.

Analysis

Vehicle's business purpose and substantive activities include investing for investment income and it has most of the typical characteristics of an investment company – i.e. Vehicle has multiple investments, has multiple investors that are not affiliated with the Bank or Manager, and is managed on a fair value basis. However, Vehicle is not an investment company because of its loan origination activities.

Loan origination is considered an activity of Vehicle because it is performed by an affiliate of Vehicle. In addition, loan origination activities are a substantive portion of Vehicle's business activities. Because there are transactions between an affiliate of Vehicle and its investees that represent a substantive portion of Vehicle's activities (including activities of its affiliates), Vehicle is considered to have the objective of obtaining returns from an investee or its affiliates that are other than capital appreciation or investment income. This is not consistent with the business purpose and investment returns fundamental characteristics of an investment company.

If the assets acquired by Vehicle were not originated by Bank, the conclusion may be different. However, if the collateral management fee were not based on the fair value of the assets under management, then Vehicle may not be considered an investment company even if the loan origination activities were performed by a non-affiliate.

Example 2.5.20 Real estate fund

Scenario 1: Entity is an investment company

Real Estate Fund (RE Fund) is a limited partnership with a 10-year life. The offering memorandum provides that RE Fund's purpose is to invest in real estate and real estate related investments for the purpose of generating investment income and capital appreciation. The general partner (GP) contributed 1% of the partners' capital and the remaining 99% of the partners' capital was contributed by 35 limited partners, none of which are related parties of the GP. The GP is also the investment manager whose responsibilities include identifying investments that meet the investment criteria prescribed by the offering memorandum.

RE Fund's investment portfolio includes entities that own operating real estate properties that are currently generating revenue and one land parcel. Other than acquiring the interests in the real estate investments to obtain returns from such investments for its investors, RE Fund does not have any other substantive business activities. RE Fund manages and evaluates the performance of its investments on a fair value basis. Information about RE Fund's financial results, including changes in the fair value of its investments, is provided by the GP to the limited partners on a quarterly basis.

To realize returns from the capital appreciation of the investees, RE Fund has plans to dispose of its investments in each of the investee real estate entities for cash at optimum value based on the investment's life cycle and the market during the 10-year stated life of the partnership.

RE Fund is an investment company. It has all three fundamental characteristics because:

- it obtains funds from investors and provides the investors with investment management services;
- its business purpose and only substantive activities, as communicated to investors in the offering memorandum, are investing solely for returns from capital appreciation and investment income;
- it has exit strategies for the investments it holds for capital appreciation; and
- it does not have an objective of obtaining returns or benefits other than capital appreciation and investment income from its investments.

RE Fund also has the following typical characteristics because:

- more than one investment: it holds more than one investment;
- more than one investor: it has more than one investor;
- investors that are not related parties of the parent (if there is a parent) or the investment manager of the entity: the investors are not related parties to the GP;
- ownership interests in the form of equity or partnership interests: its ownership is represented by partners' equity interests acquired through capital contributions; and
- substantially all of its investments are managed on a fair value basis: it manages and evaluates the performance of investments on a fair value basis.

Scenario 2: Entity is not an investment company

Assume all the facts in Scenario 1, but also assume RE Fund identifies an opportunity to increase the appreciation of the land parcel's value by developing an apartment complex. LandCo, which is the investee entity that owns the land parcel, enters into an agreement with a third-party general contractor to complete the construction. A subsidiary of GP (Affiliate) is also hired by LandCo to provide management and oversight of the general contractor in exchange for a fee that is greater than the fair value for similar services. Affiliate also provides construction management and oversight to unrelated entities, and this represents a substantive portion of the business activities of RE Fund (including Affiliate's activities).

Although RE Fund possesses some of the fundamental and typical characteristics of an investment company, it is not an investment company. Affiliate's services to LandCo are not transacted at arm's length and those activities represent a substantive business activity of Affiliate and RE Fund. Accordingly, RE Fund (together with Affiliate) has the objective of obtaining returns or benefits from an investee or its affiliates that are other than investment income or capital appreciation, which is inconsistent with business purpose and investment returns fundamental characteristics of an investment company.

2.6 Typical characteristics

This section explains the typical characteristics of an investment company. An entity that has all of the fundamental characteristics of an investment company need not have every typical characteristic to attain investment company status. Instead, it considers a given typical characteristic in light of its activities as a whole.

2.6.10 More than one investment

Excerpt from ASC 946-10

• • > More Than One Investment

55-12 An investment company typically holds multiple investments at the same time to diversify its risk and maximize its returns from capital appreciation, investment income, or both. Investments typically consist of securities of other entities, but also may include commodities, securities based on indexes, securities sold short, derivative instruments, real estate properties, and other forms of investments.

55-13 An investment company may hold investments directly or indirectly through another investment company. For example, in a master-feeder structure, a feeder fund holds multiple investments indirectly through its investment in a master fund that holds multiple investments or, in a fund-of-funds structure, an investment company holds multiple investments indirectly through its investment in an underlying fund that holds multiple investments.

55-14 Holding a single investment does not necessarily preclude an entity from being an investment company. There may be times when an investment company holds a single investment, such as in any of the following examples:

a. It is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire multiple investments.
b. It has not yet made other investments to replace those it has disposed of.
c. It is in the process of liquidation.
d. It is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (for example, when the required minimum investment is too high for an individual investor).

55-15 An investment company with a single investment also may be formed (for legal, regulatory, tax, or other business reasons) in conjunction with another investment company that holds multiple investments (for example, a master-feeder structure or blocker fund). Investment companies formed in conjunction with each other are not required to be formed at the same time. Holding a single investment for that reason does not necessarily preclude an entity from being an investment company.

Holding more than one investment is the first typical characteristic to consider when assessing investment company status. An entity will need to apply judgment in concluding whether the number of investments it holds, considering its other activities, is sufficient to conclude that it is an investment company. [946-10-55-12]

While many investment companies hold more than one investment, there are instances where an investment company may hold only one investment. However, the FASB cited holding more than one investment as a typical characteristic because investment companies often seek to maximize returns and minimize risk through diversification by holding multiple investments. [946-10-55-12]

The following table lists common circumstances in which not meeting the typical characteristic of holding more than one investment may not preclude an entity from being an investment company.

Typical characteristic: More than one investment
Common exceptions
• Funds during initial investment period (see Question 2.6.10 and section 2.7.20 for Subtopic 946-10's Example 1) • Co-investment funds (see Question 2.6.20) • Access funds (see Question 2.6.30) • Feeder funds (see section 2.7.40 for Subtopic 946-10's Example 3) • Blocker entities (see Question 2.6.60) • Funds in liquidation (see Question 2.6.10)

Question 2.6.10 Can an investment company hold a single investment during different stages of its life cycle without impacting its investment company status?

Interpretive response: Yes. Many investment companies have limited lives and there may be times when one holds a single investment, such as the following.

- It is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire multiple investments.
- It has not yet made other investments to replace those it has disposed of.
- It is in the process of liquidation.

In these situations, holding a single investment does not necessarily preclude an entity from being an investment company. [946-10-55-14]

Question 2.6.20 Can a 'co-investment fund' be an investment company?

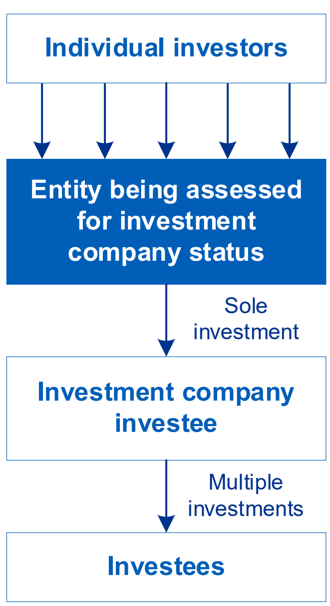
Interpretive response: Yes. An entity that is set up to provide individual investors the opportunity to invest directly into a single investment that is also owned by another investment company is commonly known as a 'co-investment fund'. If the co-investment fund was formed in conjunction with another investment company that has multiple investments, the co-investment fund would not necessarily be precluded from being an investment company. Investment companies formed in conjunction with each other do not need to be formed at the same time. [946-10-55-15]

Question 2.6.30 Can an 'access fund' be an investment company?

Background: An entity that is set up to pool investor funds to invest in a single investment company investee that might otherwise be unobtainable by the individual investors (e.g. because of high minimum investment requirements) is commonly known as an 'access fund'. Although an access fund is generally considered to be a fund of funds, it operates similar to a feeder fund in a master-feeder structure (see section 2.7.40 for Subtopic 946-10's Example 3) because it directly holds only one investment in another investment company.

Interpretive response: Yes. If the investment company investee has multiple investments, the access fund would indirectly hold multiple investments through the investee and not necessarily be precluded from being an investment company. [946-10-55-13, 55-14(d)]

The following diagram reflects this structure.



2.6.20 More than one investor

Excerpt from ASC 946-10

• • > More Than One Investor

55-16 An investment company typically pools funds from multiple investors and provides them with investment management services, including access to investment opportunities unobtainable by individual investors. Having multiple investors makes it less likely that the entity or its affiliates obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

55-17 Having a single investor does not necessarily preclude an entity from being an investment company. There may be times when an investment company has a single investor, such as in any of the following examples:

a. It is in its initial offering period, which has not expired, and it is actively identifying suitable investors.
b. It is actively identifying investors but has not yet identified suitable investors to replace those that have redeemed their ownership interests.
c. It is in the process of liquidation.

55-18 An investment company may be formed by, or for, a single investor that represents or supports the interests of a wider group of investors (for example, a pension fund, government investment fund, or endowment fund). An investment company with a single investor also may be formed (for legal, regulatory, tax, or other business reasons) in conjunction with another investment company that has multiple investors (for example, a master-feeder structure or a blocker fund). Investment companies formed in conjunction with each other are not required to be formed at the same time. Having a single investor for those reasons does not necessarily preclude an entity from being an investment company.

Having more than one investor is the second typical characteristic to consider when assessing investment company status. An entity will need to apply judgment in concluding whether the number of investors, considering its other activities, is sufficient to conclude that it is an investment company. [946-10-55-16]

While many investment companies have more than one investor, there are situations in which an investment company may have a single investor. However, the FASB cited having multiple investors as a typical characteristic of an investment company, because it reduces the risk that an entity is formed to pursue benefits not normally attributable to ownership interests, or that are other than capital appreciation or investment income. [946-10-55-16 – 55-17]

The following table lists common circumstances in which not meeting the typical characteristic of having more than one investor may not preclude an entity from being an investment company.

Typical characteristic: More than one investor
Common exceptions
• Funds during initial capital raise period (see Question 2.6.40) • Co-investment funds (see Question 2.6.20) • Sovereign wealth funds (see Question 2.6.50) • Pension funds (see Question 2.6.50) • Endowment funds (see Question 2.6.50) • Blocker entities (see Question 2.6.60) • Funds in liquidation (see Question 2.6.40) • Separate accounts

Question 2.6.40 Can an investment company have a single investor during different stages of its life cycle?

Interpretive response: Yes. Many investment companies have limited lives and there may be times when one has a single investor, such as the following scenarios.

- It is in its initial offering period, which has not expired, and it is actively identifying suitable investors.
- It is actively identifying investors but has not yet identified suitable investors to replace those that have redeemed their ownership interests.
- It is in the process of liquidation.

In these situations, having a single investor does not necessarily preclude an entity from being an investment company. [946-10-55-17]

Question 2.6.50 Can a 'fund of one' be an investment company?

Interpretive response: Yes. An entity that is set up to meet the specific needs of a single investor is commonly known as a 'fund of one'. In certain situations, the investment company may be owned indirectly by a wider group of investors (e.g. investors in a pension fund, sovereign wealth fund or endowment fund). In other situations, the investment company may be formed in conjunction with another investment company with a similar trading strategy. In these situations, the entity is formed for business reasons and indirectly has more than one investor. Therefore, it would not necessarily be precluded from being an investment company. [946-10-55-18]

Question 2.6.60 Can a wholly owned blocker corporation be an investment company?

Interpretive response: Yes. For US federal income tax or other business reasons, some investment companies establish a wholly owned entity typically to invest in a single portfolio company. Such entities are commonly referred to as blocker corporations or special purpose vehicles. A wholly owned blocker corporation does not possess the typical investment company characteristic of having more than one investor.

However, a blocker corporation is not necessarily precluded from being an investment company if it:

- possesses the fundamental characteristics and other typical characteristics of an investment company; or
- acts as an extension of another entity that meets the definition of an investment company.

When evaluating whether a blocker corporation acts as an extension of another entity that meets the definition of an investment company, the entity considers whether the combined business purpose and substantive activities of the blocker corporation and its parent are substantially the same as that of an investment company operating as a single legal entity (see Question 2.3.160 in KPMG Handbook, Consolidation). Under this analysis, the blocker corporation's substantive activities need to be performed on behalf of an investment company that has multiple investors and investments. Further, its substantive activities must be to obtain returns from capital appreciation, investment income, or both. [946-10-55-15, 55-18]

For example, assume Investment Company forms Blocker Corporation and is Blocker Corporation's sole investor. Blocker Corporation's purpose is to hold a single investment and it has no substantive activities other than to obtain returns from capital appreciation, investment income, or both from this investment. Under these circumstances, we believe Blocker Corporation can be deemed to meet the typical characteristic of having more than one investor if Investment Company has multiple investors.

2.6.30 Investors that are not related parties

Excerpt from ASC 946-10

• • > Investors That are Not Related Parties of the Parent or Investment Manager

55-19 An investment company typically has investors that are not **related parties** of the **parent** (if there is a parent) or the investment manager. Those unrelated investors, in aggregate, hold a significant interest in the investment company. Having investors that are not related parties of the parent or the investment manager makes it less likely that the entity or its affiliates obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

55-20 Investors that are related parties of the parent or investment manager should be combined and treated as a single investor, along with the parent or investment manager, for the purposes of evaluating the more-than-one-investor characteristic of an investment company in paragraph 946-10-15-7.

55-21 Having investors that are related parties of the parent or the investment manager does not necessarily preclude an entity from being an investment company. For example, an investment manager may form an investment company for its employees in conjunction with another investment company. Although the employees may be related parties of the investment manager, the investment company formed for its employees mirrors the business purpose and activities of the main investment company.

55-22 If the parent or its related parties have an implicit or explicit arrangement that would require them to acquire another investor's ownership interest in the investment company at an amount other than fair value, those interests should be combined and treated as if they were owned by the parent for the purposes of evaluating the typical characteristics of an investment company. Examples of when interests would be combined and treated as if they were owned by the parent include any of the following:

a. The parent or its related parties have a written option to acquire another investor's ownership interests in the entity at an amount other than fair value.
b. The parent finances another investor's ownership interests, and the ownership interests are collateral for the debt.

20 Glossary

Related Parties

Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.

Parent

An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)

The third typical characteristic of an investment company is that its investors are not related to the parent or the investment manager. An entity will need to apply judgment in concluding whether the nature of its investors, considering its other activities, is sufficient to conclude that it is an investment company. [946-10-55-19]

This was a characteristic of focus for the FASB, because it was one way to ensure that a larger corporate structure could not inappropriately apply the investment company accounting rules to achieve a particular accounting outcome. However, there are situations in which an entity can be an investment company even though it has investors that are related to the parent or investment manager. [946-10-55-21]

The following table lists common circumstances in which not meeting the typical characteristic of having investors that are not related parties may not preclude an entity from being an investment company.

Typical characteristic: Investors that are not related parties
Common exceptions
• Employee funds (see Question 2.6.80) • Master funds (see section 2.7.40 for Subtopic 946-10's Example 3) • Blocker entities (see Question 2.6.60)

Question 2.6.70 Can an investment company have multiple investors that are related parties?

Interpretive response: Yes. However, when evaluating the typical characteristic of having more than one investor (see section 2.6.20), an entity combines all investors that are related to the parent or investment manager and treats those related party investors as one investor (along with the parent or investment manager). [946-10-55-20]

An entity similarly combines as one investor all investors with which the parent or investment manager has an implicit or explicit arrangement that would require them to acquire the investors' ownership interest in the entity at an amount other than fair value. Examples of situations in which investor interests should be combined and treated as if they were owned by the parent include the following. [946-10-55-22]

- The parent or its related parties have a written option to acquire another investor's ownership interests in the entity at an amount other than fair value.
- The parent finances another investor's ownership interests, and the ownership interests are collateral for the debt.

In evaluating whether an entity is an investment company, its purpose and design need to be carefully considered when substantially all of its ownership interests are held by its parent or its related parties. See section 8.3 of KPMG Handbook, Financial statement presentation, for guidance on the definition of related parties. [ASU 2013-08.BC41]

Question 2.6.80 Can an 'employee fund' be an investment company?

Interpretive response: Yes. An investment manager may form a separate entity for its employees in conjunction with another investment company. This 'employee fund' generally has the same investment strategy as the main investment company but may have different investor terms to benefit the employees (e.g. lower advisory fees or lower minimum investment thresholds). Although the employees may be related parties of the investment manager, this 'employee fund' mirrors the business purpose and activities of the main investment company.

Because investors that are related parties of the investment manager are combined when evaluating the typical characteristic of having more than one investor, an 'employee fund' may not have certain of the typical characteristics of an investment company (i.e. more than one investor and investors that are not related parties). However, if the 'employee fund' was formed in conjunction with the main investment company that does have these typical characteristics, it would not necessarily be precluded from being an investment company. [946-10-55-21]

2.6.40 Ownership interests

Excerpt from ASC 946-10

• • > Ownership Interests

55-23 Ownership interests in an investment company are typically in the form of equity or partnership interests. Each ownership interest represents a specifically identifiable portion of the net assets of the investment company. An investor in an investment company contributes funds to acquire ownership interests, and the value of those interests is dependent on the changes in the fair value of the underlying investments of the investment company.

55-24 Having multiple classes of equity instruments, such as shares with distinct rights or rights that do not represent a proportionate interest in all of the underlying investments of the investment company, does not preclude an entity from meeting this characteristic of an investment company.

55-25 An investment company can be but is not required to be a separate legal entity. For example, separate accounts of life insurance companies may not be separate legal entities. However, investors in the separate accounts base their investment decisions on the changes in the fair value of the underlying investments held in those separate accounts.

55-26 In addition, having significant ownership interests that are not considered equity interests in accordance with other Topics (for example, ownership interests in the form of debt) does not necessarily preclude an entity from being an investment company provided that the holders are exposed to variable returns from changes in the fair value of the underlying investments of the entity. The economic substance of the entity, rather than its legal form, should be evaluated to determine whether the entity has that characteristic of an investment company.

The fourth typical characteristic of an investment company is that it has ownership interests in the form of equity or partnership interests. However, the FASB allows entities to consider the economic substance of ownership interests instead of focusing on legal form. To satisfy this characteristic, interests should entitle the holders to a specific portion of the net assets of the investment company. Further, the holders of the interests should be exposed to variable returns from changes in fair value of the underlying investments. [946-10-55-23, 55-26]

The following table lists common circumstances in which not meeting the typical characteristic of having ownership interests may not preclude an entity from being an investment company.

Typical characteristic: Ownership interests
Common exceptions
• Separate accounts (see Question 2.6.100) • Structured investment vehicles, such as CDOs or CLOs (see Question 2.6.110)

Question 2.6.90 Are ownership interests in an investment company required to participate in all of its underlying investments?

Interpretive response: Generally yes. Ownership interests of an investment company are typically in the form of equity or partnership interests whose values are dependent on the changes in the fair value of the underlying investments of the investment company. Each ownership interest represents a specifically identifiable portion of the investment company's net assets, including all of its investments. [946-10-55-23]

However, certain investment companies may have multiple classes of ownership interests with distinct rights or rights that do not represent a proportionate interest in all of the underlying investments of the investment company. Investors in certain classes may only participate in a portion of the investment company's investments (e.g. 'side pocket' investments). These circumstances – i.e. multiple classes of ownership interests with different investment rights – do not preclude an entity from being an investment company. [946-10-55-24]

Question 2.6.100 Is an investment company required to be a separate legal entity?

Interpretive response: No. An investment company usually is, but is not required to be, a separate legal entity. For example, separate accounts of life insurance companies may not be separate legal entities.

A portion of an entity is permitted to be an investment company if: [946-10-55-25, ASU 2013-08.BC45]

- the economic activities of that portion can be distinguished objectively from the rest of the entity;
- the financial results of that portion are useful in making decisions about whether to provide resources to that portion; and
- investors in that portion base their investment decisions on the changes in the fair value of the underlying investments held by that portion.

Question 2.6.110 Can an investment company be capitalized predominantly by beneficial interests that are classified as liabilities under US GAAP?

Interpretive response: Yes. An entity is not required to have ownership interests in the form of shares of stock or partnership interests to be an investment company. An investment company may have significant ownership interests that are not considered equity interests (e.g. ownership interests in the form of debt) provided that the holders are exposed to variable returns from changes in the fair value of the investment company's underlying investments. The economic substance of the entity, not its legal form, is evaluated to determine whether the entity possesses the typical characteristic of having ownership interests. [946-10-55-23, 55-26]

Structured investment vehicles and other entities primarily capitalized by beneficial interests that are classified as liabilities under US GAAP must be evaluated to determine whether they qualify as investment companies under the requirements of Topic 946. [946-10-55-26]

2.6.50 Managing investments on a fair value basis

Excerpt from ASC 946-10

• • > Managing on a Fair Value Basis

55-27 An investment company typically manages substantially all of its investments on a fair value basis. Determining whether an entity manages its investments on a fair value basis does not depend on the nature of its investments but, rather, includes an evaluation of whether fair value is a key component of any of the following:

a. How the entity evaluates the performance of its investments
b. How the entity transacts with its investors
c. How asset-based fees are calculated.

An investment company's activities typically demonstrate that fair value is the primary measurement attribute used to evaluate the financial performance of and to make investment decisions for substantially all of its investments. Also, an investment company typically transacts with investors on the basis of **net**

asset value per share and incurs asset-based fees, both of which are based on the fair value of its investments.

55-28 Assets held by an investment company that are used to service the investment company's own investments are not required to be managed on a fair value basis (see paragraph 946-10-55-5).

55-29 Managing investments on another basis, such as a yield basis or an income basis, does not necessarily preclude an entity from being an investment company. For example, although a short-term investment fund may evaluate the performance of its investments on a yield (amortized cost) basis, fair value is the primary measurement attribute used to evaluate the financial performance of investments and to make investment decisions because the fund monitors the fair value of its investments to minimize the differences between the carrying value and the fair value.

20 Glossary

Fair Value

The price that would be received to sell an asset or paid to transfer a liability in an **orderly transaction** between **market participants** at the measurement date.

Orderly Transaction

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

Market Participants

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not **related parties**, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms
b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary
c. They are able to enter into a transaction for the asset or liability
d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Net Asset Value per Share

Net asset value per share is the amount of net assets attributable to each share of capital stock (other than senior equity securities, that is, preferred stock) outstanding at the close of the period. It excludes the effects of assuming conversion of outstanding convertible securities, whether or not their conversion would have a diluting effect.

The fifth typical characteristic of an investment company is that it manages its investments on a fair value basis. Users of investment company financial statements place a high degree of importance on the fair value of the underlying investments. This includes the methods used to determine fair value and the changes to fair value over time, both of which allow users to understand performance of the investments.

An entity can manage its investments on a fair value basis in a number of ways. It also may use other performance metrics to manage its investments. Ultimately, the nature of its investments may impact how an entity manages them, and therefore the FASB concluded that an entity should apply judgment in determining whether it is managing its investments on a fair value basis. [946-10-55-27]

The following table lists a common circumstance in which not meeting the typical characteristic of managing investments on a fair value basis may not preclude an entity from being an investment company.

Typical characteristic: Managing on a fair value basis
Common exception
• Short-term investment funds (see Question 2.6.140)

Question 2.6.120 What factors are relevant in evaluating whether an entity manages its investments on a fair value basis?

Interpretive response: Although the nature of an entity's investments may impact how the entity manages those investments, determining whether it manages its investments on a fair value basis does not depend on the nature of its investments. Instead, it depends on whether fair value is a key input to the entity's operations and management. The following factors are relevant to this analysis:

- how the entity's financial performance is monitored and evaluated;
- the basis on which investment decisions are made;
- how information about the entity's investments is provided internally to key management personnel;
- the basis on which transactions with investors are based; and
- how asset-based fees (such as a management fee) are calculated.

An investment company's activities typically demonstrate that fair value is the primary measurement attribute used to evaluate the financial performance of, and to make investment decisions about, substantially all of its investments. Further, an investment company typically transacts with investors on the basis of NAV per share and incurs asset-based fees, both of which are based on the fair value of its investments. [946-10-55-27, ASU 2013-08.BC47]

Question 2.6.130 Are all assets of an investment company required to be managed on a fair value basis?

Interpretive response: No. An investment company typically manages its investments on a fair value basis, but not necessarily its other assets. However, an investment company should not have significant assets (or liabilities) other than those related to its investing activities, with the exception of assets related to investing-related services provided to the investment company (see Question 2.5.60). Those assets are not required to be managed on a fair value basis. [946-10-55-28]

Question 2.6.140 Can debt securities be managed on a yield basis?

Interpretive response: Yes. Managing investments on another basis, such as a yield (amortized cost) basis or an income basis, does not necessarily preclude an entity from being an investment company. An entity (e.g. a short-term investment fund) may evaluate the performance of its debt securities on a yield basis; however, fair value should be the primary measurement attribute used to evaluate the financial performance of investments and to make investment decisions (see Question 2.6.120). When an investment company manages its investments on a yield basis, it should also monitor the fair value of its investments to minimize the difference between amortized cost and fair value. [946-10-55-29]

2.7 Illustrative examples

This section contains an example that assesses whether a hypothetical private equity fund possesses the fundamental and typical characteristics of an investment company.

This section also reproduces three informative FASB examples.

Excerpt from ASC 946-10

> Illustrations

55-30 The following Examples illustrate the assessment to determine whether an entity that is not regulated under the Investment Company Act of 1940 is an investment company under this Topic:

a. Example 1: Limited partnership
b. Example 2: Technology fund
c. Example 3: Master-feeder structure.

2.7.10 Example: Investment company status for a private equity fund

A private equity investment fund (Fund) with an eight-year life is formed as a limited liability company in 201X. Fund's equity is held by 75 unaffiliated investors (98%) and the managing member and fund sponsor (Company) (2%). None of the unaffiliated investors holds a controlling financial interest in Fund. Fund's investment manager (Manager) is a subsidiary of Company and an affiliate of Fund.

Fund's purpose, as outlined in the limited liability company (LLC) agreement, is to invest in multiple portfolio company investments to generate returns solely from capital appreciation and investment income. Fund has identified exit strategies for the investments that it holds for capital appreciation. Fund manages and evaluates the performance of its investee portfolio companies on a fair value basis.

In addition to providing investment management services to Fund and other entities, Manager provides management consulting services to certain Fund investee portfolio companies in exchange for a fee. The fee charged is consistent with the fair market value of such services. The management consulting services do not represent a substantive business activity of Fund (including activities of its affiliates).

Analysis

Fund possesses the fundamental characteristics of an investment company because the following conditions exist.

- Fund obtained funds from investors and is providing the investors with investment management services.
- Fund's business purpose and only substantive activities, as communicated to investors in the LLC agreement, are investing solely for returns from capital appreciation and investment income.
- Fund has identified exit strategies for the investments it holds for capital appreciation.
- Fund does not have an objective of obtaining returns or benefits other than capital appreciation and investment income from its investments.
- Although Fund's affiliate, Manager, engages in transactions with Fund's investees (management consulting services), such services do not represent a substantive business activity of Fund (including activities of Manager) and are otherwise performed for the purpose of adding value to the investees and thus maximizing returns from capital appreciation.

Fund also possesses all of the following typical characteristics of an investment company.

- Fund holds more than one investment.
- Fund has more than one investor and the investors are not related parties to the fund sponsor, Company.

- Fund's ownership is represented by members' equity interests acquired through capital contributions.
- Fund manages and evaluates the performance of investments on a fair value basis/.

Fund is an investment company since it possesses all of the fundamental and typical characteristics of an investment company.

2.7.20 FASB Example 1: Investment company status during the start-up phase

Subtopic 946-10's Example 1 illustrates how an entity can qualify for investment company status during its start-up phase even if it has only one – or no – investments during that phase.

Excerpt from ASC 946-10

• > Example 1: Limited Partnership

55-31 Entity A, a limited partnership, is formed in 20X1 with a 10-year life. The offering memorandum provides that Entity A's purpose is to invest in operating entities with rapid growth potential, with the only objective of realizing capital appreciation from investments in those entities over the life of Entity A. One percent of Entity A's capital was contributed by the general partner (the investment manager), who has the responsibility of identifying suitable investments for Entity A. The remaining 99 percent of Entity A's capital was contributed by 75 limited partners, who are not related parties of the general partner.

55-32 Entity A begins its investment activities in 20X1. However, no suitable investments are identified during that year. In 20X2, Entity A acquires a controlling financial interest in Entity B, a corporation. Entity A is unable to identify suitable investments and complete any other investment purchases until 20X3, at which time it acquires equity interests in five additional operating companies. Other than acquiring those equity interests, Entity A conducts no other activities. Entity A manages and evaluates the performance of its investments on a fair value basis. Information about Entity A's financial results, including changes in the fair value of its investments, are provided by the general partner to the limited partners periodically.

55-33 Entity A has plans to dispose of its interests in each of its investees during the 10-year stated life of the partnership to realize returns from the capital appreciation of its investees. Those disposals include the sale of the interests for cash or the distribution of marketable equity securities to investors following a successful public offering of an investee's securities.

55-34 From formation in 20X1 to December 31, 20X3, Entity A has the fundamental characteristics of an investment company because all of the following conditions exist:

a. Entity A obtained funds from investors (the general partner and the limited partners) and is providing those investors with investment management services.
b. Entity A's business purpose and only substantive activity is acquiring interests in operating companies with the objective of realizing returns over its life from the capital appreciation of the investments. Entity A has identified exit strategies for its investments to realize the capital appreciation.
c. Entity A does not have an objective of obtaining returns or benefits other than capital appreciation from its investments.

55-35 Entity A also has all of the following typical characteristics of an investment company:

a. Entity A is funded by multiple investors.
b. The limited partners of Entity A hold a significant interest in the partnership and are not related to the investment manager (the general partner).
c. Ownership in Entity A is represented by partnership interests acquired through capital contributions.
d. Investments are managed, and their performance is evaluated on a fair value basis.

55-36 Entity A does not hold more than one investment until 20X3. However, that is because during each of the years 20X1, 20X2, and part of 20X3, it is in its start-up period and has not yet fully executed its investment plan to acquire multiple investments because it could not identify suitable investment opportunities.

55-37 Entity A is an investment company from formation in 20X1 to December 31, 20X3. It has all the fundamental characteristics of an investment company. In addition, although Entity A does not possess all of the typical characteristics of an investment company, its activities are consistent with those of an investment company.

2.7.30 FASB Example 2: Investment fund formed to invest in technology start-up companies

Subtopic 946-10's Example 2 illustrates how an entity does not have all the fundamental characteristics when one investor has the option to acquire controlling financial interests in the entity's investees at amount other than fair value.

Excerpt from ASC 946-10

• > Example 2: Technology Fund

55-38 Entity C, an investment fund, is formed in 20X1 by six corporations in the technology industry to invest in multiple technology start-up companies for capital appreciation. Entity D, one of the corporations, holds a 70 percent controlling financial interest in Entity C. The remaining 30 percent of the fund is owned by the other 5 corporations, which are not related to each other or

Entity D. Entity D holds options at amounts other than fair value to acquire controlling financial interests in the investees of the technology fund and options to purchase assets produced by the investees, if the technology developed by the investee is successful and would benefit the operations of Entity D. No plans for exiting the investments have been identified by Entity C. Entity C is managed by an investment manager that is not related to the investors. The investors in Entity C also provide significant advice to the investment manager about potential investments.

55-39 Even though Entity C's business purpose and substantive activities include investing for returns from capital appreciation and it has many of the typical characteristics of an investment company, Entity C is not an investment company because of both of the following conditions:

a. Entity D, the parent of Entity C, holds options at amounts other than fair value to acquire investees of the fund and assets of the investees if the technology developed by the investee is successful and would benefit Entity D's operations. That provides Entity D with a benefit that is other than returns from capital appreciation or investment income.
b. The investment plans of Entity C do not include exit strategies for its investments to realize returns from the capital appreciation of investees.

2.7.40 FASB Example 3: Investment company status for a master-feeder structure

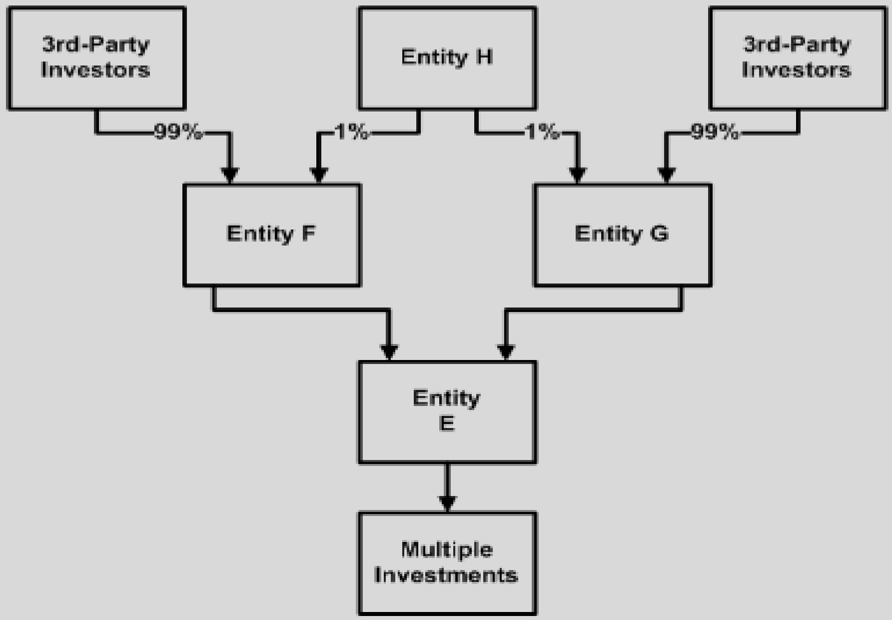
Subtopic 946-10's Example 3 illustrates a master-feeder structure in which the feeder entities qualify as investment companies.

Excerpt from ASC 946-10

• > Example 3: Master-Feeder Structure

55-40 Entity E, a master fund, is formed in 20X1 with a 10-year life. The equity of Entity E is held by Entity F and Entity G, two affiliated feeder funds. Entity F and Entity G are established in conjunction with Entity E to meet legal, regulatory, tax, or other requirements. Entity F, the domestic feeder partnership, is capitalized with a 1 percent investment from the general partner and 99 percent from unaffiliated investors (with no party holding a controlling financial interest). Entity G, the offshore feeder fund, is capitalized with a 1 percent equity investment from the sponsor and 99 percent equity investments from unaffiliated investors (with no party holding a controlling financial interest). Entity H is the investment manager for the master-feeder structure and is the general partner of Entity F and the sponsor of Entity G.

55-41 This figure illustrates the master-feeder structure.



55-42 The purpose of Entity E is to invest in multiple investments to generate returns solely from capital appreciation and investment income. Entity F and Entity G have communicated to investors that the sole purpose of the master-feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Entity E has identified exit strategies for the investments that it holds for returns from capital appreciation. In addition, Entity E manages, and evaluates the performance of, its investments on a fair value basis. Entity F and Entity G provide their investors with periodic information about the financial results of the master-feeder structure.

55-43 Entity E, Entity F, and Entity G each possess the fundamental characteristics of an investment company because all of the following conditions exist:

a. Entity E, Entity F, and Entity G obtained funds from investors and are providing those investors with investment management services.
b. The master-feeder structure's business purpose and only substantive activities, which were communicated to investors of Entity F and Entity G, are investing solely for returns from capital appreciation and investment income.
c. Entity E has identified exit strategies for the investments it holds for returns from capital appreciation. Although Entity F and Entity G do not have an exit strategy for their interests in Entity E, they are considered to have an exit strategy for their investments because Entity E was formed in conjunction with Entity F and Entity G and holds investments on behalf of them.
d. Entity E, Entity F, and Entity G do not have an objective of obtaining returns or benefits other than capital appreciation and investment income from their investments.

55-44 Entity E, Entity F, and Entity G each also possess all of the following typical characteristics of an investment company:

a. Entity E holds more than one investment. Both Entity F and Entity G also are considered to hold more than one investment because they were formed in conjunction with Entity E.
b. Both Entity F and Entity G are funded by multiple investors. Entity E also is considered to be funded by multiple investors because it was formed in conjunction with Entity F and Entity G.
c. Both Entity F and Entity G have investors that hold a significant interest in the partnership and are not related to the investment manager (Entity H). Although Entity F and Entity G are related to Entity E, Entity E is considered to have unrelated investors because it was formed in conjunction with Entity F and Entity G, which have unrelated investors.
d. Ownership in Entity E and Entity G are represented by equity interests acquired through capital contributions. Ownership in Entity F is represented by partnership interests acquired through capital contributions.
e. Entity E manages and evaluates the performance of investments on a fair value basis. Additionally, investors of Entity F and Entity G are provided with periodic financial information about the investing activities of Entity E, which includes information about the change in fair value of investments held.

55-45 Entity E, Entity F, and Entity G are investment companies. They possess all the fundamental characteristics of an investment company and all the typical characteristics of an investment company, either directly or indirectly as a result of the master-feeder structure.

2.8 Reassessment of investment company status

Excerpt from ASC 946-10

> Reassessment of Investment Company Status

25-1 The initial determination of whether an entity is an investment company within the scope of this Topic shall be made upon formation of the entity. An entity shall reassess whether it meets (or does not meet) the assessment of investment company status in paragraphs 946-10-15-4 through 15-9 only if there is a subsequent change in the purpose and design of the entity or if the entity is no longer regulated under the Investment Company Act of 1940.

25-2 An entity that is no longer an investment company under this Topic as a result of the reassessment of status shall discontinue applying the guidance in this Topic and shall account for the change in its status prospectively by accounting for its investments in accordance with other Topics as of the date of the change in status. The **fair value** of an investment at the date of the change in status shall be the investment's initial carrying amount.

25-3 An entity that subsequently is an investment company under this Topic as result of the reassessment of status shall account for the effect of the change in status from the date of the change in status. The effect of applying this

Topic shall be recognized as a cumulative-effect adjustment to net assets at the date of the change in status. The cumulative-effect adjustment shall be included in the net asset value at the beginning of the period in the per-share information included in the financial highlights. The adjustment to net assets represents both of the following:

a. The difference between the fair value and the carrying amount of the entity's investees (or **parent**'s portion of the assets minus liabilities for consolidated investments) at the date of the change in status
b. Any amounts previously recognized in accumulated other comprehensive income.

An entity's status under Topic 946 can change for a variety of reasons. First, it could either become regulated under the 1940 Act or cease to be regulated under that Act. Second, if it has not been regulated under the Act and was evaluated for investment company status by applying the fundamental and typical characteristics, a change in facts regarding anyone of those characteristics could affect this prior evaluation.

Question 2.8.10 When is investment company status reassessed?

Interpretive response: An investment company's status is reassessed using the fundamental and typical characteristics under any of the following circumstances: [946-10-25-1]

- it had been regulated under the 1940 Act but is no longer;
- it becomes regulated under the 1940 Act; or
- it had not been regulated under the 1940 Act but there has been a change in its purpose or design.

Examples of indicators that there may be a change in an entity's purpose or design resulting in the entity no longer having the characteristics of an investment company include when the entity has:

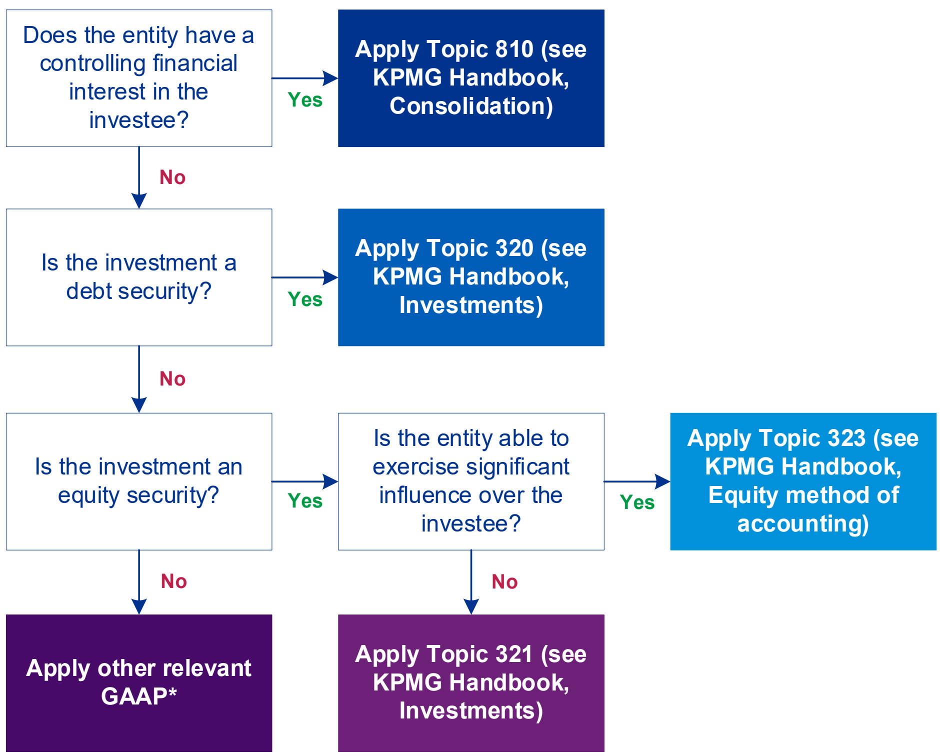
- commenced a new line of business or changed its business strategy;
- terminated its agreements with the investment manager;
- entered into a new arrangement involving goods or services with an investee (or an affiliate) (this also applies when an affiliate of the entity has entered into such a new arrangement);
- redeemed the ownership interests of investors that are not related parties of the parent or the investment manager;
- acquired a controlling financial interest in an operating company in which it does not have an exit strategy;
- become actively involved in the day-to-day management of an investee;
- entered into relationships or activities that could result in obtaining returns or benefits from an investee (or an affiliate) that are not normally attributable to ownership interests or that are other than capital appreciation

or investment income (this also applies when an affiliate of the entity has entered into such relationships) (see section 2.5.30).

Question 2.8.20 How does an entity that is no longer an investment company account for the effect of the change in status?

Interpretive response: An entity that is no longer an investment company due to a change in status discontinues applying Topic 946 and accounts for its investments under other Topics on a prospective basis as of the date of the change in status. The initial carrying amount for investments under this new basis of accounting is the fair value as of the date of the change in status. [946-10-25-2]

The following decision tree summarizes the applicable guidance to consider when accounting for the entity's investments upon the change in status.



*Other relevant GAAP applicable to an entity's other investments upon a change in status may include, e.g., Topic 310 (loans receivable), Topic 815 (derivative instruments), Topic 825 (financial instruments) and Topic 360 (property, plant and equipment).

Upon a change in status, an entity should also consider whether other Topics that may not have applied while it was an investment company now apply. For example, if the entity has a controlling financial interest in an investee, it may need to allocate the fair value of the investee to the underlying assets and liabilities of the investee (see KPMG Handbooks, Business combinations and Asset acquisitions).

Question 2.8.30 How does an existing entity that becomes an investment company account for the effect of the change in status?

Interpretive response: An entity that becomes an investment company due to a change in status applies Topic 946 as of the date of the change. The effect of initially applying Topic 946 is recognized as a cumulative-effect adjustment to the entity's net assets as of the date of the status change.

The cumulative-effect adjustment to net assets includes:

- the difference between the fair value and the carrying amount of the entity's investees (or parent's portion of the assets minus liabilities for consolidated investments) as of the date of the status change; and
- any amounts previously recognized in AOCI.

The cumulative-effect adjustment to net assets is also reflected in the NAV at the beginning of the period (i.e. as of the date of change in status) included in the per-share information presented in the financial highlights for investment companies that compute unitized NAV. Therefore, financial highlights are presented prospectively from the date of the change in status and do not reflect the operations during the period in which the entity was a non-investment company. [946-10-25-3, 946-205-50-7]

Question 2.8.40 Does an entity that becomes an investment company due to a change in status record a gain or loss from deconsolidation of its previously consolidated investees?

Background: An investment company generally accounts for its investments at fair value and does not consolidate its investees unless certain exceptions apply (see Question 2.3.130 in KPMG Handbook, Consolidation). Therefore, upon a change in status from a non-investment company to an investment company, the entity no longer applies consolidation guidance to its investees.

Interpretive response: No. Generally, the deconsolidation of a subsidiary results in removing the net assets of the subsidiary from the accounts of the former parent and the recognition of a gain or loss in net income. See Question 7.6.10 in KPMG Handbook, Consolidation.

However, we do not believe a gain or loss from deconsolidation should be recognized when the deconsolidation results from the change in status to become an investment company. Instead, we believe the effects of deconsolidation should be reflected in the cumulative-effect adjustment that is recorded upon the change in status (see Question 2.8.30) and that applying the gain or loss on deconsolidation guidance under Topic 810 would result in double-counting of the effects of deconsolidation.

2.9 Disclosures

Excerpt from ASC 946-10

> Investment Company Status

50-1 An investment company under this Topic shall disclose that it is an investment company following accounting and reporting guidance in this Topic.

• > Change in Status

50-2 An entity with a change in status (as described in paragraphs 946-10-25-1 through 25-3) shall disclose that a change in status occurred and the reasons for that change.

50-3 An entity that previously was not an investment company under this Topic and becomes an investment company under this Topic shall disclose the effect of the change in status on the reported amounts of investments as of the date of the change in status.

Excerpt from ASC 946-20

> Financial Support to Investees

50-15 If, during the periods presented, an investment company provides financial support to an investee, it shall disclose information about both of the following items, disaggregated by financial support that it was contractually required to provide and financial support that it was not previously contractually required to provide:

a. The type and amount of financial support provided, including situations in which the investment company assisted the investee in obtaining financial support
b. The primary reasons for providing the financial support.

50-16 An investment company also shall separately disclose both of the following items about financial support that it is contractually required to provide to any of its investees but has not yet provided:

a. The type and amount of financial support to be provided, including situations in which the investment company must assist the investee in obtaining financial support
b. The primary reasons for the contractual requirement to provide the financial support.

Question 2.9.10 Is an entity required to disclose that it is an investment company under Topic 946?

Interpretive response: Yes. An entity discloses that it is an investment company that is following the accounting and reporting guidance in Topic 946. [946-10-50-1]

Question 2.9.20 Is an entity required to disclose a change in investment company status?

Interpretive response: Yes. An entity with a change in status (see section 2.8) discloses that a change in status occurred and the reasons for that change. An entity that previously was not an investment company discloses the effect of the change in status on the reported amounts of investments as of the date of the change. [946-10-50-2 – 50-3]

Question 2.9.30 Is an investment company required to disclose the financial support it provides to its investees?

Interpretive response: Yes. An investment company that provides financial support to its investee during the period presented discloses the type and amount of financial support provided, including situations in which the investment company assisted the investee in obtaining financial support, and the primary reasons for providing the financial support. In addition, these disclosures must separately include financial support that the investment company is contractually required to provide but has not yet provided to investees. [946-20-50-15 – 50-16]

The objective of the financial support disclosure is to provide information about an investment company's financial support commitments as of the reporting date and potential future obligations to investees. However, such information is not intended to be forward looking in nature; therefore, the financial support disclosure does not include support that the entity is not contractually required to provide or merely intends to provide. [ASU 2013-08.BC69]

Question 2.9.40 What types of transactions constitute financial support to investees?

Interpretive response: Topic 946 does not clearly define what constitutes financial support to investees for purposes of its disclosure requirements, but paragraph 946-10-55-10 cites loans, capital commitments, and guarantees as examples of financial support that an investment company may provide to an investee (see Question 2.5.120). Because the guidance in paragraph 946-10-55-10 is within the context of evaluating whether an entity's activities are consistent with the activities of an investment company, we do not believe that the financial support disclosure requirement is intended to include financial transactions entered into with an investee with the primary objective of obtaining returns from capital appreciation or investment income (i.e. activities that are consistent with the activities of an investment company, such as purchases of securities). Therefore, we believe the financial support disclosure requirement pertains to support with a primary objective other than obtaining returns from capital appreciation or investment income.

Determining whether financial support to an investee has a primary objective other than obtaining returns from capital appreciation or investment income may require significant judgment. Certain activities – such as assisting the investee with obtaining financial support, providing capital infusions and restructuring defaulted debt – may be provided with the objective to enhance or to preserve the value of the investment company's other investments, but may not in and of itself provide the investment company with returns from capital appreciation or investment income. For example, capital infusions are expenditures made directly to the issuer to ensure that operations continue, thereby allowing the issuer to generate cash flows to service the debt (see Question 3.5.80). We believe an entity should consider the expected recoverability of expenditures, as well as any contractual requirements, when evaluating whether such items should be included in the financial support disclosure. [946-320 Glossary]

3. Investments

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3.4 Initial measurement

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3.5 Subsequent measurement

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3.6 Interest income

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3.8 Derecognition of investments

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Example 3.8.30 Partial redemptions of an investment in an investment company – Return of capital method

Example 3.8.40 Partial redemptions of an investment in an investment company – average cost method

3.9 Accounting for foreign investments

Questions

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3.1 How the standard works

An investment company's portfolio of investments generally comprises the majority of the company's net assets. Such investments are acquired to achieve the investment objectives of providing returns to investors in the form of investment income and/or capital appreciation. Because of the importance of the values of these investments to investors, investment companies measure their investments at fair value in their financial statements.

This chapter explains the specialized guidance in Topic 946 that investment companies use to recognize, measure and derecognize investments, and to account for investment income. The following table explains how the guidance in Topic 946 is structured based on two broad categories of investments.

Debt and equity securities	Subtopic 946-320 provides guidance on accounting for investments in debt and equity securities, including accounting for related interest and dividend income from investments in such securities.
'Other' investments	Subtopic 946-325 provides guidance on accounting for other investments, which include other asset classes such as loan receivables, derivative instruments, real estate properties, physical commodities and digital assets.

Recognition and measurement

Investment companies typically measure investments initially at the transaction price and subsequently at fair value. When they recognize investments depends on the transaction type.

Transaction type	Recognition date
Conventional channels (i.e. regular-way transactions)	Trade date, which is the date the investment company agrees to purchase or sell the security.
Securities that have not yet been identified or do not yet exist (e.g. TBA securities, when-issued securities)	The date the investment company enters into a commitment to purchase the security or when the commitment has been fixed.
Outside of conventional channels (e.g. private placements, tender offers)	The date the investment company obtains a right to demand the securities purchased (or to collect the proceeds of a sale) and incurs an obligation to pay the price of the securities purchased (or to deliver the securities sold).

Other issues

Other issues investment companies face concerning their investments include how to account for interest and dividends, as well as whether and when to derecognize their investments. Each of these areas has its unique issues, as does accounting for foreign investments.

The presentation and disclosure requirements for investments are addressed in chapter 7.

3.2 Types of investments

Excerpt from ASC 946-320

05-1 This Subtopic addresses an investment company's accounting for investments in debt and equity securities, including matters encountered by investment companies holding **high-yield debt securities** in their portfolios. Included is discussion of all of the following matters:

a. Interest income from step bonds and payment-in-kind bonds
b. Previously recorded purchased interest if recoverability becomes doubtful in connection with defaults or potential defaults by issuers
c. Additional expenditures made by investment companies in support of high-yield debt securities and other securities.

05-2 An investment company's securities portfolio typically comprises substantially all its net assets. Portfolio securities produce income from dividends, interest, and changes in **fair values** of securities while they are owned by the fund.

Excerpt from ASC 946-325

05-1 This Subtopic addresses an investment company's accounting for its other investments.

Excerpt from ASC 946-20

> Background Information about Investment Company Activities

05-1A Typically, an investment company sells its ownership interests, invests the proceeds to achieve its investment objectives, and provides returns to its investors from the net income earned on its investments and net gains realized on the disposal of its investments.

Excerpt from ASC 946-10

> More Than One Investment

55-12 An investment company typically holds multiple investments at the same time to diversify its risk and maximize its returns from capital appreciation, investment income, or both. Investments typically consist of securities of other entities, but also may include commodities, securities based on indexes, securities sold short, derivative instruments, real estate properties, and other forms of investments.

This chapter explains how an investment company accounts for investments in its investment portfolio. Therefore, the gating issue is whether financial instruments and other asset classes included in an investment company's portfolio are 'investments'. Topic 946 places 'investments' into two broad categories.

- Subtopic 946-320 contains specialized guidance on how an investment company accounts for investments in debt and equity securities.
- Subtopic 946-325 contains specialized guidance on how an investment company accounts for other types of investments included in its investment portfolio that are not in the form of securities (*other investments*). Such other investments can include other financial assets that do not possess the characteristics of securities as well as nonfinancial assets such as real estate properties, physical commodities and digital assets.

Question 3.2.10 What are considered to be investments of an investment company?

Interpretive response: Because neither Subtopic 946-320 nor Subtopic 946-325 specifically defines the term *investments*, it may not always be clear which classes of assets or liabilities (e.g. securities sold short and derivative instruments) should be included in an investment company's investment portfolio and therefore subject to Topic 946's specialized accounting for investments.

We believe assets and liabilities other than securities should be accounted for as other investments under Subtopic 946-325 when their nature and purpose are to provide returns from capital appreciation, investment income, or both, and they are invested in a manner consistent with the stated investment objectives of the investment company (see chapter 2).

The following table provides examples of investments that may be included in an investment company's portfolio and the applicable accounting guidance respective to those investments.

Type of investment	Subtopic 946-320	Subtopic 946-325	Reference
Equity securities	✓		Question 3.2.20
Debt securities	✓		Question 3.2.20
Securities sold short	✓		Question 3.2.30
Ownership interests in other investment companies	✓		Question 3.2.40
Short-term investments	✓		Question 3.2.50[1]
Loans receivable		✓	Question 3.2.60
Beneficial interests in securitized financial assets	✓		Question 3.2.70[2]
Repurchase agreements		✓	Question 3.2.80
Derivative instruments		✓	Question 3.2.90[3]
Real estate properties		✓	Question 3.2.100

Type of investment	Subtopic 946-320	Subtopic 946-325	Reference
Physical commodities		✓	Question 3.2.100
Digital assets		✓	Question 3.2.110
Contingent consideration receivable from the sale of a portfolio investment		✓	Question 3.2.130

Notes:

1. An investment company should consider whether its use of short-term investments is consistent with its investment objectives or related to cash management activities.
2. Beneficial interests are typically accounted for as investments in securities, and therefore follow the recognition and measurement guidance under Subtopic 946-320. However, for investments in beneficial interests that are within the scope of Subtopic 325-40, investment companies apply the income recognition guidance under Subtopic 325-40 instead of Subtopic 946-320.
3. Although derivative instruments are subject to the guidance in Subtopic 946-325, derivative instruments are also subject to the applicable requirements under Topic 815.

Question 3.2.20 Do Topics 320 and 321 apply to an investment company's investments in securities?

Interpretive response: No. Investment companies apply Subtopic 946-320 to account for investments in debt and equity securities. Although Topics 320 and 321 address accounting and reporting for investments in debt securities and equity securities, respectively, those Topics do not apply to entities in certain industries, including the investment company industry, whose specialized accounting practices include accounting for substantially all investments at fair value. [946-320-05-1, 320-10-15-3, 321-10-15-3]

Question 3.2.30 Are securities sold short considered investments under Subtopic 946-320?

Background: A short sale is a sale of securities that requires an entity to borrow equivalent securities to deliver to the buyer. Investment companies frequently enter into short sale transactions with the expectation of a decline in the fair value of a security and to realize a gain from replacing the security sold short at a lesser price than it was sold for. The resulting securities sold short (short positions) reported on the statement of assets and liabilities are not in and of themselves the securities of an issuer, but rather represent the investment company's obligation to replace the securities borrowed to effect the short sale transactions. [AAG-INV 3.73]

Interpretive response: Yes. Although Subtopic 946-320 does not explicitly address whether it applies to securities sold short, our observation is that investment companies typically account for the recognition and measurement of securities sold short and related interest and dividends under Subtopic 946-320 in the same manner as investments in securities (long positions) under longstanding industry practices. See Questions 3.6.70 and 3.7.70 on recognition of interest and dividends on securities sold short.

Question 3.2.40 Are ownership interests in other investment companies considered investments?

Interpretive response: Yes. Some investment companies invest in other investment companies with the purpose of achieving capital appreciation or receiving investment income from the other investment company. Therefore, ownership interests in other investment companies are considered investments under Topic 946. [946-210-50-8]

Ownership interests in other investment companies are typically in the form of equity interests and are therefore within the scope of Subtopic 946-320. Additionally, Subtopic 946-210 requires incremental disclosures for investments in other investment companies. See section 7.6.40 for additional guidance.

Question 3.2.50 Can short-term securities classified as cash equivalents be considered investments?

Interpretive response: Yes. For purposes of presenting a statement of cash flows (see sections 9.2 and 9.3), an investment company may elect an accounting policy to classify certain eligible short-term securities as cash equivalents – e.g. money market funds, Treasury bills and commercial paper. However, we do not believe an investment company's accounting policy for classifying short-term securities as cash equivalents affects the accounting for the short-term securities. We believe such securities are still accounted for under the same guidance as other investments in securities, if the nature and purpose for holding short-term securities is consistent with the overall investment objectives of the entity.

If the nature and purpose for holding short-term securities are primarily for treasury or cash management activities, and the expected capital appreciation and/or investment income from those investments are not significant to the investment objectives of the entity, we believe an investment company may elect an accounting policy to exclude such short-term securities from its classification of investments. However, if the short-term securities no longer have the attributes to be considered a cash equivalent, they may need to be reclassified as an investment (see Question 6.3.60 in KPMG Handbook, Statement of cash flows).

Question 3.2.60 Are loans receivable considered investments in debt securities or other investments?

Interpretive response: Loans receivable typically do not meet the definition of a debt security unless converted to a security, such as through a securitization transaction (see Question 2.4.40 in KPMG Handbook, Investments).

Loans receivable are considered other investments of an investment company when the nature and purpose of an investment company's lending activities is to generate investment income or when loans are acquired for investment income or capital appreciation. However, because Subtopic 946-325 does not provide guidance on accounting for investment income from other investments, we believe it is appropriate to account for loans receivable in a similar manner as interest-bearing securities, using the income recognition guidance in Subtopic 946-320.

Loan origination and similar activities

Certain aspects of lending activities can jeopardize an entity's investment company status, which in turn would preclude the entity from applying Topic 946 to any of its investments. Most notably, this can occur when the nature and purpose of certain lending activities, such as loan origination, is to generate fee revenues from performing a service, rather than obtaining returns from capital appreciation and/or investment income. An entity might not qualify as an investment company if these activities are substantive to the investment company or its affiliates (see Question 2.5.160).

Question 3.2.70 Are beneficial interests in securitized financial assets considered investments in securities or other investments?

Interpretive response: Investment companies may invest in beneficial interests in securitized financial assets (beneficial interests). Beneficial interests are rights to receive all or a portion of specific cash inflows received by a trust or other entity. Examples include mortgage-backed securities, asset-backed securities, collateralized debt obligations, and interest-only (IO) or principal-only (PO) strips. [860-10 Glossary]

Beneficial interests are generally considered securities that represent either debt or equity interests issued by a securitization vehicle, and therefore are investments in securities in the scope of Subtopic 946-320. However, for income recognition purposes, investment companies are required to apply the guidance in Subtopic 325-40 because they report interest income separately, even though the investments in beneficial interests are accounted at fair value. [325-40-15-7]

See Question 3.6.90 and chapter 20 in KPMG Handbook, Credit impairment, for additional guidance on the income recognition of beneficial interests.

Question 3.2.80 Are repurchase agreements and reverse repurchase agreements considered investments?

Background: Repurchase agreements (repos) and reverse repurchase agreements (reverse repos) involve the transfer of a security with a corresponding agreement for the transferor to reacquire the same (or substantially the same) security from the counterparty at a fixed or determinable price (including interest) at a future date.

Under common industry practice, the terminology is typically applied by investment companies in reverse relative to the flow of transactions as described in the ASC Master Glossary terms (i.e. the terminology is described from the perspective of the counterparty, usually a bank or broker). For investment companies, a repo describes the purchase of a security under agreement to resell (as an asset), and a reverse repo describes the sale of a security under agreement to repurchase (as a liability). [AAG-INV 3.08, 3.11]

Interpretive response: Repos and reverse repos are collateralized lending and borrowing arrangements that involve the transfer of securities between the investment company and a counterparty but may not be securities in and of themselves. Instead, an investment company may need to determine whether repos and reverse repos are considered other investments based on their nature and purpose.

Repo agreements (asset)

Under a repo agreement, an investment company transfers excess cash to the counterparty in exchange for securities, which collateralize the transaction. Because the investment company is entitled to cash proceeds plus interest when it resells the securities to the counterparty, the investment company earns investment income from the repos. Because they earn investment income, an investment company accounts for the repos as other investments.

Reverse repo agreements (liabilities)

Under a reverse repo agreement, the investment company receives cash in exchange for securities and agrees to repay cash plus interest upon the expiration of the agreement. Because reverse repos do not provide returns from capital appreciation and/or investment income, they are not considered investments. Instead, reverse repos represent fixed, determinable obligations of an investment company. As such, reverse repos are borrowings that represent financing activities. [TQA 6910.22]

Question 3.2.90 Are derivative instruments considered investments?

Interpretive response: It depends on the nature and purpose for entering into derivative transactions. Investment companies that hold derivatives for trading or speculative purposes seek to obtain returns from capital appreciation resulting from changes in the fair values of the derivatives. Therefore, derivatives held for trading or speculative purposes are considered other investments under Subtopic 946-325.

Some investment companies may use derivatives for hedging purposes rather than for trading purposes. However, derivatives used by investment companies for hedging purposes are often used to hedge risks in the investment portfolio, such as interest rate risk, foreign currency risk, credit risk and price risk.

When the objective of derivatives used for hedging purposes is to manage the risks related to investment activities, we believe the use of such derivatives may be consistent with the nature and purpose of an investment to maximize the capital appreciation and investment income. See KPMG Handbook, Derivatives and hedging, for additional guidance on the application and criteria required to apply hedge accounting.

Regardless of whether an investment company uses derivatives for trading, speculative or hedging purposes, all derivative instruments are subject to the applicable requirements under Topic 815, including subsequent measurement at fair value. [815-10-15-1, 30-1, 35-1]

Question 3.2.100 Are physical assets considered investments?

Interpretive response: It depends. An investment company may hold physical assets, such as real estate properties and physical commodities. These assets are other investments under Subtopic 946-325 if their nature and purpose are consistent with the characteristics of an investment company – i.e. to obtain returns from capital appreciation and/or investment income. Physical assets do not generate investment income in the form of interest and dividends, and therefore are generally held for capital appreciation only. However, certain physical assets, such as real estate properties, may generate cash flows that may be considered analogous to investment income.

In contrast, the nature and purpose of physical assets is not consistent with an investment company if the assets are being used as part of an entity's operations, such as real estate property currently in use as office space by personnel of the investment company or a related investment adviser. This is the case while the property is 'in use', even if the investment company has the ability to sell the property for capital appreciation in the future. Instead, we believe such real estate property is accounted for under Topic 360 while it remains in use.

Lastly, if the nature of physical assets and the purpose for holding them are to obtain returns or benefits other than capital appreciation and/or investment income, the use of such assets may indicate the entity is engaged in substantive activities that are inconsistent with those of an investment company. This could jeopardize the entity's investment company status (see Question 2.5.60).

Question 3.2.110 Are digital assets considered investments?

Background: Although not defined under US GAAP, digital assets are commonly understood to include assets that both:

- are created or reside on a distributed ledger based on blockchain (or similar) technology; and
- are secured through cryptography.

Digital assets include all the following (not exhaustive):

- 'cryptocurrencies' like bitcoin and ether;
- stablecoins that meet the US GAAP definition of a financial asset (e.g. USD Coin);
- central bank digital currencies (CBDCs);
- nonfungible tokens (NFTs); and
- various 'tokenized' securities (e.g. a digital token representing a fractionalized share of an underlying corporate bond).

Interpretive response: It depends. We believe digital asset holdings of an investment company should be accounted for as other investments under Subtopic 946-325 when those assets are held solely for returns from capital appreciation and/or investment income. The SEC staff has a similar position, indicating that it generally expects digital assets to be accounted for as other investments under Subtopic 946-325. [AICPA IC EP 5/2018]

However, such accounting may not be appropriate if the nature of the digital assets and the purpose for obtaining them suggest the assets are intended to produce benefits other than capital appreciation and/or investment income. This may be the case, for example, if the digital assets are intended solely to act as a medium of exchange for goods or services.

Crypto intangible assets are a subset of digital assets that also meet the US GAAP definition of an intangible asset. We believe most forms of cryptocurrencies that are held as other investments of an investment company will meet the definition of a crypto intangible asset. See KPMG Issues In-Depth, Accounting for crypto intangible assets by investment companies, for additional accounting information about crypto intangible assets held by investment companies.

Question 3.2.120 Are carbon credits considered investments?

Interpretive response: It depends. Carbon credits held by an investment company are accounted for as other investments under Subtopic 946-325 when those assets are held solely for returns from capital appreciation and/or investment income.

However, the nature and purpose for obtaining the carbon credits may not be for capital appreciation and/or investment income. For example, if the investment company's objective for obtaining the carbon credits was solely to offset its own carbon footprint or the carbon footprint of its investees, rather than to obtain capital appreciation and/or income from the sale of the carbon credits, the carbon credits are not considered other investments. Instead, the investment company would apply other US GAAP based on the substance of the transaction.

Question 3.2.130 Are contingent consideration arrangements from the sale of a portfolio investment considered investments?

Background: Some investment companies are entitled to contingent consideration as part of the proceeds received from the sale of portfolio investments. Examples of contingent consideration arrangements include earn out payments to be received based on future revenues exceeding a specified threshold, or milestone payments to be received contingent on meeting specified conditional events.

Interpretive response: Yes. An investment company first determines whether the contingent consideration represents a derivative by evaluating the terms of the agreement.

If the contingent consideration meets the definition of a derivative, it is recognized under Topic 815 as an asset or a liability (depending on the rights and obligations under the contract) that is initially and subsequently measured at fair value. As a derivative, it would be an other investment of the investment company because its principal purpose is to obtain returns from capital appreciation (see Question 3.2.90). [815-10-25-1, 30-1, 35-1]

If the contingent consideration is not a derivative, we believe an investment company should account for contingent consideration as an other investment when the arrangement is legally enforceable and the objective of the contingent consideration arrangement is to obtain additional capital appreciation from the sale of the portfolio investment. A legal determination may be needed to evaluate the enforceability of the legal rights and obligations under the contract.

3.3 Recognition of investments

Excerpt from ASC 946-320

> Effective Date of Transactions

• > Trade Date Recognition for Securities Purchased and Sales Other Than Private Placements and Tender Offers

25-1 An investment company shall record security purchases and sales as of the trade date, the date on which the investment company agrees to purchase or sell the securities, so that the effects of all securities trades entered by or for the account of the investment company to the date of a financial report are included in the financial report.

• > Private Placements and Tender Offers

25-2 A securities transaction outside conventional channels, such as through a private placement or by submitting shares in a tender offer, shall be recorded as of the date the investment company obtained a right to demand the securities purchased or to collect the proceeds of sale, and incurred an obligation to pay the price of the securities purchased or to deliver the securities sold, respectively. Determining the recording date may sometimes require an interpretation by legal counsel.

Excerpt from ASC 815-10

> Regular-Way Security Trades

15-15 Regular-way security trades are defined as contracts that provide for delivery of a security within the period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way security trades scope exception applies, but if the contract requires settlement in five days, the regular-way security trades scope exception does not apply unless the reporting entity is required to account for the contract on a trade-date basis.

The principles for recognizing investments under Topic 946 are distinct from those in other US GAAP topics for non-investment companies. Typically, entities not applying Topic 946 recognize investments on the settlement date. However, investment companies recognize investments (i.e. record an investment purchase as an asset and a liability for the payment) on the trade date, provided the transaction takes place through conventional channels. [946-320-25-1]

This section covers when to recognize investments, as summarized in the following table, and other measurement topics specific to investment companies.

Transaction type	Recognition date
Conventional channels (i.e. regular-way transactions)	Trade date, which is the date the investment company agrees to purchase or sell the security
Securities that have not yet been identified or do not yet exist (e.g. TBA securities, when-issued securities)	The date the investment company enters into a commitment to purchase the security or when the commitment has been fixed.
Outside of conventional channels (e.g. private placements, tender offers)	The date[1] the investment company obtains a right to demand the securities purchased (or to collect the proceeds of a sale) and incurs an obligation to pay the price of the securities purchased (or to deliver the securities sold).

Note:

1. Determining the recognition date may sometimes require an interpretation by legal counsel.

Question 3.3.10 When are purchases and sales of securities acquired through regular-way transactions recognized?

Background: Many securities transactions occur through regular-way trades that provide for delivery of a security within the period generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. The risks and rewards associated with the securities transfer to the buyer when the trade is executed, although the physical settlement of the security does not occur until several days later on the settlement date.

Interpretive response: An investment company recognizes purchases and sales of securities under regular-way trades as of the trade date, which represents the date that the investment company agrees to purchase or sell the securities. Under trade date recognition, the effects of such securities trades entered into by or for the account of the investment company are included in its NAV when the investment company is entitled to risks and rewards of the security, not when the security is physically transferred to or from the investment company. Therefore, all regular-way trades made by the investment company up to the reporting date are reflected in its closing NAV. [815-10-15-15, 946-320-25-1, AAG-INV 1.58]

Question 3.3.20 When are transactions involving securities that have not yet been identified or do not yet exist recognized?

Background: Certain types of securities transactions involve contractual terms for the purchase or sale of securities that have not yet been identified or do not yet exist. These include to-be-announced (TBA) securities and when-issued securities.

Transaction type	Description
TBA securities	Forward-settled transactions in which the actual securities that will be delivered are not identified at the time the trade is entered into; typically the securities to be delivered are identified shortly prior to the settlement date. [AAG-INV 3.19]
When-issued securities	Conditional offerings through underwriter solicitations of securities that have been authorized but not yet issued. If the offering does not generate sufficient interest, it may be cancelled by the underwriter. Once the terms of the issuance are known, the underwriter sends a when-issued price confirmation; however, the transaction is not settled until the securities have been issued. [AAG-INV 3.24]

Interpretive response: TBA securities are recognized at the time the investment company enters into a commitment to purchase or sell a security. Although the actual security is not designated at the time of commitment, the price of the TBA securities and the date that they will be delivered are typically included in the commitment terms. [AAG-INV 3.21]

A when-issued security is recognized when the commitment to pay for the security has been fixed. This typically occurs when transaction confirmation is issued by the underwriter. [AAG-INV 3.25]

Question 3.3.30 When are purchases of securities acquired outside of conventional channels recognized?

Background: Purchases of securities by an investment company may occur outside of conventional channels used for regular-way securities transactions or other transactions conducted through a securities exchange or similar mechanisms. Securities transactions outside of conventional channels may include investment transactions conducted through private placement offerings or when an investment company submits shares in a tender offer.

Interpretive response: Securities transactions outside of conventional channels are recognized on the date the investment company:

- obtained a right to demand the securities purchased; and
- incurred an obligation to pay the price of the securities purchased.

Determining the date on which the rights were obtained and obligations were incurred and the enforceability of such rights and obligations may be subject to legal interpretation. [946-320-25-2, FRR 404.03a]

Example 3.3.10 Purchase of securities through a private placement

On July 1, ABC Fund enters into an agreement to purchase shares of a privately held tech startup, TechCo, at a predetermined price in a private placement offering. The private placement agreement stipulates certain conditions that must be met before ABC Fund can demand the securities of TechCo and is obligated to pay for them. These conditions include TechCo meeting specific performance milestones and obtaining necessary regulatory approvals for the transaction.

On October 15, TechCo successfully meets the performance milestones and obtains the necessary regulatory approvals. On this date:

- ABC Fund obtains the right to demand the securities purchased: Although the agreement was signed earlier, ABC Fund only gains the legal right to demand the shares of TechCo once the stipulated conditions, including the performance milestones and regulatory approvals, are met.

- ABC Fund incurs an obligation to pay the price of the securities purchased: Similarly, ABC Fund becomes legally obligated to pay the agreed-upon price for the shares of TechCo only after these conditions are met.

Therefore, ABC Fund recognizes an investment in the securities of TechCo on October 15.

Question 3.3.40 When are purchases of other investments recognized?

Interpretive response: Subtopic 946-325 does not address the accounting recognition of an investment company's other investments. We believe an investment company should evaluate whether the purchase of other investments is specifically addressed under other US GAAP.

If other US GAAP does not specifically apply to the transaction, we believe an investment company should evaluate the facts and circumstances of a transaction to purchase such investments to determine whether to apply the recognition principles in Subtopic 946-320 by analogy.

For example, certain spot markets for physical commodities have established market conventions for trade execution and settlement that function similar to regular-way trades for securities (see Question 3.3.10). Under those circumstances, it may be appropriate to apply trade-date recognition for purchases and sales of commodities when similar market conventions exist for executing and settling trades.

When transactions for other investments occur outside of established market conventions, we believe an investment company may apply the guidance for securities transactions outside of conventional channels by analogy (see Question 3.3.30).

Question 3.3.50 When are investments in other investment companies recognized?

Interpretive response: An investment company's recognition of investments in other investment companies depends on the type of investment and nature of the transaction.

Investment in a registered fund

Some investment companies may make investments in other investment companies through conventional channels (e.g. purchasing a share in mutual fund). Investment companies recognize these investments on the trade date. We believe that a transaction to buy or redeem a share directly with the issuer based on the closing NAV of the fund (rather than a trade with a third party) and purchases/redemptions of registered closed-end funds transacted with exchanges generally fall under the conventional channels guidance and therefore should be recognized on the date the transaction was entered into. [946-320-25-1]

Investment in a nonregistered fund

Transactions for nonregistered funds are conducted outside of conventional channels. Therefore, these investments are recognized when the investor has a right to demand the securities purchased and has incurred an obligation to pay the price of the securities purchased. Nonregistered funds typically record capital subscriptions and redemptions as of the effective date specified by their governing documents. We believe advanced contributions to a nonregistered fund before the effective date of the contribution per its governing documents should be classified as a receivable and not recognized as an investment until the effective date required by the governing documents. Determining the appropriate recognition date may sometimes require an interpretation by legal counsel. [946-320-25-2]

3.4 Initial measurement

Excerpt from ASC 946-320

30-1 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.

Excerpt from ASC 946-325

30-1 An investment company shall initially measure its other investments at their transaction price. The transaction price shall include commissions and other charges that are part of the purchase transaction.

Question 3.4.10 How are investments initially measured?

Interpretive response: An investment company initially measures its investments at the transaction price, which includes commissions and other charges that are part of the purchase transaction (see Question 3.4.30). [946-320-30-1, 946-325-30-1]

Question 3.4.20 How are securities sold short initially measured?

Interpretive response: An investment company initially measures securities sold short based on the proceeds received from the short sale, net of commissions and other charges that are part of the short sale transaction (see Question 3.4.30). [946-320-30-1, 946-325-30-1]

Question 3.4.30 What other charges are included in the transaction price of an investment?

Excerpt from ASC 820-10

20 Glossary

Transaction costs

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 (similar to costs to sell, as defined in paragraph 360-10-35-38).

Interpretive response: Commissions and other charges that are part of a purchase transaction are included in the transaction price (see Questions 3.4.10 and 3.4.20). We believe other charges included in the transaction price should be limited to those that are direct and essential to the investment transaction, based on analogy to the definition of transaction costs in Topic 820. [820-10 Glossary]

Costs that are direct and essential to the investment transaction may include selling costs, closing costs and legal fees. Costs that are incurred regardless of whether the investment transaction is consummated or are related to the ongoing operations of the investment company are expensed when incurred. [AVG-PCI 12.02]

Question 3.4.40 How is the initial cost basis for multiple investments determined when the investments are acquired in the same transaction?

Interpretive response: Investment companies initially measure investments in debt and equity securities at their transaction price. [946-320-30-1]

However, Topic 946 does not specifically address initial measurement when multiple investments are acquired in the same transaction, such as when an investment company acquires common shares and warrants of an investee in a single purchase agreement. We believe an investment company should account for such transactions as an asset acquisition under Subtopic 805-50 and allocate the purchase price between the different investments acquired based on their relative fair values. [805-50-15-3, 30-3]

When additional investments are received as part of a purchase agreement involving debt instruments, the portion of the cost basis allocated to other instruments (such as detachable warrants) typically is similar in substance to a debt discount. We believe this is analogous to the accounting for debt instruments issued with detachable warrants under Subtopic 470-20, in which the portion of the cost basis allocated to the debt instrument results in a debt discount that should be amortized using the interest method over the life of the debt instrument. See Question 3.6.60. See also Example 3.6.10, illustrating the amortization of a debt discount using the interest method.

Example 3.4.10 Allocation of cost basis to purchase of debt securities and detachable warrants

On July 1, ABC Fund purchases the following instruments for $10,000,000:

- Senior debt of XYZ Company, par value of $10,000,000
- Detachable warrants to purchase common shares of XYZ Company

At the date of purchase, the fair value of the senior debt is $9,500,000 and the fair value of the warrants is $400,000.

ABC Fund records the following journal entries.

	Debit	**Credit**
Senior debt (cost)[1]	9,595,960	
Warrants (cost)[2]	404,040	
Cash		10,000,000
To recognize purchase of senior debt and warrants.		

Notes:

1. The cost basis is allocated to senior debt based on the relative fair value as:
   $10,000,000 × [$9,500,000 ÷ ($9,500,000 + $400,000)] = $9,595,960.
2. The cost basis is allocated to warrants based on the relative fair value as:
   $10,000,000 × [$400,000 ÷ ($9,500,000 + $400,000)] = $404,040.

Subsequent to acquisition, ABC Fund applies the interest method to its investment in the senior debt by amortizing the discount to par value through the maturity date (as illustrated in Example 3.6.10).

Question 3.4.50 How is the initial cost basis determined for securities received from a spinoff?

Excerpt from ASC 946-320

> Securities Received in a Spinoff

30-2 An investment company may receive securities in a spinoff wherein the entity in which the investment company has invested spins off a portion of its operations. A portion of the cost of the securities held shall be allocated to the securities received in the spinoff.

30-3 The amount allocated to securities received in a spinoff shall be based on the ratio of the fair value of the securities received to the sum of the fair value of such securities and the fair value of the original securities held by the investment company of the entity effecting the spinoff.

Interpretive response: Because the securities received from a spinoff transaction represent a distribution of a portion of the investee's operations, a portion of the cost basis of the original investment is allocated to the securities received. The cost basis is allocated to these securities based on their relative fair value compared to the sum of their fair value and the fair value of the original securities of the investee effecting the spinoff. [946-320-30-2 – 30-03]

Example 3.4.20 Securities received in a spinoff

On January 1, ABC Fund purchased common stock of DEF Company for $10,000,000.

On December 1, DEF Company spun off the operations of Subsidiary GHI by distributing the shares of Subsidiary GHI to its shareholders. Prior to the spinoff, the fair value of ABC Fund's shares in DEF Company was $12,000,000. Following the spinoff, the fair value of ABC Fund's shares in DEF Company is $9,000,000, and the fair value of the shares received in Subsidiary GHI is $3,000,000.

ABC Fund records the following journal entry.

	Debit	Credit
Investment in Subsidiary GHI (cost)[1]	2,500,000	
Investment in DEF Company (cost)		2,500,000
To allocate the cost basis of DEF Company to the securities received in the spinoff of Subsidiary GHI.		

Note:

1. The cost basis allocated to the shares received from the spinoff of Subsidiary GHI is based on the relative fair value as:

   $10,000,000 × [$3,000,000 ÷ ($9,000,000 + $3,000,000)] = $2,500,000.

Question 3.4.60 How are investments acquired through the acquisition of another investment company initially measured by registered funds?

Background: Acquisition transactions by registered funds, including BDCs, of another investment company are commonly structured as tax-free reorganizations, under which the acquirer's shares are issued in exchange for substantially all of the acquiree's assets.

Interpretive response: The initial measurement of investments acquired through the acquisition of another investment company can depend on the tax treatment of the transaction and whether the acquiree meets the definition of a business.

Taxable reorganizations

For a taxable reorganization, a registered fund evaluates whether the transaction is a business combination or an asset acquisition, which depends on whether the acquiree meets the definition of a business under Topic 805.

If the transaction is a business combination, the identifiable assets acquired are generally measured at their acquisition date fair values. If the transaction is an asset acquisition, the accumulated cost of the acquisition is generally allocated to the acquired assets and liabilities based on their relative fair values. See section 7 of KPMG Handbook, Business combinations, and chapter 4 of KPMG Handbook, Asset acquisitions.

Tax-free reorganization

For a tax-free reorganization, a registered fund is permitted to elect an accounting policy that carries forward the historical cost basis of the acquiree's investments. As a longstanding industry practice, registered funds account for tax-free reorganizations in this manner to align their reporting of realized gains subsequent to the transaction with the reporting of tax-basis distributions to their shareholders (see Question 4.4.20). [TQA 6910.33]

Registered open-end funds

The SEC staff generally has not objected to registered open-end funds applying a policy election to carry forward the historical cost basis of the acquired investments under a tax-free reorganization. [AICPA IC EP 5/2021]

Business development companies

For mergers involving BDCs, the SEC staff has expressed that they generally expect BDCs to apply asset acquisition accounting under Subtopic 805-50 instead of carrying over the historical cost basis of the investments of the acquiree. See KPMG Handbook, Asset acquisitions, for general information about asset acquisition accounting. [AICPA IC EP 5/2021]

Registered closed-end funds

The SEC staff has not indicated a specific accounting model for mergers of registered closed-end funds. Instead, it advises registrants to apply judgment based on the facts and circumstances of the transaction. Factors to consider when evaluating how to initially measure the acquired portfolio may include the composition of the acquired portfolio (e.g. liquidity and complexity of portfolio valuations) and the structure of the closed-end fund (e.g. exchange traded shares or transactions based on published NAVs). [AICPA IC EP 1/2022]

Question 3.4.70 How is an interest in a loan participation or a syndication arrangement accounted for?

Background: Loan participations and loan syndications may occur for a variety of reasons, including when a borrower wants to borrow an amount that is greater than a single lender is willing to lend. This may occur when the borrower's desired loan amount exceeds a lender's internal credit risk management guidelines or a bank's legal lending limit. In those circumstances, the loan may be funded through either a loan participation or a loan syndication.

- A loan participation is a transaction where one lender originates a loan and then transfers an interest in that loan (effectively a portion of the loan) to one or more other lenders.
- A loan syndication is a transaction where several lenders share in lending to a single borrower. Each lender loans a specific amount directly to the borrower and has the right to repayment from the borrower.

Interpretive response: Loan participations involve transfers of financial assets from the lead lender that are accounted for under Topic 860. If such transfers meet the characteristics of a participating interest as defined in Topic 860, the transfer is evaluated to determine if the transfer would be accounted for as a sale or secured borrowing. If the transfer does not meet the characteristics of a participating interest, the transfer is accounted for as a secured borrowing.

Loan syndications are not in the scope of Topic 860 since they represent the origination of a loan by each lender. Investment companies account for their interests in loan syndications under Subtopics 946-320 and 946-325, typically in the same manner as loans receivable.

See Question 2.2.20 in KPMG Handbook, Transfers and servicing of financial assets, for additional guidance on the difference between a loan participation and loan syndication and for guidance on the accounting treatment for loan participations.

3.5 Subsequent measurement

Excerpt from ASC 946-320

35-1 An investment company shall measure investments in debt and equity securities subsequently at **fair value**.

Excerpt from ASC 946-325

35-1 An investment company shall subsequently measure its other investments at **fair value**.

Question 3.5.10 How are investments measured subsequent to acquisition?

Interpretive response: An investment company subsequently measures its investments in securities and its other investments at fair value. [946-320-35-1, 946-325-35-1]

Because the values of investments held by an investment company are important to investors in evaluating an investment company's performance and returns, investment companies have historically applied specialized industry guidance to account for their investments at fair value. [AAG-INV 2.30]

However, certain exceptions to this principle apply to:

- An investment that is subject to the equity method of accounting (see Question 3.5.40)
- A feeder fund's investment in a master fund (see Question 3.5.50)
- An investment that is consolidated by an investment company (see section 9.7)

The fair value of an investment company's investments is determined in accordance with Topic 820. See KPMG Handbook, Fair value measurement, for additional guidance on fair value measurements. [820-10-05-1A]

An investment company classifies changes in the fair value of its investments in the changes in unrealized appreciation or depreciation financial statement line item in the statement of operations (see section 8.2.40).

Question 3.5.20 Is an allowance for expected credit losses recognized for investments in debt securities and loans receivable?

Background: Topic 326 requires entities to recognize an allowance for lifetime expected credit losses when certain financial assets are originated or purchased, and to remeasure the allowance for changes in expected credit losses at each reporting date.

Interpretive response: No. Subtopic 326-20 excludes from its scope financial assets measured at fair value through net income. Accordingly, an investment company does not recognize an allowance for expected credit losses for its investments in debt securities and loans receivable. Expectations of credit losses are reflected in the valuation of investments on an individual basis, based on market participant assumptions as of the measurement date. [326-20-15-3(a), ASU 2016-13.BC32]

Question 3.5.30 Are investments in equity securities evaluated for impairment?

Interpretive response: No. Because an investment company is not subject to the guidance in Topic 321, it does not apply the impairment guidance to investments in equity securities accounted for under that Topic (see Question 3.2.20). Any effect of impairment conditions to an investee are reflected in unrealized gain (loss) as part of the overall valuation of the investment. [946-320-35-1, 946-325-35-1]

Question 3.5.40 Is the equity method of accounting applied to investments?

Excerpt from ASC 946-323

> Application of the Equity Method

45-1 Except as discussed in the following paragraph, use of the equity method of accounting by an investment company is not appropriate. Rather, those noncontrolling ownership interests held by an investment company shall be measured in accordance with guidance in Subtopic 946-320, which requires investments in debt and equity securities to be subsequently measured at **fair value**.

45-2 An exception to the general principle in the preceding paragraph occurs if the investment company has an investment in an operating entity that provides services to the investment company, for example, an investment adviser or transfer agent (see paragraph 946-10-55-5). In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. If an investment company holds a noncontrolling ownership interest in such an operating entity that otherwise qualifies for use of the equity method of accounting, the investment company should use the equity method of accounting for that investment, rather than measuring the investment at fair value.

Interpretive response: Generally no. An investment company generally measures investments for which the equity method of accounting would otherwise be required at fair value with one exception.

See Question 2.3.40 in KPMG Handbook, Equity method of accounting, for further information on the exception when an investment company has invested in an operating company from which it obtains services (e.g. investment advisory or transfer agent services). [323-10-15-4(d), 946-320-35-1, 946-323-45-2]

Question 3.5.50 How does a feeder fund subsequently measure its investment in a master fund?

Excerpt from ASC 946-210

> Complex Capital Structures

• > Master-Feeder Funds

• • > Feeder Funds

45-6 Each feeder fund's statement of assets and liabilities shall show an investment in the master fund, which is the sole or principal investment of the feeder fund. The total of all feeder funds' investments in the master fund shall equal the total net assets of the master fund. A schedule of portfolio investments shall not be presented at the feeder level. The net asset value per share, total shares outstanding, and the components of net assets shall be reported. Should the feeder fund have a multiple-class structure, it would report the multiple-class information specified in this Subtopic.

Background: A master-feeder structure is composed of separate investment companies that perform the investment management and distribution functions, where the investment management function is performed by the master fund and the distribution functions are performed by the feeder funds. [AAG-INV 5.18]

The accounting for master-feeder structures involves allocating the master fund portfolio's income, expenses, and realized and unrealized gains and losses among its feeder funds. When the interests of the master fund are held solely by its feeder funds, the total of all feeder funds' investments in the master fund should equal the total net assets of the master fund. [AAG-INV 5.21, 946-210-45-6]

Interpretive response: Feeder funds measure their investments in a master fund based on their proportionate interest in the net assets of the master fund, and generally report their proportionate share of income, expenses, and realized and unrealized gains and losses from the master fund in their statement of operations. [946-220-45-11]

NAV per share practical expedient

Although Topic 820 does not preclude a feeder fund from applying the NAV per share practical expedient to an investment in a master fund, we do not believe it is necessary or beneficial for a feeder fund to do so. The NAV per share practical expedient relieves entities from the cost and effort involved to evaluate specific attributes or secondary market transactions for an investment in an investment company. Those conditions are typically not relevant to a master-feeder structure when the equity ownership of a master fund is exclusive to its feeder funds. [ASU 2009-12.BC13]

If a feeder fund elects to apply the NAV per share practical expedient, it is required to present the disclosures in Topic 820 in addition to satisfying the presentation and disclosure requirements for feeder funds in Topic 946. [820-10-50-6A]

Question 3.5.60 How are proceeds from litigation relating to an investment accounted for?

Excerpt from ASC 946-320

> Proceeds from Litigation Awards

35-21 Proceeds from litigation relating to an investment security shall be accounted for as follows:

a. If the investment company holds the securities, the proceeds are accounted for as a reduction of cost.
b. If the investment company no longer holds the securities, the proceeds are accounted for as realized gains on security transactions.

Interpretive response: If an investment company prevails in litigation against an investee, the accounting for the proceeds of the litigation award depends on whether the investment company continues to hold the investment. [946-320-35-21]

- If the investment company continues to hold the investment, the proceeds from litigation reduce the cost basis of the investment, similar to a return of capital.
- If the investment company no longer holds the investment, the proceeds from litigation represent a realized gain.

Question 3.5.70 How are workout expenditures for investments accounted for?

Excerpt from ASC 946-320

> Expenditures in Support of Defaulted Debt Securities

05-9 The market for many high-yield debt securities is relatively thin. When issuers of high-yield and other debt securities default, the bondholders often become active in any negotiations and in the workout process. This process often results in new terms that restructure the obligations to allow the issuer to continue to meet its ongoing interest obligations and maintain some, if not all, of the principal value to the holders of the obligations.

05-10 Adverse economic developments often lead to increases in the default rates of high-yield and other debt securities. In addition to occasional **capital infusions**, professional fees to legally restructure the investments are frequently incurred by the bondholders.

> Expenditures in Support of Defaulted Debt Securities

• > Workout Expenditures

35-15 Workout expenditures that are incurred as part of negotiations of the terms and requirements of capital infusions, or that are expected to result in the restructuring of or a plan of reorganization for an investment shall be recorded as realized losses.

35-16 Ongoing expenditures to protect or enhance an investment, or expenditures incurred to pursue other claims or legal actions, shall be treated as operating expenses.

20 Glossary

Workout Expenditures

Professional fees (legal, accounting, appraisal) paid to entities unaffiliated with the investment company's advisor or sponsor in connection with any of the following:

a. Capital infusions
b. Restructurings or plans of reorganization
c. Ongoing efforts to protect or enhance an investment
d. The pursuit of other claims or legal actions.

Background: When issuers of debt securities default, an investment company may become active in any negotiations and in the workout process. This process often results in new terms that restructure the obligations to allow the issuer to continue to meet its ongoing interest obligations and maintain some, if not all, of the principal value to the investment company. In addition to occasional capital infusions, professional fees to legally restructure the investments may be incurred by the investment company. Workout expenditures are professional fees (e.g. legal, accounting, appraisal) paid to entities unaffiliated with the investment company's adviser or sponsor. [946-320-05-9 – 05-10]

Interpretive response: Investment companies account for workout expenditures based on the nature of the expenditure. The below table summarizes how to record the different types of workout expenditures.

Nature of the workout expenditure	How to record the workout expenditure
Expenditures incurred as part of negotiations of the terms and requirements of capital infusions (see Question 3.5.80)	Realized loss [946-320-35-15]
Expenditures that are expected to result in the restructuring of, or a plan of reorganization for, an investment	Realized loss [946-320-35-15]
Ongoing expenditures to protect or enhance an investment	Operating expenses [946-320-35-16]
Expenditures incurred to pursue other claims or legal actions	Operating expenses [946-320-35-16]

Question 3.5.80 How are capital infusions for investments accounted for?

Excerpt from ASC 946-320

> Expenditures in Support of Defaulted Debt Securities

• > Capital Infusions

35-14 All **capital infusions** shall be recorded as additions to the cost bases of related securities.

20 Glossary

Capital Infusions

Expenditures made directly to the issuer to ensure that operations are completed, thereby allowing the issuer to generate cash flows to service the debt. Such expenditures are usually nonrecurring. In certain cases, bondholders may receive additional promissory notes, or the original bond instrument may be amended to provide for repayment of the capital infusions.

Interpretive response: An investment company's additional funding of its investee (e.g. additional debt or equity to fund losses from ongoing operations of an investee) is reflected as additional investment cost. Any effect resulting from losses incurred by the investee is reflected in unrealized gain (loss) as part of the overall valuation of the investee. [946-320-35-14]

3.6 Interest income

3.6.10 Recognition of interest income

Excerpt from ASC 946-320

> High-Yield Debt Securities

05-3 High-yield debt securities (**junk bonds**) take various forms. The most common forms may include zero-coupon bonds, **payment-in-kind bonds**, and deep-discount **step bonds**. High-yield debt securities have supplied significant capital for business expansion and corporate restructuring. These securities are inherently different from investment-grade debt securities. They present additional credit, liquidity, and market risks for all participants in this marketplace: holders, issuers, underwriters, and broker-dealers.

05-4 High-yield debt securities typically are unsecured and subordinate to other debt outstanding. Many issuers of high-yield debt securities are highly leveraged, with limited equity capital. That, plus a market for such securities that may not always be liquid, may increase the market risk, liquidity risk, and credit risk of high-yield debt securities as follows:

a. Market risk. In contrast to investment-grade bonds (the market prices of which change primarily as a reaction to changes in interest rates), the market prices of high-yield bonds (which are also affected by changes in interest rates) are influenced much more by credit factors and financial results of the issuer and by general economic factors that influence the financial markets as a whole. Such factors often make it difficult to substantiate the market valuation of high-yield bonds.
b. Liquidity risk. The market risk is often heightened by liquidity risk; that is, the absence of centralized high-yield bond exchanges and relatively thin trading markets, which make it more difficult to liquidate holdings quickly and increase the volatility of the market price. There is generally no centralized or regulated procedure for pricing high-yield debt issues.
c. Credit risk. Issues of high-yield debt securities are more likely to default on interest or principal than are issues of investment-grade securities.

05-5 High-yield debt securities may be issued or traded at significant discounts from their face amounts (principal).

05-6 Interest for some high-yield debt securities is not paid currently. Instead, interest may be deferred and paid at maturity (zero-coupon bonds) or in periodic interest payments that do not commence until a specific date in the securities' life cycle (step bonds), or interest may be paid in the form of additional debt securities of the issuer bearing similar terms (payment-in-kind bonds).

> Instruments

15-2 Securities that have no credit rating shall be classified as **high-yield debt securities** if they otherwise have the characteristics of such securities.

> High-Yield Debt Securities

• > Payment in-Kind Bonds

30-4 Payment-in-kind bonds typically trade flat (that is, interest receivable is included in the market value quote obtained each day). Accordingly, that portion of the quote representing interest income needs to be identified. The sum of the acquisition amount of the bond and the discount to be amortized shall not exceed the undiscounted future cash collections that are both reasonably estimable and probable.

> High-Yield Debt Securities

• > Payment in-Kind Bonds

35-10 An investment company shall use the **interest method** (see paragraph 835-30-35-2) to determine interest income on **payment-in-kind bonds**.

• > Step bonds

35-12 Income on **step bonds** should be recognized using the interest method (see paragraph 835-30-35-2).

> Premiums and Discounts

35-20 Premiums and discounts shall be amortized using the interest method. The amortization of premiums on purchased callable debt securities that have explicit, noncontingent call features that are callable at fixed prices on preset dates shall be consistent with the guidance in paragraph 310-20-35-33.

20 Glossary

High-Yield Debt Securities

Corporate and municipal debt securities having a lower-than-investment-grade credit rating (BB+ or lower by Standard & Poor's, or Ba or lower by Moody's). Because high-yield debt securities typically are used when lower-cost capital is not available, they have interest rates several percentage points higher than investment-grade debt and often have shorter maturities. These high-yielding corporate and municipal debt obligations are frequently referred to as junk bonds.

Interest Method

The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.

Payment-in-Kind Bonds

Bonds in which the issuer has the option at each interest payment date of making interest payments in cash or in additional debt securities. Those additional debt securities are referred to as baby or bunny bonds. Baby bonds generally have the same terms, including maturity dates and interest rates, as the original bonds (parent payment-in-kind bonds). Interest on baby bonds may also be paid in cash or in additional like-kind debt securities at the option of the issuer.

Step Bonds

Bonds that involve a combination of deferred-interest payment dates and increasing interest payment amounts over the bond lives and, thus, bear some similarity to zero-coupon bonds and to traditional debentures.

Excerpt from ASC 946-830

• > Purchased interest

45-14 Purchased interest represents the interest accrued between the last coupon date and the settlement date of the purchase. It should be recorded in the functional currency as interest receivable at the spot rate on the purchase trade date, and subsequently measured at fair value using each valuation date's spot rate. After the settlement date, daily interest income should be accrued at the daily spot rate. It may be impractical to prepare the foregoing calculations daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

Investment companies receive interest income on debt instruments that they hold. Sources of interest can include, but are not limited to, corporate debt securities, US government and agency obligations, state and municipal obligations, sovereign debt obligations, loans receivable and repurchase agreements.

Question 3.6.10 How is interest income from investments in debt securities and loans receivable recognized?

Interpretive response: Recognizing interest income from investments in debt securities (or other debt instruments such as loans receivable) generally involves two components:

- accrual of interest; and
- amortization of purchase premiums or discounts to the face amount of the debt security.

Accrued interest

Interest income on debt securities is generally accrued daily based on the stated interest rate of the debt instrument or loan. [S-X Rule 6-03(g), AAG-INV 2.131]

Premiums and discounts

Debt securities are commonly purchased at a discount or a premium to their face amounts. The discount or premium typically results from the difference between the stated interest rate and market rates for similar issues at the time of issuance or acquisition of the investment. [AAG-INV 2.125]

Investment companies generally amortize premiums and discounts on debt securities using the interest method (see Question 3.6.60). [946-320-35-20]

Question 3.6.20 Is interest income accrued as of the trade date or settlement date?

Interpretive response: Interest income is accrued starting on the settlement date, which is when the legal transfer of the securities is delivered to the investment company. The interest from the last coupon date through the settlement date of the purchase represents purchased interest that is included in interest receivable but is excluded from interest income because the investment company does not have legal ownership of the debt instrument prior to the settlement date (see Question 3.6.30). [946-830-45-14]

Question 3.6.30 How is purchased interest accounted for?

Background: The term 'purchased interest' derives from the concept that when a buyer purchases a debt instrument, it not only pays for the fair value of the debt instrument but also 'purchases' the interest that has accrued from the last coupon date through the settlement date. When the issuer of the debt makes its next periodic interest payment, it pays all of the interest to the current holder of record. This interest payment is inclusive of the interest earned by the investment company after the settlement date and the purchased interest (which accrued while the seller owned the debt instrument).

Interpretive response: Purchased interest is the interest accrued between the last coupon date and the settlement date of the purchase. Purchased interest is included in interest receivable when the related debt security is recognized (i.e. as of the trade date) because it will ultimately be received by the investment company when the issuer of the debt makes its next coupon payment. [946-830-45-14]

Question 3.6.40 Is interest income calculated on a daily basis?

Interpretive response: It depends on whether the investment company is required to calculate current NAV on a daily basis.

Registered funds

A registered fund is required to accrue interest income daily when calculating the current NAV of a redeemable security. The current NAV of a redeemable security issued by a registered fund represents the current price for the purpose of daily purchases and redemptions of shares. [S-X Rule 6-03(g), CFR 270.2a-4(a)(6)]

Nonregistered funds

A nonregistered fund typically does not calculate NAV daily or provide for daily purchases and redemptions of equity interests. Instead, it performs these calculations on a less frequent basis, such as monthly. Because Topic 946 does not specify the frequency of accruing interest, we believe a nonregistered fund may accrue interest at a less frequent interval to correspond with its policies for calculating periodic NAVs.

Question 3.6.50 When is interest income from TBA securities recognized?

Interpretive response: TBA securities are forward-settled transactions in which the actual securities that will be delivered are not identified at the time the trade is entered into. Typically the securities to be delivered are identified shortly prior to the settlement date. Investment companies do not accrue interest on TBA securities until the payment and delivery of the securities have taken place. [AAG-INV 3.21]

Question 3.6.60 How is the interest method applied to recognize interest income?

Interpretive response: Under the interest method, premiums and discounts on debt investments are generally amortized to interest income over the life of the investment to arrive at a periodic interest amount that represents a constant effective interest rate on the principal amount of the investment, adjusted for amounts of unamortized premiums or discounts or other yield adjustments. The difference between the interest income recognized under the interest method and the cash coupon payment is the amount of periodic amortization that adjusts the cost basis of the investment. [946-320 Glossary, 835-30-35-2 – 35-3]

Example 3.6.10 Amortization of bond discount under the interest method

On January 1, Year 1, ABC Fund purchases a $10 million par value bond with a stated interest rate of 8% for $9,800,000. The bond pays interest on an annual basis, is not prepayable, and matures on December 31, Year 5. ABC Fund calculates interest income on an annual basis.

The following table represents the amortization schedule for the bond discount under the interest method based on the contractual cash flows and effective interest rate of 8.51% (rounded).

Year	Beginning cost balance	Coupon payments[1]	Interest income[2]	Amortization of bond discount[3]	Ending cost balance
1	9,800,000	800,000	833,748	33,748	9,833,748
2	9,833,748	800,000	836,619	36,619	9,870,367
3	9,870,367	800,000	839,735	39,735	9,910,102
4	9,910,102	800,000	843,115	43,115	9,953,217
5	9,953,217	800,000	846,783	46,783	10,000,000
Total		4,000,000	4,200,000	200,000	

Notes:
1. $10,000,000 par amount × 8% stated interest rate.
2. Beginning cost balance × 8.51% effective interest rate (rounded).
3. Difference between interest income recognized under the interest method and the cash coupon payment, which is accreted to the cost basis of the bond.

ABC Fund records the following journal entry to recognize interest income at December 31, Year 1.

	Debit	Credit
Cash[1]	800,000	
Investments (cost)[2]	33,748	
Interest income		833,748
To recognize interest income using the interest method.		

Notes:
1. Represents the cash coupon payment for Year 1.
2. Represents the amortization of the bond discount for Year 1.

Example 3.6.20 Amortization of bond premium under the interest method

On January 1, Year 1, ABC Fund purchases a $10 million par value bond with a stated interest rate of 8% for $10,500,000. The bond pays interest on an annual basis, is not prepayable, and matures on December 31, Year 5. ABC Fund calculates interest income on an annual basis.

The following table represents the amortization schedule for the bond premium under the interest method based on the contractual cash flows and effective interest rate of 6.79% (rounded).

Year	Beginning cost balance	Coupon payments[1]	Interest income[2]	Amortization of bond premium[3]	Ending cost balance
1	10,500,000	800,000	712,685	87,315	10,412,685
2	10,412,685	800,000	706,759	93,241	10,319,444
3	10,319,444	800,000	700,430	99,570	10,219,874
4	10,219,874	800,000	693,671	106,329	10,113,545
5	10,113,545	800,000	686,455	113,545	10,000,000
Total		4,000,000	3,500,000	500,000	

Notes:
1. $10,000,000 par amount × 8% stated interest rate.
2. Beginning cost balance × 6.79% effective interest rate (rounded).
3. Difference between interest income recognized under the interest method and the cash coupon payment, which is amortized to the cost basis of the bond.

ABC Fund records the following journal entry to recognize interest income at December 31, Year 1.

	Debit	Credit
Cash[1]	800,000	
Investments (cost)[2]		87,315
Interest income		712,685
To recognize interest income using the interest method.		

Notes:

1. Represents the cash coupon payment for Year 1.
2. Represents the amortization of the bond discount for Year 1.

Question 3.6.70 Is the interest method used to recognize interest expense on securities sold short?

Interpretive response: Yes. An investment company recognizes interest expense on securities sold short in the same manner as long positions. Therefore, it recognizes all economic elements of interest, including the amortization of premiums and discounts. [946-320-35-20, TQA 6910.21]

Question 3.6.80 How is the interest method applied to premiums on callable debt securities?

Background: Certain debt securities (primarily municipal securities) issued at a premium to their face amount may also include noncontingent call features that permit the issuer to repurchase the debt at specified call prices on preset dates (callable debt securities). Although premiums and discounts on debt securities are typically amortized over the life of the instrument, this is not consistent with the economics of the transaction for some callable debt securities because market participants typically assume that the issuer will call the security when that is in its economic best interests (i.e. to call the security prior to maturity when the call price is less than the amount owed). [ASU 2017-08.BC4]

Interpretive response: When a callable debt security includes explicit, noncontingent call features that are callable at fixed prices on preset call dates, an investment company evaluates whether the amortized cost basis of the security exceeds the amount that is repayable to the issuer at the next call date (i.e. the excess premium). When there is an excess premium as of the reporting date, the investment company amortizes the excess premium to the next call date.

If the call option is not exercised, or the amortized cost is not at a premium to the call price at the next call date, an investment company reevaluates whether there are additional future call dates at specific prices that are exercisable. If so, the updated excess premium is amortized to the next call date, and so forth. [310-20-35-33, ASU 2017-08.BC21]

If there is no remaining excess premium to amortize or if there are no further call dates, the effective yield is reset using the contractual payment terms of the security. [946-320-35-20, 310-20-35-33]

Example 3.6.30 Application of the interest method to callable debt securities issued at a premium

Assume the same facts as Example 3.6.20, except for the following:

- The bond is callable on January 1, Year 3 for $103, and on January 1, Year 5 for $101
- The call features are noncontingent

Scenario 1: Issuer calls the bond at the first call date

Because the amortized cost basis of the bond exceeds the amount repayable by the issuer at the next call date, ABC Fund amortizes the excess premium from January 1, Year 1 to the first call date of January 1, Year 3 based on the contractual cash flows and effective interest rate of 6.70% (rounded).

Year	Beginning cost balance	Coupon payments[1]	Interest income[2]	Amortization of bond premium[3]	Ending cost balance
1	10,500,000	800,000	703,240	96,760	10,403,240
2	10,403,240	800,000	696,760	103,240	10,300,000[4]

Notes:

1. $10,000,000 par amount × 8% stated interest rate.
2. Beginning cost balance × 6.70% effective interest rate (rounded).
3. Difference between interest income recognized under the interest method and the cash coupon payment, which is amortized to the cost basis of the bond.
4. $10,000,000 par amount × the call price of $1.03.

ABC Fund records the following journal entry to recognize interest income at December 31, Year 1.

	Debit	Credit
Cash[1]	800,000	
Investments (cost)[2]		96,760
Interest income		703,240
To recognize interest income using the interest method.		

Notes:

1. Represents the cash coupon payment for Year 1.
2. Represents the amortization of the bond discount for Year 1.

ABC Fund records the following journal entry to recognize interest income at December 31, Year 2.

	Debit	Credit
Cash[1]	800,000	
Investments (cost)[2]		103,240
Interest income		696,760
To recognize interest income using the interest method.		
Notes: 1. Represents the cash coupon payment for Year 2. 2. Represents the amortization of the bond discount for Year 2.		

ABC Fund records the following journal entry to recognize the bond call at January 1, Year 3.

	Debit	Credit
Cash	10,300,000	
Investments (cost)		10,300,000
To recognize the bond call at $103.		

Scenario 2: Issuer calls the bond at the second call date

Assume the same facts as Scenario 1, except the issuer does not call the bond at the first call date.

Because the issuer does not call the bond at the first call date, ABC Fund amortizes the updated excess premium to the second call date of January 1, Year 5 based on the contractual cash flows and effective interest rate of 6.83% (rounded).

Year	Beginning cost balance	Coupon payments[1]	Interest income[2]	Amortization of bond premium[3]	Ending cost balance
3	10,300,000	800,000	703,301	96,699	10,203,301
4	10,203,301	800,000	696,699	103,301	10,100,000

Notes:
1. $10,000,000 par amount × 8% stated interest rate.
2. Beginning cost balance × 6.83% effective interest rate (rounded).
3. Difference between interest income recognized under the interest method and the cash coupon payment, which is amortized to the cost basis of the bond.

ABC Fund records the following journal entry to recognize interest income at December 31, Year 3.

	Debit	Credit
Cash[1]	800,000	
Investments (cost)[2]		96,699
Interest income		703,301
To recognize interest income using the interest method.		

Notes:
1. Represents the cash coupon payment for Year 3.
2. Represents the amortization of the bond discount for Year 3.

Question 3.6.90 Is an allowance for expected credit losses maintained to determine the accretable yield when the interest method is applied to investments in beneficial interests?

Background: Investment companies are required to apply the income recognition guidance under Subtopic 325-40 to their investments in beneficial interests. [325-40-15-7]

Subtopic 325-40 requires holders of beneficial interests to recognize accretable yield as interest income over the life of the beneficial interest using the effective yield method. Accretable yield represents the excess of cash flows expected to be collected over the reference amount of the beneficial interest, and is updated over the life of the beneficial interest based on the holder's best estimate of current conditions and reasonable and supportable forecasts. [325-40-30-2, 35-1, 35-3]

Subtopic 325-40 further requires holders to account for expected credit losses on beneficial interests classified as held-to-maturity or available-for-sale under Topic 326. In each accounting period, if a holder determines a change in estimated cash flows (either favorable or adverse) has occurred, it first adjusts the allowance for credit losses before applying any remaining portion of the change in cash flows to the accretable yield. [325-40-35-4 – 35-4A]

This accounting does not apply to investment companies because they do not classify investments in beneficial interests as held-to-maturity or available-for-sale, but instead account for investments at fair value through earnings, which is commensurate with the accounting treatment for securities classified as trading. Subtopic 325-40 does not specify whether holders of beneficial interests classified as trading are required to account for expected credit losses when determining accretable yield.

Interpretive response: No. The FASB staff indicated that financial assets measured at fair value through net income are excluded from the scope of Subtopic 326-20. As such, entities are not required to maintain an allowance for credit losses for beneficial interests classified as trading. The FASB staff further noted that entities should apply reasonable judgment to determine the accretable yield for beneficial interests classified as trading. [TRG 11-18.14]

See chapter 20 in KPMG Handbook, Credit impairment, for additional guidance on the income recognition for beneficial interests.

Question 3.6.100 Are nonrefundable fees and costs an adjustment to the effective yield when applying the interest method to loans receivable?

Interpretive response: It depends. An investment company may receive fees for originating loans receivable that are included in its investment portfolio. Topic 946 does not provide guidance for accounting for loan origination fees and related costs. The accounting for nonrefundable fees and costs (which includes fees and costs related to loan originations and loan commitments) associated with lending activities is addressed by Subtopic 310-20.

Under Subtopic 310-20, loan origination fees, net of related direct loan origination costs, are deferred and recognized as an adjustment to the effective interest yield over the life of the loan. However, Subtopic 310-20 does not apply to nonrefundable fees and costs associated with originating or acquiring loans when the changes in fair value of the related loans are recognized in earnings, which effectively excludes investment companies from the scope of this guidance. [310-20-15-3, 25-2, 30-2, 35-2, 35-18]

However, we understand it is common in practice for investment companies to apply Subtopic 310-20 by analogy to include nonrefundable fees and costs as an adjustment to the cost basis of the loan, with such adjustment subsequently amortized into interest income over the life of the loan as an adjustment to yield when applying the interest method.

Alternatively, we believe it is acceptable to apply other US GAAP by analogy to loan origination fees and related loan origination costs, such as the revenue recognition guidance in Topic 606 and the guidance on costs to fulfill a contract in Subtopic 340-40.

An investment company, that is not regulated by the 1940 Act, with loan origination activities should evaluate whether those activities are substantive. If its loan activities are substantive, an investment company is precluded from meeting the definition of an investment company (see Questions 2.4.110 and 2.5.160).

Question 3.6.110 Is the interest method used to recognize interest income on payment-in-kind (PIK) bonds?

Background: A payment-in-kind (PIK) bond is a type of bond that allows borrowers to pay interest with additional bonds instead of cash. This means that the issuer can make interest payments by issuing more bonds of the same or similar type to the bondholders, rather than paying interest in cash. These bonds are typically high yielding debt and may have higher market, liquidity and/or credit risk than investment grade bonds and therefore are often more likely to default than other types of bonds or debt investments. These bonds may be issued or traded at a significant discount to their face amount (principal) since interest is not paid currently. [946-320 Glossary, 946-320-05-03 – 05-06]

Interpretive response: Investment companies use the effective interest method to determine interest income on PIK bonds (see section 3.6.10). When determining interest income, it is important to consider PIK bonds typically trade flat (that is, the interest component to be paid in-kind is included in the market value quote obtained each day). Thus, the interest component must be bifurcated from the purchase price to arrive at the true cost basis of the bond component upon recognition. [946-320-35-10]

Question 3.6.120 Is the interest method used to recognize interest income on step bonds?

Background: Step bonds involve a combination of deferred-interest payment dates and increasing interest payment amounts over the bonds' lives. Therefore, they bear some similarity to zero-coupon bonds and to traditional debentures. These bonds are typically high-yielding debt and may have higher market, liquidity and/or credit risk than investment grade bonds and therefore are often more likely to default than other types of bond or debt investments. These bonds may be issued or traded at a significant discount to their face amount (principal) since interest is not paid currently. [946-320 Glossary, 946-320-05-03 – 05-06]

Interpretive response: Yes. Investment companies use the effective interest method to determine interest income on step bonds (see section 3.6.10). [946-320-35-12]

3.6.20 Evaluating collectibility of interest income

Excerpt from ASC 946-320

> Interest Receivable Purchased on Defaulted Debt Securities

05-7 Interest receivable from debt securities generally comprises both of the following distinct components:

a. Interest purchased from the previous bondholder
b. Interest accrued by the investment company during the holding period.

05-8 If market prices fluctuate significantly or issues of debt securities have defaulted, a judgment about whether to write off interest receivable will involve both components. Writeoffs of interest receivable differ from traditional writeoffs of trade accounts receivable since they can significantly affect an investment company's statement of operations, the performance measurement ratios of expenses to average net assets, and net investment income to average net assets.

> High-Yield Debt Securities

• > Payment in-Kind Bonds

35-11 To the extent that interest income to be received in the form of **baby bonds** is not expected to be realized, a reserve against income shall be established. Specifically, the investment company shall determine periodically that the total amount of interest income recorded as receivable, plus the initial cost of the underlying payment-in-kind bond, does not exceed the fair value of those assets.

• > Step bonds

35-13 To the extent that interest income is not expected to be realized, a reserve against income shall be established. Specifically, the sum of the acquisition amount of the bond and the discount to be amortized shall not exceed the undiscounted future cash collections that are both reasonably estimable and probable.

> Interest Receivable Purchased on Defaulted Debt Securities

35-17 The portion of interest receivable on defaulted debt securities written off that was recognized as interest income shall be treated as a reduction of interest income.

35-18 Write offs of purchased interest should be reported as both of the following:

a. Increases to the cost basis of the security
b. Unrealized losses until the security is sold.

35-19 Those reserves shall be recorded when they become probable and estimable in accordance with the guidance in Subtopic 450-20.

Question 3.6.130 How is collectibility of accrued interest receivable determined?

Interpretive response: An investment company generally accrues interest as a receivable through the next coupon date. However, when determining the amount to accrue, an investment company considers whether interest income is collectible from the issuer or counterparty. Recognition of accrued interest may not be appropriate if collection of interest income is uncertain as of the reporting date. [AAG-INV 2.131]

When determining the collectibility of interest income, an investment company should evaluate its accrued interest receivables regularly to determine that coupon payments are received timely and in the correct amounts. [AAG-INV 2.133]

We believe an investment company should write off an accrued interest receivable in accordance with the loss contingency guidance in Subtopic 450-20. A loss is recognized under that guidance when it is probable that a portion of the accrued interest receivable is uncollectible and the uncollectible amount can be reasonably estimated. [946-320-35-19, 450-20-25-2, FAS 5.22]

Question 3.6.140 How are uncollectible amounts of accrued interest receivable accounted for?

Interpretive response: Accrued interest receivable amounts not expected to be realized are written off and reflected as a reduction to interest income in the period of the writeoff, even if the interest income was originally recognized in a prior period. [946-320-35-11, 35-13, 35-17]

Question 3.6.150 How is uncollectible interest on PIK bonds and step bonds determined?

Interpretive response: A reserve against income is established to the extent that interest income is not expected to be realized on step bonds or PIK bonds. When determining whether interest income is not expected to be realized, an investment company performs the following:

PIK bonds

An investment company periodically determines that the total amount of interest income reported as a receivable, plus the initial cost of the underlying PIK bond, does not exceed the current fair value of those assets. [946-320-35-11]

Step bonds

An investment company periodically determines that the sum of the acquisition amount of the step bond and the discount to be amortized does not exceed the undiscounted future cash collections that are both reasonably estimable and probable. [946-320-35-13]

Question 3.6.160 How are uncollectible amounts of purchased interest accounted for?

Interpretive response: Like interest accruals (see Question 3.6.130), purchased interest is written off when: [450-20-25-2]

- it becomes probable that the interest will not be collected; and
- the amount of uncollectible interest can be reasonably estimated.

Unlike interest accruals, a writeoff of purchased interest is reported as an increase to the cost basis of the security, which will result in an unrealized loss until the security is sold. [946-320-35-18]

Question 3.6.170 Is it appropriate to place nonperforming debt securities or loans receivable on nonaccrual status?

Interpretive response: Except under limited circumstances, US GAAP does not specifically address placing nonperforming investments on nonaccrual status. We understand it is a common industry practice for investment companies to place investments on nonaccrual status when interest income is not expected to be collected.

We believe placing nonperforming investments on nonaccrual status is an acceptable practice that results in a similar accounting outcome to recognizing an interest income accrual and then writing off the accrued interest receivable as uncollectible at each coupon period (see Question 3.6.130).

We also believe an investment company may use a cost recovery method to account for interest income collections of investments on nonaccrual status if it is unable to reasonably estimate the amount of uncollectible interest. Under this method, collections received reduce the cost basis of the investment, and no interest income is recognized until the cost has been fully recovered. [FAS 5.23, APB 10 (n8)]

Question 3.6.180 How are collections of defaulted bonds accounted for?

Excerpt from SEC Financial Reporting Releases Section 404

404.02. Accounting for Interest Collected on Defaulted Bonds

ASR 36:

A question has been raised as to the treatment by an investment company of interest collected on defaulted bonds applicable to a period prior to the date on which such bonds and defaulted interest were acquired. In the particular case an investment company purchased, at a "flat" price of $260,000, $1,000,000 principal amount of bonds with attached defaulted interest coupons amounting to $250,000. The company subsequent to the purchase received an interest payment of $40,000 on account of defaulted interest coupons for periods prior to the purchase.

Where a purchase is made of defaulted bonds with defaulted interest coupons attached, it is clear that the purchase price covers not only the right to receive the principal of the bond itself, but also the right to receive any payments made on the defaulted interest coupons purchased. Under these circumstances, the price paid cannot be deemed to reflect only the cost of acquisition of the issuer's obligation to pay the principal sum, but must instead be considered to reflect as well the cost of acquisition of the issuer's existing obligation to pay the interest coupons already matured. In the usual case, moreover, there is no satisfactory basis on which to allocate the total price between the bond on the one hand and the defaulted interest coupons on the other. Under such circumstances, the bond and defaulted coupons should be treated as a unit for accounting purposes and collections on account of the defaulted interest coupons should be treated not as interest on the sum invested but rather as repayments thereof. Moreover, in view of the uncertainty of eventually receiving payments in excess of the purchase price, ordinarily no part of any payment, whether on account of principal or the defaulted interest, should be considered as profit until the full purchase price has been recovered.

In the instant case, therefore, the receipt of the $40,000 interest payment should be treated as a reduction of the cost of the investment and not as interest income, or as a profit on the investment. After payments are received on account of the principal and defaulted interest in an amount equal to the purchase price, any further collections thereon should be treated not as interest, but as profit on securities purchased. On the other hand, it seems clear that collection of interest coupons covering periods subsequent to the purchase may be treated as interest income unless the circumstances of a particular case are such as to indicate that, despite the apparent nature of the payment, recovery of the cost of the investment through sale or redemption is so uncertain as to make it necessary to treat the payment as a reduction of the investment.

Interpretive response: A purchase of a defaulted bond with defaulted interest coupons attached contains the right to collect on both the principal of the bond and defaulted interest coupons. Because of the uncertain attribution of the purchase price between the bond and the defaulted interest coupons, the defaulted principal and interest coupons are considered a single unit of account.

Collections of amounts in arrears as of the purchase date

Collections of defaulted amounts reduce the cost basis of the investment (i.e. the purchase price), and therefore are not recognized as interest income. If collections of defaulted principal and interest amounts exceed the purchase price, the excess collections are realized gains.

Collections for periods subsequent to the purchase date

Amounts received for interest coupons that are attributed to periods subsequent to the purchase of the defaulted bond are recognized as interest income. However, if there is significant uncertainty in the ultimate recovery of the cost of the investment through sale or redemption, such amounts should be accounted for as a reduction of the cost basis of the investment instead of interest income. [FRR 404.02]

Example 3.6.40 Collections on purchased bond in default

On January 1, ABC Fund purchased a $5,000,000 par value bond issued by DEF Company from XYZ Fund for $500,000. The bond is in default status as of the purchase date and includes attached defaulted interest coupons of $250,000.

On June 30, ABC Fund received a payment in default of $200,000.

On September 30, ABC Fund received an additional payment in default of $400,000.

ABC Fund records the following journal entries.

	Debit	Credit
January 1		
Investment in DEF Company bond (cost)	500,000	
Cash		500,000
To record the purchase of DEF Company bond in default status.		
June 30		
Cash	200,000	
Investment in DEF Company bond (cost)		200,000
To record the collection of defaulted payment as a recovery of cost.		
September 30		
Cash	400,000	
Investment in DEF Company bond (cost)		300,000
Realized gain on securities[1]		100,000
To record the collection of defaulted payment as a recovery of cost and the excess over the purchase price as a realized gain.		

Note:

1. A realized gain of $100,000 is recognized on September 30 as the excess of the payments in default ($600,000) over the purchase price of the defaulted bond ($500,000).

Because both payments are attributed to defaulted coupon periods at the time of purchase, no portion of those payments is attributed to interest income.

3.7 Dividends and other distributions from investments

An investment company applies the guidance in Subtopic 946-320 to account for dividends and other distributions from investments.

Question 3.7.10 How are dividends and other distributions from investments accounted for?

Excerpt from ASC 946-320

> Effective Date of Transactions

• > Dividends

25-4 Investment companies shall record dividend income on the ex-dividend date, not on the declaration, record, or payable date, because on the ex-dividend date the quoted market price of listed securities and other market-traded securities tends to be affected by the exclusion of the dividend declared. Also, investment companies shall record liabilities for dividends to shareholders on the ex-dividend or ex-distribution date because mutual fund shares are purchased and redeemed at prices equal to or based on net asset value. Investors purchasing shares between the declaration and ex-dividend dates are entitled to receive the dividend, whereas investors purchasing shares on or after the ex-dividend date are not entitled to the dividend.

> Dividends

35-5 Dividends on investment securities shall be recorded on the ex-dividend date. Distributions that represent returns of capital shall be credited to investment cost rather than to investment income.

35-6 Stock splits and stock dividends in shares of 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 option, because in such cases cash is usually the best evidence of fair value of the stock.

35-8 Stock rights (that is, subscription rights) received shall be allocated a prorated portion of the cost basis of the related investment; however, allocation is not required if the fair value of the rights is 15 percent or less of the fair value of the investment company's holdings.

35-9 Cash dividends declared on stocks for which the securities portfolio reflects a short position as of the record date shall be recognized as an expense on the ex-dividend date.

Interpretive response: How an investment company accounts for dividends and other distributions from its investments depends on the distribution type.

Distribution type	Proper accounting treatment
Dividends that result from the underlying economic earnings generated by the investee[1]	Recognize as dividend income on the ex-dividend date. [946-320-25-4]
Distributions that represent returns of capital[1]	Reduce (i.e. credit) investment cost rather than recognize dividend income. [946-320-35-5] Generally, distributions representing returns of capital that exceed the investment cost are realized gains.

Distribution type	Proper accounting treatment
	However, we believe the recognition of realized gain is limited to only those amounts for which no commitment, obligation or contingency exists. This limitation can be triggered if the investment company has a commitment or other obligation to fund additional capital into the investee or a contingency exists to fund capital or to repay a portion of the distribution back to the investee.
Stock dividends and stock splits[2,3]	Allocate the cost of the shares previously held equitably to the total shares held after the stock dividend or split. When any shares are later disposed of, a gain or loss is determined on the basis of the adjusted cost per share. [946-320-35-6]
Stock rights (i.e. subscription rights)	Allocate a prorated portion of the cost of the related investment prior to the stock rights distribution to the stock rights.[4] The allocation is based on the relative fair value of the stock rights and related investment. [946-320-35-8]
Dividends on securities sold short	Recognize as dividend expense on the ex-dividend date. [946-320-35-9]

Notes:

1. See Question 3.7.80 for discussion on how to determine if distributions represent returns of capital or dividends that result from the underlying economic earnings generated by the investee.
2. This distribution type includes stock dividends and stock splits when an alternative option to receive the dividends in the form of cash is not provided by the investee. See Question 3.7.30.
3. See Question 3.7.60 for discussion on the accounting for stock dividends from preferred stock.
4. Allocation is not required if the fair value of the stock rights is 15% or less of the fair value of the related investment company's holdings.

3.7.10 Dividends

Question 3.7.20 When are dividends from securities recognized?

Interpretive response: Investment companies generally recognize dividend income on the ex-dividend date, which is the date shareholders of record of the investment are entitled to the dividend declared. On this date the shares start trading without the value of the next dividend payment. [946-320-25-4, 35-5]

There is no explicit guidance on when an investment company recognizes dividend income from an investment that is not publicly traded (i.e. there is no ex-dividend date). In such instances, we believe an investment company should recognize dividend income when it has a legal right to receive the dividend. This may be on the declaration date, which is the date the board of directors (or similar governing body that supervises the activities of the investee) declares a dividend and the investee becomes liable for the dividend payment.

Question 3.7.30 How are stock dividends accounted for?

Interpretive response: It depends on whether an investment company has the option to receive dividends in the form of cash or stock.

Only stock can be received

Stock splits and stock dividends in shares of the same class are typically dilutive in nature and do not result in the investment company acquiring additional interests or economic benefits from the investee. An investment company generally does not recognize income from stock splits or stock dividends in shares of the same share class owned. As such, an investment company does not recognize any changes to the 'investments in securities' balance, but only adjusts the number of shares and cost basis per share. [946-320-35-6]

Option to receive cash instead of stock

If an investment company has the option to receive dividends in the form of cash or stock, it recognizes dividend income consistent with the accounting treatment for cash dividends (see Question 3.7.20). The dividend income is the amount that would be received under the cash option, because in such cases cash is usually the best evidence of the stock's fair value. [946-320-35-6]

Question 3.7.40 How are dividends in the form of noncash assets accounted for?

Excerpt from ASC 946-320

> Dividends

35-7 Other noncash dividends shall be recognized as investment income at the fair value of the property received.

Background: An investee may issue dividends in other forms, such as shares in a different share class than those owned by an investment company, or in the form of other noncash assets.

Interpretive response: A distribution of noncash assets (i.e. a distribution-in-kind) is measured at fair value. [946-320-35-7]

Further, an investment company should consistently apply an accounting policy election on when to accrue for dividend income (see Question 3.7.20).

Question 3.7.50 When are dividends on foreign equity securities recognized?

Background: Information relating to corporate actions by foreign issuers is sometimes difficult to obtain and verify on a timely basis. Some investment companies do not recognize foreign corporate actions until a formal notification is received from a custodian or other service provider that verifies the corporate action has occurred.

Interpretive response: Because Topic 946 requires investment companies to recognize dividends on the ex-dividend date (see Question 3.7.20), it is generally not appropriate for an investment company to delay recognizing foreign dividends if the investment company knew (or should have known had it exercised reasonable diligence) that the corporate action had occurred. However, the SEC staff has expressed the view that delayed recognition of foreign corporate actions may be appropriate if the investment company was not aware the corporate action had occurred after exercising reasonable diligence. Under such circumstances, the investment company should recognize foreign dividends promptly after the information is received. [IM-DCFO 1996-02]

Question 3.7.60 How is a stock dividend from preferred stock accounted for?

Interpretive response: Although the preferred stock investment is in legal form an equity instrument, the terms of the preferred stock may contain features that are more akin to a debt instrument, such as seniority, redemption, or other features. If the preferred stock takes priority to other classes of interest in a liquidation waterfall, and the dividends are deemed to be collectible, we believe an investment company recognizes dividend income for the stock dividend (or payment-in-kind dividend) when the dividend is declared. This is because the stock dividend transfers value from the other equity classes to the preferred equity.

If the preferred equity is the only interest in the company, or the subordinated interests (e.g. common shares) are worthless, the stock dividend is dilutive to the price of the preferred shares and therefore no income is recognized (see Question 3.7.30).

Question 3.7.70 How are dividends on securities sold short accounted for?

Interpretive response: Similar to dividend income on long positions (see Question 3.7.20), dividends on securities sold short are recognized on the ex-dividend date. Dividends on securities sold short are presented as expenses of an investment company. [946-320-35-9]

3.7.20 Other distributions

Question 3.7.80 How does an investment company determine if distributions represent returns of capital?

Excerpt from ASC 946-320

20 Glossary

Return of Capital

Distributions by investment companies in excess of tax-basis earnings and profits.

> Dividends

35-5 Dividends on investment securities shall be recorded on the ex-dividend date. Distributions that represent **returns of capital** shall be credited to investment cost rather than to investment income.

Interpretive response: An investment company should consistently apply an accounting policy election to determine the portions of distributions that represent:

- a return of capital; or
- dividends that result from the underlying economic earnings generated by the investee.

The objective of Topic 946 in reporting investment income from equity investments is to characterize dividends or other distributions as investment income to the extent they are paid from the underlying economic earnings generated by an investment. In contrast, distributions that represent returns of capital are credited to investment cost. [946-320-35-5]

A return of capital is defined in Topic 946 as "*distributions by investment companies* in excess of tax-basis earnings and profits"[emphasis added]. While this definition of return of capital is specific to distributions by investment companies (see section 4.4), we believe the concept can be analogized to distributions received from both investment companies and non-investment company investees (i.e. companies that do not meet Topic 946's definition of an investment company). Examples of investees that are not investment companies are master limited partnerships (MLPs), real estate investment trusts (REITs) and operating companies. [946-320 Glossary]

Determining which portion of a distribution from a non-investment company investee is a return of capital versus a dividend is difficult if information about an investee's tax-basis earnings and profits is not available by the investment company's financial reporting deadline. As a result, there is diversity in practice in determining if distributions represent returns of capital or dividends that result from the underlying economic earnings generated by the investee. See Question 3.7.90 for acceptable methods to make this determination.

Question 3.7.90 What are acceptable methods for determining the portion of a distribution that results from an investee's underlying economic earnings?

Interpretive response: It depends.

We believe an investment company's method for determining the economic earnings for its investments is generally an accounting policy decision applied to each investment type based on the availability of information an investee reports. We are aware of diversity in practice and have observed that investment companies apply various methods to determine economic earnings that include US GAAP, US federal tax-basis earnings and profits, IFRS® Accounting Standards and other comparable methods.

Although Topic 946 describes a return of capital as distributions in excess of tax-basis earnings and profits, such tax-basis information may not be uniformly available from investees by the time an investment company is issuing its financial statements. Therefore, we believe the use of methods other than US federal tax-basis earnings and profits is an acceptable practice. However, we believe the use of another method would not be considered to be preferable. [946-320 Glossary]

For entities that choose to determine economic earnings based on US federal tax-basis earnings and profits, we believe reliance on Internal Revenue Code Section 312 is appropriate, in part, because the intent of Section 312 is to measure economic earnings available for distribution by an investee.

If an investment company chooses not to use US federal tax-basis earnings and profits to determine economic earnings, we believe it should measure the economic earnings of an investee using the financial reporting framework applicable to the investee, such as US GAAP, if available. Similarly, an investment company investing globally may be faced with practical difficulties in obtaining US GAAP or US tax-basis information from its investees. Accordingly, the use of IFRS Accounting Standards may be an appropriate method of measuring economic earnings in such circumstances.

Question 3.7.100 Over what period are the economic earnings of an investment calculated?

Interpretive response: An investment company calculates economic earnings of an investment because it recognizes dividend income from that investment only when the distribution is paid from those economic earnings. Dividends or distributions paid in excess of economic earnings are credited to the investment account as a return of capital. See Question 3.7.80.

Because dividends typically represent distributions from an investee's retained earnings (or equivalent), we believe dividends or distributions should be characterized as investment income to the extent they are paid from the accumulated economic earnings generated by the investee. Therefore, we believe an investment company should calculate economic earnings of an investee from the time the investee commenced operations, not from the time it acquired the investment. [AAG-INV 6.26]

However, if an investment company is unable to determine the accumulated economic earnings since the investee commenced operations, we believe it would be acceptable to calculate economic earnings and profits from when the investment company acquired the investment.

Question 3.7.110 How are cash distributions received in excess of investment cost accounted for?

Interpretive response: If an investment company receives a cash distribution that does not result from the underlying economic earnings generated by the investee, it treats the distribution as a return of capital and credits investment cost (see Question 3.7.80). However, if such a distribution exceeds investment cost, the investment company has realized a gain. We believe an investment company recognizes this gain to the extent that the distribution received is not subject to be returned due to any commitments, obligations or contingencies. Recognition of the gain is deferred and classified as a liability if the investment company has a commitment or other obligation to fund additional capital into the investee or a contingency exists to fund capital or to repay a portion of the distribution.

Question 3.7.120 How is a change in methodology used to calculate return of capital distributions from the prior period accounted for?

Interpretive response: We believe that a change in methodology used to calculate return of capital distributions should generally be accounted for as a change in accounting estimate effected by a change in accounting principle. As such, the change is accounted for prospectively. Because the change in estimate is effected by a change in principle, a preferability assessment is required to support the change. [250-10 Glossary, 250-10-45-19]

However, if there was an error in previously measuring return of capital distributions, the change in methodology is a correction of an error in previously issued financial statements, which would require restatement of the prior-period financial statements if material.

See KPMG Handbook, Accounting changes and error corrections, for additional guidance on changes in accounting principles.

Question 3.7.130 Is investment income accounted for differently for investments structured or taxed as partnerships and investments structured in corporate form?

Interpretive response: No. An investment company accounts for investment income from equity investments structured as partnerships (or taxed as partnerships) consistent with investment income from investments structured as corporations. [946-320-35-5]

3.8 Derecognition of investments

When or whether an investment company derecognizes an investment depends on the nature of the investment and type of transaction.

Question 3.8.10 When are securities sold through regular-way transactions derecognized?

Interpretive response: When an investment company sells securities through a regular-way trade, it derecognizes the securities as of the trade date, which represents the date it agrees to sell the securities or close a short position. Similar to the recognition of purchases of securities (see Question 3.3.10), securities sold through regular-way transactions are derecognized on their trade date to record the effects of those transactions entered into as of the reporting date. Even if trades are not settled until after the reporting date, securities are removed from an investment company's portfolio of investments on the trade date. [946-320-25-1, AAG-INV 1.58]

Question 3.8.20 When are securities sold outside of conventional channels derecognized?

Interpretive response: Consistent with when securities purchased outside of conventional channels are recognized (see Question 3.3.30), securities sold outside of conventional channels are derecognized on the date the investment company:

- obtains a right to collect the proceeds of a sale; and
- incurs an obligation to deliver the securities sold.

The dates on which the right to proceeds is obtained and the obligation to deliver the securities is incurred, as well as the enforceability of such right and obligation, may be subject to legal interpretation. [946-320-25-2, FRR 404.03.a]

Question 3.8.30 How does an investment company evaluate derecognition of other investments?

Interpretive response: Subtopic 946-325 does not address derecognition of an investment company's other investments. We believe an investment company should first evaluate whether the sale of other investments is specifically addressed under other US GAAP such as Subtopic 610-20 for sales of nonfinancial assets when control of the asset has been transferred.

If other US GAAP does not apply to the transaction, we believe an investment company should evaluate the facts and circumstances to determine whether to apply the principles for derecognition of investments in securities under Subtopic 946-320 by analogy to transactions that are similar to regular-way security trades (see Questions 3.3.10 and 3.8.10) or transactions outside of conventional channels (see Question 3.3.30 and 3.8.20).

In addition, an investment company should also consider the interaction of other US GAAP that addresses whether an other asset should be derecognized, such as Topic 860 for transfers of financial assets (see Question 3.8.40) or Subtopic 610-20, if a contract does not exist, for sales of nonfinancial assets.

See Chapter 17 of KPMG Handbook, Revenue recognition, for guidance on derecognition of nonfinancial assets and in-substance nonfinancial assets.

Question 3.8.40 Does Topic 860 apply for derecognition of investments in financial assets?

Background: Topic 860 applies to certain transfers of financial assets that are within its scope. Examples of common investment company transactions accounted for under Topic 860 include repo and reverse repo agreements, dollar rolls, and securities borrowing and lending arrangements. [860-10-15-2 – 15-3, AAG-INV 2.29]

Interpretive response: It depends.

When an investment company transfers a financial asset that is within the scope of Topic 860, it evaluates both when the transaction is recorded under Subtopic 946-320 and whether the transfer is accounted for as a sale or a secured borrowing under Topic 860. A transfer of financial assets is not accounted for as a sale if the transferor has not surrendered control over the transferred assets. If a transfer of financial assets does not meet the requirements for sale accounting under Topic 860, the transfer is accounted for as a secured borrowing.

If an investment company transfers a financial asset that is not within the scope of Topic 860, we believe it only applies the derecognition guidance for investments under Subtopic 946-320.

See KPMG Handbook, Transfers and servicing of financial assets, for guidance on derecognition of financial assets within the scope of Topic 860.

Question 3.8.50 How are realized gains and losses determined upon the sale or disposition of an investment?

Excerpt from ASC 946-320

> Determining costs and realized gains and losses

40-1 The cost of investment securities held in the portfolio of an investment company and the net realized gains or losses thereon shall be determined on the specific identification or average-cost methods. An investment company shall use only one method for all of its investments.

Interpretive response: Upon the sale or disposition of an investment, an investment company determines the realized gain or loss based on the difference between:

- the proceeds of the sale (net of transaction costs); and
- the cost basis of the investment as of the transaction date.

When there is a partial sale or disposal of a particular investment, an investment company determines the net realized gain or loss from the partial sale or disposal and the cost basis of the remaining investments using a cost relief method. Acceptable cost relief methods include the specific identification and average cost methods. [946-320-40-1]

The 1940 Act specifically permits registered funds to use FIFO and LIFO when determining the cost basis of investment securities. We believe the use of FIFO or LIFO cost relief methods are acceptable applications of the specific identification method for both registered and nonregistered funds. Whichever cost relief method an investment company chooses should be applied consistently to all of its investments. [CFR 270.2a-2]

In addition, previously recorded unrealized gains or losses are reversed upon the realization of the investment.

Example 3.8.10 Realization of investments

Investment Fund ABC holds 10 shares of Investment DEF with an average cost basis per share of $200. The fair value of each share as of the last measurement date was $300. Investment Fund ABC relieves cost of investments sold using the average cost method.

Investment Fund ABC sells all of its shares of Investment DEF for $330 a share with $10 per share of transaction costs. It records the following journal entry.

	Debit	Credit
Cash[1]	3,200	
Change in unrealized appreciation on investments[2]	1,000	
Investments (unrealized appreciation)[2]		1,000
Realized gain on investments[3]		1,200
Investments (cost)		2,000
To report sale of shares of Investment DEF.		

Notes:

1. The cash received is calculated as the price per share less the transaction costs per share then multiplied by the number of shares sold:

   ($330 – $10) × 10 shares = $3,200

2. Upon a sale, the unrealized appreciation/depreciation as of the previous measurement date is reduced to zero.
3. The realized gain is calculated as the difference between the proceeds of the sale (net of transaction costs) and the cost basis as of the transaction date:

   (($330 – $10) – $200)) × 10 shares = $1,200

Question 3.8.60 Can different cost relief methods be applied to different types of investments?

Interpretive response: No. An investment company must use only one cost relief method for all of its investments. [946-320-40-1]

An investment company that subsequently changes its cost relief method accounts for the change as a change in accounting principle. See KPMG Handbook, Accounting changes and error corrections.

Question 3.8.70 Which cost relief methods are used to derecognize other investments?

Interpretive response: We believe an investment company should generally apply the same cost relief method for its other investments as used for its investments in securities (see Question 3.8.60). [946-320-40-1]

However, we understand that the SEC staff has objected to the use of the average cost method rather than specific identification for investments in digital assets that are accounted for under the sales of nonfinancial assets guidance in Subtopic 610-20.

Question 3.8.80 Is a realized gain or loss recognized when an investee engages in a merger or acquisition transaction?

Interpretive response: It depends on the nature and substance of the transaction, as well as the consideration exchanged in the transaction.

Change in substance of investment

Often, when an investee engages in a merger or is acquired, the investment company receives shares in the acquiring company. These shares may represent an investment that is distinct and has different economic risks and rewards from the investment company's previous investment in the investee. In those instances, we would consider the substance of the transaction to be a sale, where the investment in the investee is derecognized, and a realized gain or loss is recognized for the difference between the fair value of the shares received from the acquiring company as of the transaction date and the cost basis of the investee. The fair value of the shares received from the acquiring company as of the transaction date would represent the initial measurement of the cost basis of the acquired shares by the investment company. [860-20-40-1A]

No change in substance of investment

An investment company should consider whether the transaction has unique circumstances where there is no change in substance of the investment. For example, this can occur if the investee and the acquiring company have a preexisting common control relationship, or if the economic risks and rewards attributed to the shares received from the acquiring company are not substantially different from the shares of the investee. Further, we believe that no substantive exchange of investments has occurred when the investment company has continuing involvement in the risks and rewards of the transferred investment. Under such circumstances, the transaction may be considered a change in legal form, such as a reorganization, but not a change in substance of the investment, where no realized gain or loss is recognized from the transaction, and the cost basis of the investee is carried over to the investment in the acquiring company. Such a determination involves significant judgment and requires careful consideration of the specific facts and circumstances. [845-10-25-1]

Example 3.8.20 Merger or acquisition transaction of an existing investee

Background

ABC Investment Company owns 80% of the partnership interests in DEF Partnership, a bio-tech limited liability partnership currently undergoing clinical trials for a novel drug. On November 30, ABC Investment Company has a cost basis in DEF Partnership of $20,000,000 with an estimated fair value of $60,000,000.

Scenario 1: Investee conversion into a corporation

Assume that DEF Partnership was a limited liability partnership when ABC Investment Company made its investment. On December 1, in advance of a planned initial public offering, DEF Partnership is converted into a corporation and all partnership interests are exchanged for an equal percentage of shares in the newly formed corporation. There are no other changes in the expected operations of DEF Partnership.

ABC Investment Company does not recognize any realized gain from the transaction because there have been no changes in the control of the investment and the economic risks and rewards of the investment have not substantially changed. The cost basis of DEF Partnership is carried over to the investment in the newly formed corporation.

Scenario 2: Investee is acquired by a third party

Assume the same facts as scenario 1 with the exception that DEF Partnership is not converted into a corporation, but instead is acquired by XYZ Company, a multinational pharmaceutical entity. Prior to the transaction, XYZ Company had no existing relationship or shared ownership with DEF Partnership. In exchange for its investment in DEF Partnership, ABC Investment Company receives 1% of the shares of XYZ Company, valued at $60,000,000.

The shares of a multinational pharmaceutical company have substantially different and distinct economic risks and rewards than a bio-tech investment. Additionally, there has been a change in control of DEF Partnership. Therefore, ABC Investment Company records a realized gain through the following journal entry.

	Debit	**Credit**
Investment in XYZ Company (cost)	60,000,000	
Investment in DEF Partnership (cost)		20,000,000
Investment in DEF Partnership (unrealized appreciation)[1]		40,000,000
Change in unrealized appreciation on investments[1]	40,000,000	
Realized gain on investment[2]		40,000,000
To recognize the gain from sale of DEF Partnership.		

Notes:

1. Upon a sale, the unrealized appreciation/depreciation as of the previous measurement date is reduced to zero.
2. The realized gain is calculated as the difference between the fair value of the shares received from XYZ Company and the cost basis of DEF Partnership as of the transaction date:

   $60,000,000 – $20,000,000 = $40,000,000

Question 3.8.90 Is a realized gain or loss recognized when an option contract expires unexercised?

Background: An option is a contract that gives its owner the right, but not the obligation to purchase or sell a specified item at a fixed price. In exchange for the option, the purchaser pays a premium to the seller or writer of the option. For a purchased option, the premium paid represents the cost basis of the investment, and for a written option, the premium received is similar to proceeds received for securities sold short. Option contracts are subsequently measured at fair value and may also meet the definition of a derivative under Topic 815. [AAG-INV 3.41]

Interpretive response: Yes. If a purchased option expires unexercised, an investment company derecognizes the investment and recognizes a realized loss for the premium paid. If a written option expires unexercised, the obligation to deliver the underlying securities (under a written call option) or to purchase the underlying securities (under a written put option) is generally discharged, and therefore the investment company derecognizes the liability and recognizes a realized gain for the premium received. [815-10-40-1, 405-20-40-1, AAG-INV 3.42]

Question 3.8.100 Is a realized gain or loss recognized upon the conversion of a convertible security or exercise of an option contract for an investment in the same issuer?

Interpretive response: It depends.

While Topic 946 does not provide specific guidance on accounting for the conversion of convertible securities or exercise of option contracts, we do not believe a realized gain or loss should be recognized from the derecognition of the prior instrument upon the conversion or exercise when conversion or exercise was made pursuant to the instrument’s contractual terms. This is because the new instrument received is in substance a continuation of the original investment decision.

Consistent with our observations of industry practice, we believe the cost basis of the prior instrument, plus any costs or premiums associated with the conversion or exercise, should be the initial measurement of the cost basis for the shares acquired through conversion or exercise.

However, if the conversion or exercise is not executed in accordance with the original contractual terms of the instrument, we believe a departure from the original investment decision may have occurred and, depending on the facts and circumstances, it may be appropriate to account for it as a realized gain or loss.

Treatment of accrued interest

Investment companies should consider how a conversion impacts any accrued interest of a convertible debt security. We believe in instances when the holder receives additional consideration in the conversion transaction for accrued interest (e.g. additional shares), converting the carrying amount of accrued interest into the cost basis of the new investment may be appropriate. When no additional consideration is given for the accrued interest, it may be appropriate to write off the accrued interest through a reduction in interest income (see Question 3.6.140).

Question 3.8.110 Is a realized loss recognized when an investment has a zero value?

Interpretive response: It depends. Topic 946 does not address when an investment company should write off (i.e. derecognize) a worthless investment that it continues to hold and as a result, to recognize a realized loss and remove the investment from the schedule of investments. In practice, an investment company generally continues to recognize its investments in its financial statements (including the schedule of investments) even when the fair value of an investment has substantially diminished or has been written down to zero.

However, SEC staff guidance provides that an investment company should write off an investment only when it classifies the investment as a worthless security for federal income tax purposes. Until such classification is made, an investment company should continue to include securities with a zero value in its schedule of investments and not classify the write off as a realized loss. [IM-DCFO 1994-04]

Question 3.8.120 Is a realized gain or loss recognized for periodic payments received or paid on swap contracts?

Background: A swap contract represents an agreement between two parties to exchange cash flows determined by reference to a financial instrument (or other underlying) agreed upon by each of the respective parties. Following the initial swap transaction, periodic payments are exchanged between the counterparties at recurring payment dates until the swap contract expires or is terminated. These periodic payments represent streams of cash flows exchanged between the counterparties, which are determined by variables associated with the underlying to the swap contract, such as fixed or floating interest rates, foreign exchange rates, commodity prices, or equity prices.

Depending on the legal terms of agreements entered into between parties or executed under the conditions of an exchange or clearinghouse, the periodic payments can represent legal settlements of cash flows between counterparties to the swap contract, or payments of collateral to the swap contract (either in favor of the investment company or the swap counterparty).

Interpretive response: It depends. If periodic payments represent the exchange of collateral between the counterparties to the swap contract, we believe an investment company should either recognize a payable to return collateral received from the counterparty or a receivable for the return of collateral posted by the investment company to the counterparty.

However, if periodic payments represent legal settlements of the contract, we believe an investment company should account for periodic payments received or paid in connection with its swap contracts as realized gains or losses in the statement of operations.

Interest and dividend components

For many swap contracts, the cash flows underlying the contract include the exchange of interest or dividends associated with the reference asset or payments of interest on fixed payments under the contract's terms. We believe the underlying accrued income and expenses between payment dates should be recorded as changes in unrealized gains or losses in the statement of operations. When periodic payments for accrued income and expenses are subsequently exchanged, those amounts are reclassified from unrealized to realized gains or losses.

Question 3.8.130 How are partial redemptions of an investment in a partnership investee accounted for?

Background: Investment companies may hold investments in other investment companies (e.g., fund of funds) that are not unitized. Such investments are often organized as partnerships. Typically, investments in investment companies are not realized in a single transaction but rather through partial redemptions over time. Investment companies must determine how to relieve cost for each partial redemption.

Interpretive response: Topic 946 does not provide guidance on how to account for the redemption of a portion of an investment of an investee organized as a partnership. Typically, cost relief for investments in unitized funds is readily determinable because each unit has a specific cost basis. However, in our experience, there is diversity in practice in how investment companies allocate redemption proceeds for non-unitized funds (e.g. limited partnership entities) between reduction of investment cost and realized gains or losses. We believe two of the alternatives applied in practice are acceptable: (1) return of capital method and (2) average cost basis (proportional).

Under the return of capital method, redemptions in excess of tax-basis earnings and profits reduce the cost of the investment. Future redemption receipts continue to be allocated between returns of capital and realized gains in the same manner. However, once the investment cost is reduced to zero, any incremental redemption receipts are realized gains. [946-320-35-5]

Under the average cost basis method, the redemption amount is allocated proportionally between a reduction in cost and realized gains. Any future redemption receipts continue to be allocated based upon the portion of the investment interests redeemed. [946-320-40-1]

We are also aware that some investment companies have used the cost recovery method to account for partial redemptions of investments in partnership investees. However, we do not believe the cost recovery method is a preferable accounting method because it results in a disproportionate allocation between the reduction of investment cost and recognition of realized gains or losses.

Example 3.8.30 Partial redemptions of an investment in an investment company – Return of capital method

On June 1, Year 1, Investment Company A purchased a 20% interest in Investment Company B for $100. Investment Company B is a nonregistered limited partnership. Investment Company A redeemed 7% and 8% of the outstanding shares in Investment Company B on March 1, Year 4 and July 1, Year 5, respectively. The following summarizes the transaction.

	June 1, Year 1	March 1, Year 4	July 1, Year 5
% of investee fund owned prior to transaction	0%	20%	13%
% of investee fund purchased/redeemed	20%	7%	8%
Accumulated earnings and profits attributable to redemption	N/A	20	40
Cash paid/proceeds received	100	60	50

Return of capital method

Under the return of capital method, redemptions in excess of tax-basis earnings and profits reduce the cost of the investment. Future redemption receipts continue to be allocated between returns of capital and realized gains. However, once the investment cost is reduced to zero, any incremental redemption receipts are realized gains. Investment Company A records the following journal entries in Years 4 and 5.

	Debit	Credit
March 1, Year 4		
Cash	60	
Investments (cost)[1]		40
Realized gain		20
To recognize realized gain on partial redemption of investment.		
July 1, Year 5		
Cash	50	
Investments (cost)[2]		10
Realized gain		40
To recognize realized gain on partial redemption of investment.		

Notes:
1. Calculated as cash received ($60) less the earnings and profits ($20) = $40.
2. Calculated as cash received ($50) less the earnings and profits ($40) = $10.

Example 3.8.40 Partial redemptions of an investment in an investment company – average cost method

Assume the same facts as Example 3.8.30, except Investment Company A uses the average cost method to account for the redemptions of interests in Investment Company B.

Under the average cost method, the redemption amount is allocated proportionally between a reduction in cost and realized gains. Investment Company A records the following journal entries in Years 4 and 5.

	Debit	Credit
March 1, 20X4		
Cash	60	
Investments (cost)[1]		35
Realized gain		25
To recognize realized gain on partial redemption of investment.		
July 1, 20X5		
Cash	50	
Investments (cost)[2]		40
Realized gain		10
To recognize realized gain on partial redemption of investment.		

Notes:

1. The reduction in cost is computed by identifying the proportion of the investment redeemed, which was 7% of the investment company's shares relative to the 20% ownership stake, equating to 35%. This percentage is then applied to the existing investment cost of $100, resulting in a cost reduction of $35.
2. The reduction in cost is computed by identifying the proportion of the investment redeemed, which was 8% of the investment company's shares relative to the 13% ownership stake, equating to approximately 61.5%. This percentage is then applied to the existing investment cost of $65, resulting in a cost reduction of $40.

Question 3.8.140 How is interest receivable accounted for when a debt instrument is sold between interest payment dates?

Background: Generally, when a debt instrument is sold, the seller receives both the fair value of the debt instrument and interest that has accrued since the last coupon date and the settlement date (see Question 3.6.20). [946-830-45-22]

Interpretive response: An investment company derecognizes a debt instrument on the trade date. However, it continues to accrue interest until the settlement date. No interest is accrued after the settlement date.

When the proceeds are received by the investment company on the settlement date, the portion attributed to accrued interest is applied against the accrued interest receivable and is not included in the determination of the realized gain or loss on a sale of the debt instrument. [AAG-INV 2.114]

3.9 Accounting for foreign investments

3.9.10 Investments in foreign securities

Excerpt from ASC 946-830

> Overall Guidance

45-4 The practice of not separately disclosing the portion of the changes in **fair values** of investments and realized gains and losses thereon that result from foreign currency rate changes is permitted. However, separate reporting of such gains and losses is allowable and, if adopted by the reporting entity, shall conform to the guidance in this Subtopic.

• > Subsequently Measuring at Fair Value

45-15 A fund investing in foreign securities generally invests in such securities to reap the potential benefits offered by the local capital market. It may also invest in such securities as a means of investing in the foreign currency market or of benefiting from the foreign currency rate fluctuation. The extent to which separate information regarding foreign currency gains or losses will be meaningful will vary depending on the circumstances, and separate information may not measure with precision foreign exchange gains or losses associated with the economic risks of foreign currency exposures. A foreign currency rate fluctuation, however, may be an important consideration in the case of foreign investments, and a reporting entity may choose to identify and separately report any resulting foreign currency gains or losses as a component of unrealized fair value gains or losses on investments.

45-16 The fair value of securities shall initially be determined in the foreign currency and translated at the spot rate on the purchase trade date. The unrealized gain or loss between the original cost (translated on the trade date) and the fair value (translated on the valuation date) comprises both of the following elements:

a. Changes in the fair value of securities before translation
b. Movement in foreign currency rate.

45-17 Such movements may be combined as permitted by paragraph 946-830-45-4. If separate disclosure of the foreign currency gains and losses is chosen, the changes in the fair value of securities before translation should be measured as the difference between the fair value in foreign currency and the original cost in foreign currency translated at the spot rate on the valuation date. The effect of the movement in the foreign exchange rate shall be measured as the difference between the original cost in foreign currency translated at the current spot rate and the historical functional currency cost. These values can be computed as follows:

a. (Fair value in foreign currency - original cost in foreign currency) x valuation date spot rate = unrealized fair value appreciation or depreciation.
b. (Cost in foreign currency times valuation date spot rate) - cost in functional currency = the unrealized foreign currency gain or loss.

45-18 The preceding formulas could be refined to isolate and report the rate change element in the changes in the gains or losses on investments between valuation dates. However, the cost of doing so would not be justified for the relatively minor improvement thereof. Furthermore, such refinement would both:

a. Be a departure from the method required for federal income tax reporting for realized foreign currency gains or losses on debt securities
b. Represent a departure from the practice of those investment companies that presently separately report in their financial statements the effects of foreign exchange on securities gains or losses.

45-19 For short-term securities held by a fund that follows the amortized cost method of valuation, the amortized cost value should be substituted for fair value in the formulas given in the preceding two paragraphs if separate reporting is chosen by the reporting entity.

• > Sale of securities

45-20 If separate reporting of foreign currency gains and losses on sales of securities is chosen by the reporting entity, the computation of the effects of the changes in fair value and the foreign currency rate is similar to that described in paragraphs 946-830-45-17 through 45-18. Fair value in the formula given in those paragraphs should be replaced with sale proceeds and valuation date shall be replaced with sale trade date. Accordingly, the values shall be computed as follows:

a. (Sale proceeds in foreign currency - original cost in foreign currency) x sale trade date spot rate = realized fair value gain or loss on sale of security.
b. (Cost in foreign currency x sale trade date spot rate) - cost in functional currency = realized foreign currency gain or loss.

45-21 The sale of a security results in a receivable for the security sold. The related receivable shall be recorded on the trade date at the spot rate. On the settlement date, the difference between the recorded receivable amount and the actual foreign currency received converted into the functional currency at the spot rate shall be recognized as a realized foreign currency gain or loss.

20 Glossary

Spot Rate

The exchange rate for immediate delivery of currencies exchanged.

Excerpt from ASC 946-320

• > Foreign investments

35-4 In general, the discussion of valuation of securities in this Subtopic also applies to foreign securities. Portfolio securities that are traded primarily on foreign securities exchanges shall be valued at the functional currency (usually the U.S. dollar equivalent) values for such securities on their exchanges.

Question 3.9.10 How are investments in foreign securities measured?

Interpretive response: An investment company initially measures its investments in foreign securities by translating the cost basis to its functional currency using the spot rate as of the trade date. [946-830-45-16]

Subsequently, it translates the fair value of foreign securities to its functional currency using the spot rate as of the reporting date. [946-830-45-16, 946-320-35-4]

The spot rate quoted by currency exchanges will represent the current exchange rate used to translate the investment company's assets and liabilities. See KPMG Handbook, Foreign currency, for guidance when a current spot rate is not available due to a temporary lack of exchangeability between foreign currencies.

Question 3.9.20 How are the foreign currency effects of changes in unrealized appreciation or depreciation on investments in foreign securities reported?

Interpretive response: The unrealized appreciation or depreciation on foreign securities includes the effects from both changes in their fair values (before translation) and changes in foreign currency exchange rates. When reporting the effect of foreign currency gains or losses from investments in foreign securities, an investment company may elect to either:

- report the changes in fair value and changes in foreign currency rates on a combined basis (combined reporting); or
- separately report the portion of the changes in fair values of investments in foreign securities from changes in foreign currency rates (separate reporting). [946-830-45-4]

Under combined reporting, the unrealized appreciation or depreciation on investments in foreign securities is the difference between: [946-830-45-16]

- the fair value of the foreign securities translated at the current spot rate; and
- the original cost of the foreign securities translated at the historical exchange rate.

Under separate reporting, the separate effects are determined as follows. [946-830-45-17]

- The *change in unrealized appreciation or depreciation in fair value* is calculated as the difference in the fair value denominated in foreign currency, less the cost basis denominated in foreign currency, multiplied by the current spot rate.
- The *unrealized foreign currency gain or loss* is calculated as the cost as denominated in foreign currency multiplied by the current spot rate, less the cost in functional currency translated using the historical exchange rate.

In subsequent periods, an investment company determines the change in unrealized appreciation or depreciation from the last reporting date to the current reporting date.

Example 3.9.10 Change in unrealized appreciation on foreign securities

ABC Fund uses the US Dollar as its functional currency.

On July 1, Year 1, ABC Fund purchased 10,000 shares in Overseas Corp for €25.00 per share. On that date, the spot rate was €1.00 = $1.10.

On December 31, Year 1, the market price of Overseas Corp was €27.50 per share. On that date, the spot rate was €1.00 = $1.08.

Scenario 1: Entity records changes in fair value and changes in foreign currency rates on a combined basis

If combined reporting is elected, ABC Fund records the following journal entries to account for the purchase in functional currency and the change in unrealized appreciation at December 31, Year 1.

	Debit	Credit
July 1, Year 1		
Investments (cost)[1]	275,000	
Cash		275,000
To recognize purchase of shares in Overseas Corp at the trade date spot rate.		

	Debit	Credit
December 31, Year 1		
Investments (unrealized appreciation)[2]	22,000	
Change in unrealized appreciation		22,000
To report unrealized appreciation in the fair value of Overseas Corp and foreign currency gain on a combined basis.		

Notes:

1. The cost basis is translated at the purchase trade date spot rate as:

   (10,000 × €25.00) × $1.10 = $275,000.

2. The change in unrealized appreciation is translated at the current spot rate as:

   [(10,000 × €27.50) × $1.08] – [(10,000 × €25.00) × $1.10] = $22,000.

Scenario 2: Entity records changes in foreign currency rates separately from changes in fair value

If separate reporting is elected, ABC Fund records the same journal entry at July 1, Year 1. However, the December 31, Year 1 journal entry to account for the change in unrealized appreciation in fair value and unrealized foreign currency gain differs from the journal entry in scenario 1.

	Debit	Credit
Investments (unrealized appreciation)	22,000	
Unrealized foreign currency loss[1]	5,000	
Change in unrealized appreciation[2]		27,000
To report unrealized appreciation in the fair value of Overseas Corp and foreign currency loss on a separate basis.		

Notes:

1. The unrealized depreciation on foreign currency is measured as the difference between the original cost in foreign currency translated at the current spot rate and the historical cost in functional currency as:

   [(10,000 × €25.00) × $1.08] – [(10,000 × €25.00) × $1.10] = $5,000.

2. The unrealized fair value appreciation is translated at the current spot rate as:

   [(10,000 × €27.50) - (10,000 × €25.00)] × $1.08 = $27,000.

Question 3.9.30 How are the foreign currency effects of realized gains or losses from sales of foreign securities accounted for?

Interpretive response: An investment company's accounting for sales of foreign securities depends on whether it applies separate reporting or combined reporting (see Question 3.9.20).

If the investment company applies combined reporting, it determines the realized gain or loss from foreign investments based on the difference between: [946-830-45-16, 45-20]

- the sale proceeds translated at the sale trade date spot rate; and
- the original cost of the foreign securities translated at the historical exchange rate.

If the investment company applies separate reporting, it determines those separate effects as follows. [946-830-45-20]

- The *realized gain or loss from foreign investments* is calculated as the difference between the sale proceeds and the cost basis denominated in foreign currency, multiplied by the sale trade date spot rate.

- The *realized foreign currency gain or loss* is calculated as the cost basis denominated in foreign currency multiplied by the sale trade date spot rate, less the cost basis translated into the functional currency using the historical exchange rate.

Example 3.9.20 Realized gain from sale of foreign securities

Assume the same facts as Example 3.9.10, except for the following.

On July 1, Year 2, ABC Fund sells its 10,000 shares in Overseas Corp for €30.00 per share. On that date, the spot rate is €1.00 = $1.12.

Scenario 1: ABC Fund records changes in fair value and changes in foreign currency rates on a combined basis

If it elects combined reporting, ABC Fund records the following journal entry to account for the sale.

	Debit	**Credit**
Cash[1]	336,000	
Investments (cost)[2]		275,000
Realized gain from investments		61,000
Change in unrealized appreciation[3]	22,000	
Investments (unrealized appreciation)[3]		22,000
To recognize sale of shares in Overseas Corp at the sale trade date spot rate on a combined basis.		

Notes:

1. The sale proceeds amount is translated at the sale trade date spot rate as:

   (10,000 × €30.00) × $1.12 = $336,000.

2. The cost basis is translated at the purchase trade date spot rate as:

   (10,000 × €25.00) × $1.10 = $275,000.

3. Upon a sale, the unrealized appreciation/depreciation as of the previous measurement date is reduced to zero.

Scenario 2: Entity records changes in foreign currency rates separately from changes in fair value

If separate reporting is elected, ABC Fund records the following journal entry to account for the sale.

	Debit	**Credit**
Cash	336,000	
Investments (cost)		275,000
Realized gain from investments[1]		56,000
Realized foreign currency gain[2]		5,000
Change in unrealized appreciation[3]	27,000	
Investments (unrealized appreciation)[3]		22,000
Unrealized foreign currency loss[3]		5,000
To recognize sale of shares in Overseas Corp at the sale trade date spot rate on a separate basis.		

Notes:

1. The realized gain is translated at the sale trade date spot rate as:
   [(10,000 × €30.00) - (10,000 × €25.00)] × $1.12 = $56,000.
2. The realized foreign currency gain is translated at the sale trade date spot rate as:
   [(10,000 × €25.00) × $1.12] – [(10,000 × €25.00) × $1.10] = $5,000.
3. Upon a sale, the unrealized appreciation/depreciation as of the previous measurement date is reduced to zero.

Question 3.9.40 Must the election of either combined reporting or separate reporting be applied to both changes in unrealized appreciation or depreciation and realized gains or losses from foreign securities?

Interpretive response: Yes. An investment company's choice to apply either combined reporting or separate reporting of the changes in fair value of foreign securities and changes in foreign currency rates is an accounting policy election that is applied consistently to the reporting of both realized and unrealized gains and losses from investments in foreign securities. [946-830-45-4]

Question 3.9.50 How is separate reporting applied to short-term investments?

Background: Investment companies may hold short-term investments for which amortized cost is used to approximate their fair value. A common example of an investment company that uses this approach is a money market fund.

Interpretive response: When applying separate reporting of foreign currency rate changes (see Questions 3.9.20 and 3.9.30) to short-term investments measured at amortized cost, an investment company uses the amortized cost amounts in place of fair value. [946-830-45-19]

3.9.20 Interest income on foreign securities

Excerpt from ASC 946-830

• > Purchased interest

45-14 Purchased interest represents the interest accrued between the last coupon date and the settlement date of the purchase. It should be recorded in the functional currency as interest receivable at the spot rate on the purchase trade date, and subsequently measured at fair value using each valuation date's spot rate. After the settlement date, daily interest income should be accrued at the daily spot rate. It may be impractical to prepare the foregoing calculations daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation should be made daily.

• > Sale of Interest

45-22 Interest sold represents the accrued interest receivable between the last coupon date and the settlement date of sale of the security. The difference between the recorded interest receivable amount and the actual foreign currency received (converted into the functional currency at the spot rate) shall be recognized as a realized foreign currency gain or loss.

> Receivables and Payables

45-23 All receivables and payables that are denominated in a foreign currency and that may relate to income or expense, or to securities sold or purchased, shall be translated into the functional currency each valuation date at the spot rate on that date. The difference between that amount and the functional currency amount that was recorded at various spot rates for income and expense items, and at the trade date spot rate in the case of sales and purchases of securities, is unrealized foreign currency gain or loss. Upon liquidation of the receivable or payable balance in a foreign currency, the difference shall be reclassified as realized foreign currency gain or loss.

> Income

• > Interest

45-25 Interest on securities denominated in a foreign currency shall be calculated at the stated rate of interest in the foreign currency. The interest shall be accrued daily in the foreign currency at the stated interest rate and translated into the functional currency at the daily spot rate. It may be impractical to prepare such a calculation daily, and, therefore, the use of a weekly or monthly average rate may be appropriate in many cases, especially if the exchange rate does not fluctuate significantly. However, if the exchange rate fluctuation is significant, the calculation shall be made daily.

45-26 The related receivable balance along with purchased interest, if any, shall be accumulated in the foreign currency and translated into the functional currency daily using the spot rate for that date. The difference between the income accrued in the functional currency and the foreign currency receivable at the valuation date spot rate shall be recognized as an unrealized foreign currency gain or loss.

45-27 When the interest is received and recorded in the functional currency at the spot rate on that date, the unrealized foreign currency gain or loss shall be reclassified as realized foreign currency gain or loss.

• > Accretion and amortization

45-28 Accretion of discounts and amortization of premiums on bonds shall be calculated daily in the foreign currency. The resulting amount of income or offset to income shall be translated into the functional currency using that day's spot rate. The same foreign currency amount shall be recorded as an addition to cost for accretion of discounts and a reduction to cost for amortization of premiums. Accordingly, cost consists of the original cost, translated at the spot rate in effect on the trade date the bond was bought and adjusted for discount accretion or premium amortization at the spot rate on the date of adjustment. As stated in paragraph 946-830-45-25, use of a weekly or monthly average rate may be appropriate in certain circumstances.

45-29 On maturity, the carrying cost (including accretion or amortization) of the security in the foreign currency equals the proceeds. However, this will not be the case in the functional currency. The original cost shall be translated into the functional currency at the spot rate on the trade purchase date and the accretion or amortization shall be translated at periodic spot rates. The proceeds shall be translated into the functional currency at the spot rate on the maturity date. The difference between the proceeds and the accumulated cost in the functional currency shall be recognized as a realized foreign currency gain or loss.

Question 3.9.60 How is accrued interest on securities denominated in foreign currency accounted for?

Interpretive response: An investment company translates the daily interest accrual into its functional currency at the daily spot rate. However, it may be appropriate to use a weekly or monthly average exchange rate if the exchange rate does not fluctuate significantly. [946-830-45-25]

The related interest receivable is translated into the functional currency at the applicable exchange rate as interest is accrued. An unrealized foreign currency gain or loss is recorded for the difference between: [946-830-45-26]

- the cumulative accrued interest income amounts as translated into the functional currency; and
- the foreign currency receivable translated at the spot rate as of the measurement date.

When the interest is received from the issuer, the cumulative unrealized foreign currency gain or loss is reclassified as a realized foreign currency gain or loss. [946-830-45-27]

Question 3.9.70 How is amortization of premiums and discounts on debt investments denominated in foreign currency accounted for?

Interpretive response: An investment company determines the amortization of premiums and discounts (see Question 3.6.60) on debt investments denominated in foreign currency by translating the adjustment to interest income into the functional currency using the applicable daily spot rate. However, it may be acceptable to use a weekly or monthly average exchange rate if the exchange rate does not fluctuate significantly. [946-830-45-28]

The cost basis of the debt investment is initially translated into the functional currency at the purchase trade date spot rate and subsequently adjusted for the translation of accretion or amortization at the periodic spot rates. Upon maturity of the debt investment, the difference between the proceeds and the accumulated cost basis translated in the functional currency is recognized as a realized foreign currency gain or loss. [946-830-45-29]

Example 3.9.30 Recognition of interest on foreign currency denominated securities

On January 1, Year 1, ABC Fund purchases a €10 million par value bond with a stated interest rate of 8% for €9,800,000. The bond pays interest on an annual basis, is not prepayable, and matures on December 31, Year 5. ABC Fund calculates interest income on an annual basis.

- On the purchase date, the spot rate is €1.00 = $1.10.
- ABC Fund uses the US Dollar as its functional currency.

For simplicity, assume a spot rate for each year-end of €1.00 = $1.09 and the average exchange rate for each period of €1.00 = $1.08.

The following table represents the amortization schedule for the bond discount under the interest method based on the contractual cash flows and effective interest rate of 8.51% (rounded), as presented under the local currency.

Year	Beginning cost balance	Coupon payments[1]	Interest income[2]	Amortization of bond discount[3]	Ending cost balance
(Amounts in €)					
1	9,800,000	800,000	833,748	33,748	9,833,748
2	9,833,748	800,000	836,619	36,619	9,870,367
3	9,870,367	800,000	839,735	39,735	9,910,102

Year	Beginning cost balance	Coupon payments[1]	Interest income[2]	Amortization of bond discount[3]	Ending cost balance
(Amounts in €)					
4	9,910,102	800,000	843,115	43,115	9,953,217
5	9,953,217	800,000	846,783	46,783	10,000,000
Total		4,000,000	4,200,000	200,000	

Notes:
1. €10,000,000 par amount × 8% stated interest rate.
2. Beginning cost balance × 8.51% effective interest rate (rounded).
3. Difference between interest income recognized under the interest method and the cash coupon payment, which is accreted to the cost basis of the bond.

The following table represents the amortization schedule for the bond discount under the interest method translated into the functional currency.

Year	Beginning balance[1]	Coupon payments[2]	Interest income[3]	Amortization of bond discount[3]	Ending balance[4]
(Amounts in $)					
1	10,780,000	864,000	900,448	36,448	10,816,448
2	10,816,448	864,000	903,549	39,549	10,855,997
3	10,855,997	864,000	906,913	42,913	10,898,910
4	10,898,910	864,000	910,564	46,564	10,945,474
5	10,945,474	864,000	914,526	50,526	10,996,000
Total		4,320,000	4,536,000	216,000	

Notes:
1. The initial cost basis is translated into the functional currency at the purchase trade date spot rate as:

   Purchase price of €9,800,000 × the purchase trade date spot rate of €1.00 = $1.10.
2. Represents the translation of the interest coupon payments using the average exchange rate of €1.00 = $1.08.
3. Represents the translation of the interest income recognized under the interest method and resulting amortization of bond discount adjustment using the average exchange rate of €1.00 = $1.08.
4. Subsequent to acquisition, the original cost basis translated into the functional currency at the purchase trade date spot rate is adjusted for the amortization of bond discount.

ABC Fund records the following journal entry to recognize interest income at December 31, Year 1.

	Debit	Credit
Cash[1]	872,000	
Investments[2]	36,448	
Interest income		900,448
Foreign currency gain[3]		8,000
To recognize interest income using the interest method and foreign currency gain on receipt of interest.		

Notes:

1. Represents the cash coupon payment for Year 1 translated at the spot rate of €1.00 = $1.09.
2. Represents the amortization of the bond discount for Year 1 translated using the average exchange rate of €1.00 = $1.08.
3. Represents the foreign currency gain based on the difference between the income accrued in the functional currency and the receipt of cash at the spot rate.

At the end of Year 5, ABC Fund records the following journal entry to account for the foreign currency loss upon the maturity of the bond.

	Debit	Credit
Cash[1]	10,900,000	
Foreign currency loss[2]	96,000	
Investments		10,996,000
To recognize foreign currency loss on maturity of the bond.		

Notes:

1. The proceeds received upon maturity are translated at the spot rate as:

   €10,000,0000 × [$1.00 ÷ €1.09] = $10,900,000.

2. Represents the foreign currency based on the difference between the amortized cost basis translated into the functional currency and the receipt of cash at the spot rate.

Question 3.9.80 How are the foreign currency effects of purchased interest accounted for?

Background: Purchased interest represents the interest accrued between the last coupon date and the settlement date of the purchase of the related debt instrument. When the issuer of the debt makes its next periodic interest payment, it pays all of the interest to the current holder. Generally, the seller is entitled to the interest accrued prior to the settlement date, which is typically paid for by the investment company on the settlement date.

Interpretive response: Purchased interest is recognized through interest receivable on the trade date because it will ultimately be received by the investment company when the debt issuer makes its next debt payment (see Question 3.6.30). An investment company accounts for the foreign currency effects of purchased interest by translating the interest receivable amount into the functional currency using the purchase trade date spot rate.

Subsequent to the trade date, the purchased interest receivable is remeasured using the measurement date spot rate, with the changes to the functional currency amounts recorded as unrealized foreign currency gain or loss. [946-830-45-14, 45-23]

After the settlement date, the daily interest income is accrued at the daily spot rate or average spot rate as appropriate (see Question 3.9.60). [946-830-45-14]

Question 3.9.90 How is interest sold on securities denominated in foreign currency accounted for?

Background: Interest sold represents the interest accrued between the last coupon date and the settlement date of the sale of the related debt instrument to another party. Generally, the investment company is entitled to the portion of the interest coupon accrued through the settlement date.

Interpretive response: An investment company accounts for interest sold by recognizing a realized foreign currency gain or loss for the difference between: [946-830-45-22]

- the previously recorded interest receivable amount in the functional currency (see Question 3.9.60); and
- the actual amount received for the interest, translated into the functional currency at the spot rate.

3.9.30 Dividends on foreign securities

Excerpt from ASC 946-830

• > Dividends

45-30 Recording dividends on foreign securities is often difficult because, in certain countries, entities customarily declare dividends retroactively or there is a lack of timely information. Additionally, in some countries, the sequencing of the declaration date and ex-dividend date may be different from the sequencing of these dates in the United States, thus necessitating a modification of the practice of recording dividends on the ex-dividend date (see paragraph 946-320-35-5). Also, foreign entities often declare stock dividends instead of cash dividends or take other corporate actions such as issuing rights or warrants.

45-31 Dividend income on securities denominated in foreign currency shall be recorded on the ex-date, at the spot exchange rate of the foreign currency to the reporting currency on that date. The related dividend receivable shall be translated into the functional currency daily at the spot rate, and the difference between the dividend accrued in the functional currency and the foreign currency receivable at the valuation date spot rate shall be recognized as an unrealized foreign currency gain or loss. When the dividend is received, the unrealized foreign currency gain or loss shall be reclassified as realized foreign currency gain or loss.

45-32 The preceding approach to measuring investment income ensures that investment income accrued on foreign securities reflects the investment transaction without regard to the foreign currency gain or loss created in the time between the accrual and collection of the income.

Question 3.9.100 How are dividends on securities denominated in foreign currency accounted for?

Interpretive response: An investment company recognizes dividends on securities denominated in foreign currency as of the ex-dividend date based on the spot rate as of that date.

The related dividend receivable is translated daily into the investment company's functional currency. The difference between the dividend receivable translated as of the initial recognition date and translated on the remeasurement date is recorded as an unrealized foreign currency gain or loss.

When the dividend is received from the issuer, the cumulative unrealized foreign currency gain or loss is reclassified as a realized foreign currency gain or loss. [946-830-45-31]

Example 3.9.40 Dividend on foreign currency denominated securities

Investment Company A owns 10,000 shares in Investment B, a French utilities company that trades on a foreign stock exchange. On September 1, Investment B announces a €0.50 dividend per share with an ex-dividend date of September 15 and a payment date of October 15. The USD/EUR spot rate on September 15 and October 15 is $1.12 and $1.18, respectively.

Ex-dividend date

Investment Company A records the following journal entry to recognize the dividend on the ex-dividend date (September 15th).

	Debit	Credit
Dividend receivable[1]	5,600	
Dividend income		5,600
To recognize dividend income.		
Note: 1. Calculated as the dividend (€.50) multiplied by the number of shares (10,000) and the spot rate ($1.12).		

Investment Company A translates the dividend receivable on each day using the spot rate. Through the payment date, the cumulative impact is shown below.

	Debit	Credit
Dividend receivable[1]	300	
Unrealized foreign currency gain		300
To record cumulative impact of foreign currency prior to dividend payment.		
Note: 1. The cumulative effect of the translation is calculated as the current spot rate ($1.18) less the spot rate on the ex-dividend date ($1.12) then multiplied by the dividend (€.50) and the number of shares held (10,000).		

On the payment date (October 15th), Investment Company A records the cash receipt and reclassifies the unrealized gain on foreign currency to realized gain using the following journal entry.

	Debit	Credit
Cash[1]	5,900	
Unrealized foreign currency gain[2]	300	
Dividend receivable		5,900
Realized foreign currency gain[2]		300
To record cash receipt of dividend.		
Notes: 1. Calculated as the dividend (€.50) multiplied by the number of shares (10,000) and the spot rate ($1.18). 2. The unrealized gain on foreign currency is reclassified to a realized gain.		

4. Capital transactions

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4.1 How the standard works

The principal activities of an investment company include selling its ownership interests to investors. The guidance for capital transactions in Topic 946 considers the specific needs of investors who generally focus on an investment company's NAV. The intention of Topic 946 is to provide investors with a reasonable approximation of the fair value of the net assets of the investment company.

An investment company's accounting and financial reporting for capital transactions differs from that followed by many non-investment companies in several key respects. These differences generally relate to the timing of transactions, accounting for the costs of raising capital, and disclosures. This chapter addresses the following areas of capital transactions that are specific to investment companies.

Area	Primary implication of Topic 946	Reference
Capital share subscriptions and redemptions	Transactions are recognized at fair value on the trade date (or effective date).	Section 4.2
Class of shares	NAVs are determined for each class of shares.	Section 4.3
Dividends to investors	Dividends are recognized on the ex-dividend date with tax basis disclosures.	Section 4.4
Components of capital	Components of capital are determined on a tax basis.	Section 4.5
Offering costs	Certain offering costs are recognized as a deferred charge and amortized to expense.	Section 4.6
Distribution costs	Certain distribution costs are recognized as an accrued expense.	Section 4.7

4.2 Capital share subscriptions and redemptions

Excerpt from ASC 946-20

> Capital Share Transactions

25-7 Accounting for shareholder transactions of open-end funds differs from the accounting followed by commercial entities in several key aspects. Sales of fund shares are recorded daily by crediting capital stock for the par value of the stock to be issued and additional paid-in capital for the amount paid over the par value; redemptions are recorded daily by debiting those accounts. The offsetting debit (credit), however, is made to an asset (liability) account, typically captioned as receivable for fund shares sold (payable for fund shares redeemed). These entries are made on or as of the date the order to purchase or sell fund shares is received (trade date), not on the day the payment is due (settlement date) as is typical practice for the recording of issuance of equity shares by commercial entities.

25-8 Investment partnerships shall record capital subscription and redemption commitments as of the date required by the partnership agreement. Cash received before this date shall be recorded as an advance capital contribution liability.

An investment company differs from many non-investment companies in its accounting and financial reporting of capital share subscriptions and redemptions, which are typically based on the NAV of the investment company. To better reflect the fair value of subscriptions and redemptions, Topic 946 contains specific guidance relating to the timing of transactions.

Question 4.2.10 Are capital share transactions recognized on the settlement date?

Interpretive response: No. When transactions are recognized depends on whether the investment company is regulated under the 1940 Act.

Registered funds

Capital share transactions of registered funds are recorded on the date that the order to purchase or sell fund shares is received (trade date), not the date that the payment is due (settlement date), as is typical practice for recording the issuance of equity shares by non-investment companies. However, certain registered closed-end funds (e.g. interval funds) may allow investors to periodically redeem shares and recognize those transactions on the effective date specified by the fund. [946-20-25-7]

Nonregistered funds

Nonregistered funds (e.g. partnerships or similar entities) typically allow investors to subscribe or redeem shares on specified dates (e.g. monthly or quarterly). These investment companies record capital subscriptions and redemptions as of the effective date specified by the governing documents (e.g. partnership agreements). However, cash received for capital subscriptions before that date is recorded as an advance capital contribution liability. [946-20-25-8]

Question 4.2.20 How are subscriptions recognized ?

Interpretive response: It depends. Sales of shares of an investment company are recognized on the trade date or effective date as follows (see Question 4.2.10). [946-20-25-7]

Debit	Credit
Asset or contra-equity account (e.g. 'receivable for fund shares sold')	Paid-in capital (inclusive of par value and amounts paid over par)

Receivables for the issuance of equity are accounted for under Topic 505, which indicates that an entity may receive a note, rather than cash, as a contribution to its equity. Reporting a note receivable as an asset is generally not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short time.

However, those receivables may be recorded as an asset if collected in cash before the financial statements are issued or are available to be issued. Generally, registered open-end funds settle subscriptions within a short time period, which allows them to recognize the receivable as an asset. For nonregistered funds, the predominant practice is to offset the receivable for shares sold with the investment company's capital subscriptions in the equity section. [505-10-45-2]

See section 5.3.50 of KPMG Handbook, Debt and equity financing, for guidance on common shares issued for a note receivable.

Question 4.2.30 Are unfunded capital commitments from investors recognized as a receivable by nonregistered funds?

Background: Certain nonregistered funds (e.g. private equity and venture capital funds) obtain capital commitments from investors and periodically call capital under those commitments as needed to make investments or to pay operating expenses.

Interpretive response: No. Capital share transactions are not recognized until the effective date stipulated in the governing documents (see Question 4.2.10). For capital commitments of nonregistered funds, the effective date is typically not determined until those commitments are called. After the effective date, amounts not yet received in cash are recognized as a deduction from equity similar to a receivable for the issuance of equity (see Question 4.2.20). [505-10-45-2]

Question 4.2.40 Is a gain or loss recognized for defaulted capital commitments?

Background: An investment company's governing documents typically include contractual remedies when an investor is in default of its unfunded capital commitments. Examples of contractual remedies available to the investment company 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.

Determining the appropriate contractual remedy under the investment company's governing documents may sometimes require an interpretation by legal counsel.

Interpretive response: No. Typically, forfeitures of the defaulting investor's capital account under enforced contractual remedies are reallocated to the other investors in proportion to their capital commitments in accordance with the investment company's governing documents. When the investment company'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 is recorded as a capital redemption from the defaulting investor with a corresponding capital contribution to the other investors, not as income to the investment company.

Similarly, when the governing documents state that interest received for defaulted capital calls reduces the outstanding capital call amount, the receipt of such interest is 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 company.

We believe that legal fees and other expenses incurred to resolve defaulted capital commitments should be recorded as an expense, not as a charge against equity, because such costs are not analogous to an offering of equity interests (see section 4.6).

Question 4.2.50 Are in-kind capital contributions recognized on a fair value basis?

Background: An investment company may receive investments or other noncash consideration for the purchase of its shares (or partnership interests or similar equity). Often this consideration is received from investors or other investment companies that are related parties of the investment company.

Interpretive response: Generally yes. When an investment company issues its shares for cash, the cash received is presumed to equal the fair value of the issued shares, absent evidence to the contrary. However, when an investment company issues its shares for in-kind consideration from related parties, it should not presume that the agreed-upon value of the shares is their fair value.

If the fair value of the in-kind consideration does not equal the fair value of the shares issued (e.g. the NAV), the investment company determines whether the transaction involves a stated or unstated right, privilege or obligation requiring separate accounting. If a right, privilege or obligation exists, the fair value of the in-kind consideration is allocated between it and the shares. See section 5.3.40 of KPMG Handbook, Debt and equity financing, for guidance on common shares issued at an off-market price.

Common control situations

The accounting is different if the related party is under common control with the investment company. Generally, when accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests initially measures the recognized assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. See section 28 of KPMG Handbook, Business combinations, for guidance on combination of entities under common control. [805-50-30-5]

Example 4.2.10 Related party in-kind contribution

Adviser A is the general partner of Fund B, an investment company. At the inception of Fund B, Adviser A committed to sell its investment in Company C in exchange for a 2% ownership interest in Fund B. On the effective date of the sale, the fair value of the investment in Company C is $10,000,000. However, Adviser A and the limited partners in Fund B agree to a sales price of $9,500,000. Adviser A is a related party, but does not control Fund B.

Because the fair value of the in-kind consideration of the investment in Company C does not equal the fair value of the partnership interest, Fund B determines whether the transaction involves a stated or unstated right, privilege or obligation requiring separate accounting. Fund B determines that the substance of this transaction involves an adjustment of the partner capital contributions and recognizes the fair value difference through an equity allocation between the general partner and limited partners.

Fund B records the following journal entries.

	Debit	**Credit**
Investment in Company C	10,000,000	
General partner interest		10,000,000
To recognize the in-kind contribution at fair value.		

	Debit	Credit
General partner interest[1]	500,000	
Limited partner interest[1]		500,000
To recognize the difference between the sales price and the fair value of investment in Company C.		
Note: 1. Amount is calculated as: \$10,000,000 – \$9,500,000 = \$500,000.		

Question 4.2.60 Are redemption requests recognized as a liability?

Background: The redemptions of registered funds are recognized on the trade date and the redemptions of nonregistered funds and certain registered closed-end funds (e.g. interval funds) are recognized as of the effective date stipulated in the governing documents (see Question 4.2.10). However, certain investment companies have a redemption notice period (e.g. 30 to 60 days before the effective date) for investors to redeem their shares.

Interpretive response: It depends. Redemptions of registered open-end fund shares are recorded on the trade date or effective date as follows. [946-20-25-7]

Debit	Credit
• Paid-in capital (inclusive of par value and amounts paid over par) • Distributable earnings	• Liability account (e.g. 'payable for fund shares redeemed')

However, when an investment company receives a redemption request from an investor before the trade date or effective date of the redemption, the shares of the investment company may become a mandatorily redeemable financial instrument under Topic 480. If the investment company is not an SEC registrant (e.g. a nonregistered fund), it does not recognize a liability for the redemption unless the redemption's effective date is fixed and the redemption amount is either fixed or determined by a reference to an interest rate index, currency index, or other external index. For a nonregistered fund whose redemption is based on its NAV, the redemption amount is typically not fixed until the redemption's effective date. [480-10-15-7A – 15-7F]

See section 6.4 of KPMG Handbook, Debt and equity financing, for guidance on mandatorily redeemable financial instruments.

Question 4.2.70 When are suspended redemption requests recognized as a liability?

Background: An investment company may have provisions in its governing documents that enable it to suspend or 'gate' redemptions. This is typically done during periods when the investment company is unable to sell illiquid investments or otherwise has insufficient cash to fund redemptions.

Interpretive response: It depends. When an investment company suspends redemptions, it may be delaying the trade date or effective date of the redemption request, and therefore delaying recognition of the liability (see Question 4.2.10). However, any provision that defers or delays the timing of a mandatory redemption does not affect the classification of a mandatorily redeemable financial instrument as a liability under Topic 480 (see Question 4.2.60). [480-10-25-6]

See section 6.4 of KPMG Handbook, Debt and equity financing, for guidance on mandatorily redeemable financial instruments.

Question 4.2.80 Does a registered fund classify its shares as temporary equity when they are conditionally redeemable upon events outside its control?

Background: The SEC's temporary equity guidance is applied by certain issuers to instruments that are not classified as liabilities under other relevant guidance. It may require that an issuer present an equity-classified instrument in 'temporary equity' (sometimes referred to as 'mezzanine equity'), which is presented below debt but outside of permanent equity on the balance sheet. This distinction is important so that financial statement users can identify which equity-classified instruments could result in future cash outflows (or other assets) from the issuer that are outside the issuer's control.

Interpretive response: It depends. The SEC's temporary equity guidance applies to issuers that are subject to S-X Rule 5-02.27. Because registered funds are not subject to S-X Rule 5-02.27 (instead they are subject to S-X Article 6), they generally do not classify their shares that are conditionally redeemable upon events outside their control as temporary equity. [S-X Rule 5-01(a), 480-10-S99-3A]

Exception for registered closed-end funds

In a letter dated July 12, 2002 to the chairman of the SEC Regulations Committee of the AICPA, the SEC staff provided interpretive guidance applicable to registered closed-end funds that issue preferred stock with redemption requirements that are contingent on events outside their control. Under this guidance, redeemable preferred stock issued by registered closed-end funds are classified outside of permanent equity (i.e. below liabilities and above net assets on the statement of assets and liabilities). Changes in the carrying amounts of redeemable preferred shares (including distributions paid to preferred shareholders and accretion of the carrying amount) are presented below net investment income in the statement of operations, the statement of changes in net assets and financial highlights (see Question 8.2.260).

When there is uncertainty as to redemption, the carrying amount is adjusted when it becomes probable that the preferred stock will be redeemed. Offering costs related to the issuance of the preferred stock may be charged to paid-in capital at the date of issuance and the preferred stock reported at its redemption value provided there is disclosure that such costs will be borne immediately by the common shareholders in both the prospectus to common shareholders and the financial statements (see section 4.6).

This SEC guidance does not apply to registered closed-end funds with preferred stock that is redeemable on a fixed or determinable date. See section 6.4 of KPMG Handbook, Debt and equity financing, for guidance on mandatorily redeemable financial instruments.

Question 4.2.90 How are redemption fees classified?

Background: When investors redeem shares, an investment company may charge a redemption fee as reimbursement for associated costs, which is deducted from the redemption amount.

For a registered fund, the redemption fee is typically assessed by the intermediary processing the share transactions, such as a distributor or transfer agent, who remits the redemption fee proceeds to the fund. For a nonregistered fund, a redemption fee is typically reallocated to the other shares (or partnership interests or similar equity) in accordance with its governing documents.

Contingent-deferred sales loads are sometimes transmitted to a registered fund once the excess costs of the distributor are fully recovered (see Question 4.7.40). These payments to the fund are similar to a redemption fee.

Interpretive response: Redemption fees are credited to capital rather than classified as income to the investment company. When a redemption fee is reallocated (based on the investment company's governing documents), the redemption fee is deducted from the redemption amount paid to the redeeming investors and reallocated as a contribution to the continuing investors in the investment company. [AAG-INV 4.08]

4.3 Class of shares

Excerpt from ASC 946-20

> Background Information about Investment Company Activities

05-1D Multiple-class funds issue more than one class of shares. Each class of shares typically has a different kind of sales charge, such as a **front-end load**, **contingent-deferred sales load**, **12b-1** fee (referring to Rule 12b-1 in Chapter 17 of the Code of Federal Regulations, which implements the Investment Company Act of 1940), or combinations thereof. Multiple-class funds may charge different classes of shares for specific or incremental expenses, such as transfer-agent, registration, and printing expenses related to each class.

Excerpt from ASC 946-210

• > Multiple-Class Funds

45-4 The composition of net assets shall be reported in total, but **net asset value per share** and shares outstanding shall be reported for each class.

Excerpt from ASC 946-235

• > Multiple-Class Funds

50-2 Notes to financial statements shall include all of the following:

a. Description of each class of shares, including sales charges, shareholder servicing fees, and distribution fees
b. Disclosure of the method used to allocate income and expenses, and realized and unrealized capital gains and losses, to each class
c. Description of fee arrangements for class-specific distribution plans and for any other class-level expenses paid to affiliates
d. Disclosure of capital share transactions (if not disclosed separately in the statement of changes in net assets) for each class
e. Disclosure of total sales charges paid to any affiliates for each class.

Excerpt from ASC 946-505

> Net Asset Value per Share

50-1 Net asset value per share shall be disclosed for each class of shares.

> Capital Share Transactions

50-2 The net change in net assets (excluding amounts shown separately if equalization accounting is used) arising from capital share transactions shall be disclosed for each class of shares. All of the following components of the change shall be disclosed on the face of the statement or in the notes to financial statements for each class of shares:

a. The number and value of shares sold
b. The number and value of shares issued in reinvestment of distributions
c. The number and cost of shares reacquired
d. The net change.

20 Glossary

Net Asset Value per Share

Net asset value per share is the amount of net assets attributable to each share of capital stock (other than senior equity securities, that is, preferred stock) outstanding at the close of the period. It excludes the effects of assuming conversion of outstanding convertible securities, whether or not their conversion would have a diluting effect.

Excerpt from AICPA TQA 6910

.29 Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations

Inquiry—The governing documents of some nonregistered investment partnerships (as defined in chapter 7 of the AICPA Audit and Accounting Guide *Investment Companies*), may contain provisions which do not allow allocations of unrealized gains or losses, or do not require the recognition of carried interest (also referred to as *carry*, *incentive*, or *performance fees and allocations*), and clawback obligations (also referred to as *lookback*, *negative carried interest*, or *general partner giveback*) until a specified date or time (for example, at the time of the partnership's liquidation or termination), or until the occurrence of a specific event (such as the actual disposition of an investment). Often, in these cases, the partnership's investments are either not marketable or are of such limited liquidity that interim valuations are highly subjective, and the intent of the provision is to delay the general partner's receipt of incentive allocations in cash until the gains can be measured objectively. In preparing financial statements of an investment partnership in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class, how should cumulative unrealized gains (losses), carried interest, and clawback be reflected in the equity balances of each class of shareholder or partner at the balance sheet date? In particular, should cumulative period-end unrealized gains and losses, nonetheless, be allocated as if realized in accordance with the partnership's governing documents prior to the date, time, or event specified in the partnership agreement?

Reply—If a nonregistered investment partnership reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents. Further discussion of the presentation of each item follows.

Certain partnerships record an expense for fees (including incentive fees) due a general partner, whereas others allocate net income from limited partner capital accounts to the general partner capital account. These amounts could either be considered a disproportionate income allocation or a compensation arrangement, and the accounting should conform to the structure of the partnership agreement, with the financial statement disclosures set forth in FASB ASC 946.

A basic premise for the preparation and presentation of the financial statements of an investment company is to reflect each class of shareholders' or partners' interest in the net assets of the reporting entity as of the reporting date. Another objective is to present total return for nonmanaging investor classes after incentive allocations and fees, as expressed in FASB ASC 946.

Other accounting literature related to the presentation of data similar to total return is consistent with FASB ASC 946. FASB ASC 260, *Earnings per Share*, refers to allocating earnings or undistributed earnings for a period to participating securities "as if all of the earnings for the period had been distributed."

Although this guidance does not relate specifically to the presentation of capital accounts, measuring period-end capital balances for those classes under the same methodology appears consistent with this guidance. Accordingly, if an entity reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents. Further discussion of the presentation of each item follows.

Cumulative Unrealized Gains (Losses)

Cumulative unrealized gains (losses) would be included in the ending balances of each class of shareholders' or partners' interest in the reporting entity at the reporting date, and the changes in such amounts would be reported in the changes in net asset value and partners' capital for the reporting period.

Carried Interest

The carried interest generally is due to the investment manager, an affiliated entity, or both, and is either in the form of a fee (usually for offshore funds) or as an allocation from the limited partners' capital accounts, pro rata, to the general partner's capital account (usually for domestic funds). Although many variations exist, the investment manager is often entitled to receive its carry on a "deal-by-deal" basis. On this basis, as individual investments are sold, the investment proceeds are allocated based on a specific methodology defined in the governing documents to determine the amount of carry, if any, to which the investment manager is entitled.

In presenting each class of shareholders' or partners' interest in the net assets as of the reporting date, the financial statements would consider the carry formula as if the investment company had realized all assets and settled all liabilities at their reported fair value, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date.

Clawback

Although all classes of shareholder or partner may be subject to clawback provisions in the governing documents, a clawback most frequently involves an obligation on the part of the investment manager to return previously received incentive allocations to the investment fund due to subsequent losses. Such clawback amounts, when paid, are typically distributed to other investors.

Consistent with the previously discussed principle to reflect each class of shareholders' or partners' interest in the net assets of the reporting entity as of the reporting date, the impact of a clawback would be calculated as of each reporting date under the methodology specified in the fund's governing documents.

Consistent with FASB ASC 310-10-45-14, such an obligation would not be recognized as an asset (receivable) in the entity's financial statements unless substantial evidence exists of ability and intent to pay within a reasonably short period of time. Rather, in most instances, the obligation would be reflected as a deduction from the general partner's capital account.

The specific circumstances, including whether the clawback represents a legal obligation to return or contribute funds to the reporting entity, require consideration before determining whether a clawback, resulting in a negative general partner capital balance (that is, contra-equity), is recognized in the financial statements. A careful reading of the governing documents ordinarily is required. Additionally, it may not be appropriate to reflect a negative general partner capital balance (and a corresponding increase to limited partner capital balances) if the general partner does not have the financial resources to make good on its obligation. It may be helpful to consult with the entity's legal counsel for clarification before recording a negative general partner capital balance.

Even if not recognized within the capital accounts, at a minimum, it would be appropriate to disclose the existence of a clawback in the footnotes to the financial statements because in almost all cases, the existence of the clawback would modify the manner in which future distributions are made.

Investment companies may issue more than one class of shares (or partnership interests) and may charge different classes of shares for specific or incremental expenses.

For registered funds, each class of shares typically has a different kind of sales charge, such as a front-end load, contingent-deferred sales load, or 12b-1 fee (see section 4.7). [946-20-05-1D]

Nonregistered funds typically have at least two classes of ownership interest, with one class being the management interest and the other being the investment interest.

Management interest	Investment interest
Usually a voting class (e.g. a general partner class)	Usually a nonvoting class (e.g. a limited partner class)

Generally, each class's rights are determined by the fund's governing documents and local law.

An investment company differs from many non-investment companies in its accounting and financial reporting of its classes of shares. Investment companies have unique disclosure requirements involving their shares that non-investment companies do not have, including disclosing NAV per share for each class of shares.

Question 4.3.10 What disclosures are required for each class of shares?

Interpretive response: Whether in the statement of changes in net assets or in the notes to the financial statements, an investment company's financial statement disclosures include the following for each class of shares: [946-210-45-4, 946-235-50-2, 946-505-50-1 – 50-3]

- description of each class of shares, including sales charges, shareholder servicing fees, and distribution fees;
- capital share transactions (including number and value of shares sold, number and value of shares issued in reinvestment of distributions, number and cost of shares reacquired, and the net change);
- net assets at the beginning and end of the year;
- NAV per share;
- shares outstanding;
- the method used to allocate income and expenses, and realized and unrealized capital gains and losses, to each class;
- description of fee arrangements for class-specific distribution plans and for any other class-level expenses paid to affiliates; and
- total sales charges paid to any affiliates for each class.

Question 4.3.20 Are the components of net income allocated to each class of shares to determine NAV per share?

Interpretive response: Yes. An investment company reports its NAV per share for each class of shares (see Question 4.3.10). NAV per share is the amount of net assets attributable to each share of capital stock outstanding at the close of the period. The net assets of each share include the components of the investment company's net income attributable to that share. Therefore, an investment company determines the income, expenses, and realized and unrealized gains or losses to allocate to each class of shares.

Allocation of expenses

To allocate expenses, an investment company first classifies its fees and expenses as either fund-level expenses or class-level expenses. While most expenses apply to all classes (fund-level expenses), certain fees (e.g. sales charges and investment advisory fees) are charged directly to the individual classes they relate to (class-level expenses). See Question 4.3.30 for the appropriate allocation methods. [946-210-45-4, 946-505 Glossary, AAG-INV 5.07]

Question 4.3.30 How are the components of net income allocated to each class of shares?

Interpretive response: Topic 946 does not specify a method for allocating the components of net income to each class of shares. We believe this generally is a legal determination based on the provisions in the governing documents that specify how the components of net income are allocated to each class of shares. In some circumstances there may be differences in the timing of certain transactions (e.g. carried interest) between the governing documents and recognition in the financial statements (see Question 4.3.40). [TQA 6910.29]

However, Rule 18f-3 of the 1940 Act contains prescribed methods for registered open-end funds to allocate income, expenses, and realized and unrealized gains and losses to each class of shares. [CFR 270.18f-3]

Disclosure of allocation method required

An investment company discloses the method it uses to allocate income and expenses, and realized and unrealized capital gains and losses, to each class of shares (see Question 4.3.10). [946-235-50-2(b)]

Question 4.3.40 When are the components of net income allocated to each class of shares?

Background: The governing documents of some investment companies may contain provisions that:

- do not allow allocations of unrealized gains or losses; or
- do not require the recognition of carried interest (also referred to as carry, incentive, or performance fees and allocations), and clawback obligations (also referred to as lookback, negative carried interest, or general partner giveback) until a specified date or time (e.g. at the time of the investment company's liquidation or termination), or until the occurrence of a specific event (e.g. the actual disposition of an investment).

Often, in these cases, the investments are either not marketable or are of such limited liquidity that interim valuations are highly subjective, and the intent of the provision is to delay the general partner's receipt of carried interest in cash until the gains can be measured objectively.

Interpretive response: The components of net income are allocated to each class of shares based on the provisions of the investment company’s governing documents (see Question 4.3.30). However, the components of net income are allocated at each reporting date as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shares consistent with the provisions of the investment company's governing documents. We believe an investment company should allocate components of net income to each class of shares at intervals that correspond with its policies for calculating periodic NAVs. [TQA 6910.29]

Question 4.3.50 Are unrealized gains or losses allocated to each class of shares?

Interpretive response: Yes. Cumulative unrealized gains (losses) are included in the ending balances of the NAV of each class of shares in the investment company at the reporting date (see Question 4.3.20). Accordingly, the changes in such amounts are reported in the changes in NAV of each class of shares for the reporting period. [TQA 6910.29]

Question 4.3.60 Does a partnership consider unrealized gains or losses in determining its carried interest allocation to the general partner class?

Background: The carried interest generally is due to the investment manager, an affiliated entity, or both, and is either:

- in the form of a fee (usually for offshore funds); or
- as an allocation from the limited partners' capital accounts, pro rata, to the general partner's capital account (usually for domestic funds).

Although many variations exist, the investment manager is often entitled to receive its carry on a 'deal-by-deal' basis. On this basis, as individual investments are sold, the investment proceeds are allocated based on a specific methodology defined in the governing documents to determine the amount of carry, if any, to which the investment manager is entitled.

Interpretive response: Yes. In presenting each class of shares in the net assets as of the reporting date, an investment company considers the carry formula as if it had realized all assets and settled all liabilities at their reported fair value, and allocated all gains and losses and distributed the net assets at the reporting date to each class of shares, including the general partner class. [TQA 6910.29]

Question 4.3.70 How are clawback obligations accounted for?

Background: Although all classes of shares may be subject to clawback provisions in the governing documents, a clawback most frequently involves an obligation on the part of the investment manager to return previously received incentive allocations to the investment company due to subsequent losses. Such clawback amounts, when paid, are typically distributed to other investors.

Interpretive response: The impact of a clawback obligation is calculated as of each reporting date under the methodology specified in the investment company's governing documents (see Question 4.3.40). In most instances, the obligation is reflected as a deduction from the general partner's capital account. Such an obligation is not recognized as a receivable in the investment company's financial statements unless substantial evidence exists of ability and intent to pay within a reasonably short period of time (see Question 4.2.20).

In certain circumstances, the clawback obligation can result in a negative general partner capital balance (i.e. contra-equity) and a corresponding increase in the limited partners' capital balances. However, before recognizing a negative general partner capital balance in its financial statements, an investment company should carefully consider the specific circumstances, including whether:

- the clawback represents a legal obligation to return or contribute funds to the investment company; and
- the general partner has the financial resources to make good on its obligation.

The existence of a clawback should be disclosed in the financial statements of the investment company because it would modify the manner in which future distributions are made. [TQA 6910.29]

Question 4.3.80 Is NAV per share disclosed for preferred stock?

Interpretive response: No. NAV per share is the amount of net assets attributable to each share of capital stock other than senior equity securities (i.e. preferred stock). [946-505 Glossary]

Question 4.3.90 Does NAV per share include the effect of assuming conversion of outstanding convertible securities?

Interpretive response: No. NAV per share excludes the effects of assuming conversion of outstanding convertible securities, whether or not their conversion would have a diluting effect. [946-505 Glossary]

Question 4.3.100 Does a master fund organized as an offshore corporation that elects to apply partnership accounting disclose capital share transactions?

Background: Some master funds that are organized as offshore corporations make a check the box election to be taxed as partnerships for US federal taxation purposes, and also account for their capital transactions and the allocation of profits and losses to their feeder funds in a manner similar to partnership accounting for financial reporting purposes.

Interpretive response: Yes. Investment companies that are organized as corporations are required to disclose capital share transactions for each class of shares during the reporting period (see Question 4.3.10). Although a master fund may elect to account for its capital transactions and the allocation of profits and losses to its feeder funds in a manner similar to partnership accounting for financial reporting purposes, this election does not eliminate the requirement for a master fund to disclose its capital share transactions in the financial statements. A master fund's use of partnership accounting is an election for tax purposes and does not override the rights and privileges of the share classes stated in the master fund's governing documents. For that reason, we do not believe that it is appropriate for a master fund to disclose an accounting policy election of partnership accounting in the financial statements.

Some master fund entities do not maintain a share register or track their capital share activities. However, certain offshore jurisdictions require domiciled corporations to maintain a share register. Failure to maintain a share register may result in noncompliance with statutory laws under the jurisdiction where the master fund is domiciled and may result in monetary penalties, notification to regulators, or suspension of business activities. To the extent that the effect of regulatory noncompliance is material to the master fund, additional disclosures may be necessary to keep the financial statements from being misleading. [946-505-50-2]

4.4 Dividends to investors

Excerpt from ASC 946-20

> Dividends

25-9 Both closed-end and open-end investment companies record distribution liabilities on the ex-dividend date rather than the declaration date. For closed-end investment companies, a purchaser typically is not entitled to a dividend for shares purchased on the ex-dividend date. Open-end investment companies record the liability on the ex-dividend date to properly state the net asset value at which sales and redemptions are made. When large (in excess of 15 percent of a closed-end fund's net asset value) dividends or distributions are declared, it is the policy of some exchanges to postpone the ex-dividend date until the dividend has been paid. In such circumstances, the liability for the dividend distribution would be recorded on the books of the fund on the payment date.

> Dividends

50-8 Dividends paid to investors shall be disclosed as a single line item in the statement of changes in net assets, except tax **return of capital** distributions, which shall be disclosed separately. The notes shall disclose the tax basis components of the dividends paid (that is, either from ordinary income, capital gains, or tax return of capital). Disclosing dividends on a tax basis is consistent with how dividends are reported to shareholders during and at the end of the calendar year. The financial highlights table would disclose per-share information that is consistent with the statement of changes in net assets.

50-10 If management of a fund determines that a tax return of capital is likely to occur for the fund's fiscal year, although the exact amount may not be estimable, that fact shall be disclosed in a note to the interim financial statements.

Excerpt from ASC 946-205

> Statement of Changes in Net Assets

45-3 The statement of changes in net assets summarizes results from operations, net equalization credits or debits, dividends and distributions to shareholders, capital share transactions, and capital contributions. The increase or decrease in net assets of a registered investment company comprises the following categories:…

c. Distributions to shareholders. Distributions shall be disclosed as a single line item, except for tax **return of capital** distributions, which shall be presented separately. Distributions made by regulated investment companies often differ from aggregate undistributed net investment income (including net equalization credits or debits and undistributed net investment income) determined in accordance with generally accepted accounting principles (GAAP) and accumulated net realized gains (total net realized gains determined in accordance with GAAP). The principal cause is that required minimum fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, rather than GAAP. The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. If in a subsequent period all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference shall be reclassified to paid-in capital.

Excerpt from ASC 946-505

> Dividends Paid

50-5 All of the following tax-basis components of dividends paid shall be disclosed in the notes:

a. Ordinary income distributions
b. Long-term capital gains distributions
c. Return of capital distributions.

> Difference Between Net Investment Income and Net Realized Gain and Actual Distributions

50-6 The primary reasons for any significant difference between total net investment income determined in accordance with generally accepted accounting principles (GAAP) and net realized gain and actual distributions shall be disclosed in the notes to financial statements.

20 Glossary

Actual-Income-Available Method

A method to calculate distributions to shareholders from net investment income in which actual net investment income that has been allocated to each class (as recorded on the books) is divided by the record date shares for each class to derive the dividend payable per share.

Record-Share Method

A method to calculate distributions to shareholders from net investment income in which the sum of net investment income available for all classes after deducting allocated expenses, but before consideration of class-specific expenses, is divided by the total outstanding shares on the dividend record date for all classes to arrive at a gross dividend rate for all shares. From this gross rate, an amount per share for each class (the amount of incremental expenses accrued during the period divided by the record date shares outstanding for the class) is subtracted. The result is the per-share dividend available for each class.

Return of Capital

Distributions by investment companies in excess of tax-basis earnings and profits.

Simultaneous-Equations Method

A method to calculate distributions to shareholders from net investment income that seeks to ensure, by using simultaneous equations, that the distribution rates will differ among the classes by the anticipated differential in expense ratios.

Dividends are distributions of an entity's equity to its shareholders. These distributions can be from earnings or may represent a return of the entity's capital. Further, they can be paid on either preferred or common shares and in the form of cash, other assets (called dividends-in-kind) or shares. The following are key dates relating to dividends.

Declaration date	Date on which the board of directors declares a dividend
Ex-dividend date	Date on which the shares start trading without the value of the next dividend payment
Record date	Dividends are payable to shares on record as of the record date
Payment date	Date on which the dividends are paid in cash – i.e. the date actual cash payment is made to the shareholder of record
Reinvestment date	Date on which the dividends are paid in shares

An investment company differs from many non-investment companies in its accounting and financial reporting of dividends to investors. These differences generally relate to the timing of transactions and additional disclosures that are unique to investment companies.

Question 4.4.10 Are dividends to investors recognized on the ex-dividend date?

Interpretive response: Yes. Investment companies record dividends and the corresponding dividend distribution liabilities on the ex-dividend date, not the declaration date. Registered closed-end funds record dividends on the ex-dividend date because a purchaser typically is not entitled to a dividend for shares purchased on that date. Open-end funds record dividends on the ex-dividend date to properly state the NAV at which sales and redemptions are made.

When dividends are paid in shares on the reinvestment date, the number of shares is typically determined using the NAV per share on the ex-dividend date. [AAG-INV 4.27]

When large dividends or distributions are declared (i.e. in excess of 15% of a closed-end fund's NAV), it is the policy of some exchanges to postpone the ex-dividend date until the dividend has been paid. In such circumstances, the liability for the dividend distribution is recorded on the books of the fund on the payment date. [946-20-25-9]

Question 4.4.20 Does a registered fund disclose the components of its dividends on a tax basis?

Background: A registered fund that elects to be taxed as a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code (IRC) deducts dividends paid to its shareholders. Under the IRC, a dividend is defined as a distribution of current or accumulated earnings and profits. As a result, a registered fund that distributes its taxable income to its shareholders has no taxable income and no tax liability.

Interpretive response: Yes. In the statement of changes in net assets (see chapter 9) and in the per-share information in the financial highlights (see chapter 8), a registered fund discloses dividends it paid to investors as a single line item except for 'tax return of capital distributions' (i.e. distributions in excess of tax-basis earnings and profits), which is disclosed separately.

Further, in the notes to the financial statements, a registered fund discloses the following tax basis components of the dividends paid:

- ordinary income distributions
- long-term capital gains distributions
- return of capital distributions.

Disclosing dividends on a tax basis is consistent with how dividends are reported to shareholders during and at the end of the calendar year. If the fund's management determines that a tax return of capital is likely to occur for the fund's fiscal year that fact is disclosed in the notes to the interim financial statements, even if the amount is not estimable. [946-20-50-8, 50-10, 946-505-50-5]

Registered funds may issue more than one class of shares (see section 4.3). Dividends are also allocated to each class of shares (see Question 4.4.40). [946-505-55-1]

See Question 4.4.50 for discussion on whether nonregistered funds disclose the components of their dividends.

Question 4.4.30 Does a registered fund disclose the components of its dividends on a GAAP basis?

Interpretive response: No. A registered fund discloses the components of its dividends on a tax basis (see Question 4.4.20). Required minimum fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, not US GAAP. However, since distributions made by registered funds often differ from aggregate undistributed net investment income and accumulated net realized gains determined in accordance with US GAAP, the primary reasons for any significant difference are disclosed in the notes to the financial statements.

The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. If in a subsequent period all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference is reclassified to paid-in capital (see Question 4.5.20). [946-205-45-3(c), 946-505-50-6]

Question 4.4.40 What methods can a registered fund use to allocate dividends to each class of shares?

Interpretive response: The following methods are generally used by registered funds to calculate distributions to shareholders from net investment income. [946-505 Glossary]

Record-share	A method in which the sum of net investment income available for all classes after deducting allocated expenses, but before consideration of class-specific expenses, is divided by the total outstanding shares on the dividend record date for all classes to arrive at a gross dividend rate for all shares. From this gross rate, an amount per share for each class (the amount of incremental expenses accrued during the period divided by the record date shares outstanding for the class) is subtracted. The result is the per-share dividend available for each class.
Actual-income-available	A method in which actual net investment income that has been allocated to each class (as recorded on the books) is divided by the record date shares for each class to derive the dividend payable per share.
Simultaneous-equations method	A method that seeks to ensure, by using simultaneous equations, that the distribution rates will differ among the classes by the anticipated differential in expense ratios. In other words, the use of simultaneous equations is an iterative approach to adjust the distributions allocated between the share classes until they arrive at annualized distribution rates that only differs by the differences in expense ratios between the share classes.

Subtopic 946-505's Example 1 (reproduced directly below) illustrates the record-share, actual-income-available, and simultaneous-equations methods generally used to calculate distributions to shareholders from net investment income.

Excerpt from ASC 946-505

> Illustrations

Example 1: Multiple-Class Funds—Methods of Computing Income Distributions to Shareholders

55-1 This Example illustrates the **record-share**, **actual-income-available**, and **simultaneous-equations methods** generally used to calculate distributions to shareholders from net investment income.

	Total	Class A	Class B
Assumptions:			
Net investment income before class specific expenses	$1,000,000		
Class-specific expenses:			
Class A		$ 13,000	
Class B			$ 59,000
Record date shares outstanding	5,000,000	2,000,000	3,000,000
Record Share Method			
Net investment income before class specific expenses	$1,000,000		
Total record date shares outstanding	5,000,000		
Gross dividend rate for all shares	$ 0.2000	$ 0.2000	$ 0.2000
Per share class-specific expenses:			
Class A ($13,000 ÷ 2,000,000)		(0.0065)	
Class B ($59,000 ÷ 3,000,000)			(0.0197)
Per share dividend for each class		$ 0.1935	$ 0.1803
Actual Income Available Method			
Actual net investment income recorded on books of each class	$ 928,000	$ 417,600	$ 510,400
Record date shares outstanding for each class		2,000,000	3,000,000
Per share dividend for each class		$ 0.2088	$ 0.1701

Simultaneous Equations Method

EQUATION #1: A + B = $928,000

Where—A and B represent the total dividend amounts to be paid to each class.

EQUATION #2: (A ÷ 2,000,000) - (B ÷ 3,000,000) = (0.5% x $10.50) ÷ 4

Where

- 2,000,000 and 3,000,000 represent the record date shares of each class
- 0.5% represents the expense differential between Class A and Class B
- $10.50 represents the average daily net asset value of the fund
- 4 refers to the fact that the dividend period is a quarter

Solving the above simultaneous equations produces the following results:

	Total	Class A	Class B
Total dividends to be paid	$ 928,000	$ 386,961	$ 541,039
Record date shares outstanding for each class		2,000,000	3,000,000
Per share dividend for each class		$ 0.1935	$ 0.1803
Annualized distribution rates to average daily net asset value		7.37%	6.87%
Difference in distribution rates		0.50%	

Question 4.4.50 Does a nonregistered fund disclose the components of its dividends?

Interpretive response: No. Nonregistered funds are not subject to the tax regulations for RICs (see Question 4.4.20). In addition, for partnerships and other pass-through entities, the results from operations are deemed distributed to each partner (see Question 4.5.10). Accordingly, a nonregistered fund does not disclose the components of its dividends in the statement of changes in net assets or in the per-share information in the financial highlights. [946-20-50-14]

4.5 Components of capital

Excerpt from ASC 946-20

> Components of Capital and Distributable Earnings

50-11 This guidance requires all investment companies to disclose two components of capital on the balance sheet: shareholder capital and distributable earnings. The components of distributable earnings, on a tax basis, shall be disclosed in a note to financial statements. This information enables investors to determine the amount of accumulated and undistributed earnings they potentially could receive in the future and on which they could be taxed.

50-12 The notes shall disclose all of the following tax-basis components of distributable earnings as of the most recent tax year end:

a. Undistributed ordinary income
b. Undistributed long-term capital gains
c. Capital loss carryforwards
d. Unrealized appreciation (depreciation).

50-13 Paragraphs 946-740-35-1 and 946-740-50-1 require that, if a provision for deferred income taxes on unrealized appreciation exists, it be charged against the unrealized gains account and disclosed as such in the statement of operations. Explanations shall be provided for the differences between the total of these amounts and distributable earnings (accumulated losses).

50-14 Investment partnerships and other pass-through entities shall aggregate all elements of equity into partners' capital, because the results from operations are deemed distributed to each partner.

Excerpt from ASC 946-505

> Capital Contributions

50-3 Net assets at the beginning of the year and at the end of the year shall be disclosed. The balance of net assets at the end of the year shall agree with the comparable amount shown in the statement of assets and liabilities or in the statement of net assets.

> Multiple-Class Funds

50-4 For financial reporting purposes, a **return of capital** is not determined at the class level and distributable earnings is disclosed only at the fund level.

Investment companies may be organized as corporations, common law trusts, limited partnerships, limited liability investment partnerships and companies, and other more specialized entities, such as separate accounts of insurance companies that are not in themselves legal entities. [946-20-05-1B]

Regardless of the legal form, all investment companies generally aggregate all of their components of capital into net assets (i.e. assets less liabilities). [946-505-50-3]

However, certain investment companies disclose the components of capital on a tax basis, which differs from how many non-investment companies disclose their components of capital.

Question 4.5.10 Are the components of capital required to be disclosed?

Interpretive response: It depends. Investment companies typically disclose two components of capital on the face of the statement of assets and liabilities – shareholder capital and distributable earnings – on a tax basis. This information enables investors to determine the amount of accumulated and undistributed earnings they potentially could receive in the future and on which they could be taxed.

Further, in the notes to the financial statements, investment companies disclose the following tax basis components of distributable earnings: [946-20-50-11 – 50-12]

- undistributed ordinary income
- undistributed long-term capital gains
- capital loss carryforwards
- unrealized appreciation or depreciation.

Distributed earnings are disclosed only at the fund level. Therefore, if an investment company has more than one class of shares (see section 4.3), it does not determine distributable earnings for each class. [946-505-50-4]

If a provision for deferred income taxes on unrealized appreciation exists, it is charged against the unrealized gains account and disclosed as such in the statement of operations (see section 8.2.60). Differences between the total of these amounts and distributable earnings (accumulated losses) are disclosed. [946-20-50-13]

Investment companies not subject to tax

Some investment companies are not subject to tax and do not make distributions to investors based on their results of operations. Many partnerships and other pass-through entities typically aggregate all elements of equity into partners' capital because the results of operations are deemed distributed to each partner. In addition, certain nonregistered funds organized as offshore corporations may not be subject to taxation in their country of domicile. These investment companies do not disclose the components of their capital. [946-20-50-14]

Question 4.5.20 Does a registered fund include the impact of book-to-tax differences in its distributable earnings?

Background: A registered fund that elects to be taxed as a RIC under Subchapter M of the IRC is subject to minimum distributions requirements to maintain its qualification for RIC tax status. These minimum distributions are based on the income and gains of the fund under the federal income tax basis. This can result in book-to-tax differences from amounts determined in accordance with US GAAP, which can either be temporary, meaning that they will reverse in the future, or permanent.

Interpretive response: It depends. A registered fund is not required to separately account for temporary differences when reporting the components of distributable earnings on a tax basis (see Question 4.5.10). Instead, it records the changes in distributable earnings as the effects of temporary differences reverse in the future.

However, in some instances, temporary differences may become permanent, such as when capital loss carryforwards expire. During a period when all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference is reclassified from distributable earnings to paid-in-capital. [946-205-45-3(c), SOP 93-2.13]

Question 4.5.30 Are the accumulated changes in the fair value of debt classified in distributable earnings?

Background: If an entity has elected Topic 825's fair value option for an eligible financial liability, such as its debt, the entity presents the portion of the total change in the fair value of the liability resulting from a change in the instrument-specific credit risk separately in OCI. All other changes in the fair value of the liability are recognized in net income. [825-10-45-5]

Interpretive response: It depends. An investment company discloses information about distributable earnings on a tax basis (see Question 4.5.10). Because the portion of the change in fair value of the investment company's debt reported in net income is a component of earnings, we believe that it is appropriate to include such accumulated changes in distributable earnings. [946-20-50-11 – 50-12]

However, we believe AOCI represents a separate component of net assets that is distinct from paid-in capital and distributable earnings, and therefore should not be included in either category. We believe that reporting such amounts as either AOCI or 'other elements of capital' is acceptable provided that the caption used and the amounts agree with the statement of changes in net assets. [S-X Rule 6-04.18]

4.6 Offering costs

Excerpt from ASC 946-20

> Offering Costs

25-5 Offering costs of **closed-end funds** and investment partnerships shall be charged to paid-in capital upon sale of the shares or units.

25-6 Offering costs of open-end investment companies and of closed-end funds with a continuous offering period shall be recognized as a deferred charge.

> Offering Costs

35-5 Offering costs recognized as a deferred charge under paragraph 946-20-25-6 shall be amortized to expense over 12 months on a straight-line basis when operations begin.

35-6 Offering costs of unit investment trusts shall be charged to paid-in capital on a pro rata basis as the units or shares are issued or sold by the trust (when the units are purchased by the underwriters). Units sold to underwriters on a firm basis are considered sold by the trust, and the offering costs associated with those units shall be charged to paid-in capital when the units are purchased by the underwriters. Offering costs that remain unamortized at the end of the year shall be reviewed for impairment. (For guidance concerning organization and offering costs, see Subtopic 720-15.)

20 Glossary

Closed-End Funds

Closed-end funds are investment companies that issue a fixed number of shares (that generally trade on an open market) to raise capital, similar to the way in which an entity sells stock in an initial public offering.

Offering Costs

Offering costs include all of the following:

a. Legal fees pertaining to the investment company's shares offered for sale
b. Securities and Exchange Commission (SEC) and state registration fees
c. Underwriting and other similar costs
d. Costs of printing prospectuses for sales purposes
e. Initial fees paid to be listed on an exchange
f. Tax opinion costs related to offering of shares
g. Initial agency fees of securing the rating for bonds or preferred stock issued by closed-end funds.

Excerpt from ASC 340-10

> SAB Topic 5.A, Expenses of Offering

S99-1 The following is the text of SAB Topic 5.A, Expenses of Offering.

Facts: Prior to the effective date of an offering of equity securities, Company Y incurs certain expenses related to the offering.

Question: Should such costs be deferred?

Interpretive Response: Specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering. However, management salaries or other general and administrative expenses may not be allocated as costs of the offering and deferred costs of an aborted offering may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

Excerpt from AICPA TQA 6910

.23 Accounting Treatment of Offering Costs Incurred by Investment Partnerships

Inquiry—According to FASB ASC 946-20-25-6 and FASB ASC 946-20-35-5, all open-end registered investment companies and those closed-end registered investment companies with a continuous offering period should defer offering costs and amortize them to expense over 12 months on a straight-line basis. However, FASB ASC 946-20-25 does not indicate whether an investment partnership should apply the same treatment. Should an investment partnership that continually offers its interests also defer and amortize such costs over 12 months?

Reply—Yes, an investment partnership that continually offers its interests should defer offering costs incurred prior to the commencement of operations and then amortize them to expense over the period that it continually offers its interests, up to a maximum of 12 months. The straight-line method of amortization should generally be used. If the offering period terminates earlier than expected, the remaining deferred balance should be charged to expense.

.24 Meaning of "Continually Offer Interests"

Inquiry—How should an investment partnership determine if it continually offers its interests?

Reply—An investment partnership is deemed to continually offer its interests if an eligible, new investor may enter into an agreement to purchase an interest in the partnership on any business day or on a series of specified business days over a continuous period of time. A new investor is one that does not already own any interest in the investment partnership at the time of purchase.

Some investment partnerships may offer their interests at a single point in time and require new investors to commit to providing capital contributions over a period of time. As interests are not available for purchase over a continuous period, such investment partnerships would not be deemed to have a continuous offering period.

An investment company differs from many non-investment companies in its accounting and financial reporting of offering costs to investors. These differences generally relate to the timing and method of the recognition of those costs and additional disclosures that are unique to investment companies.

Question 4.6.10 What are offering costs?

Interpretive response: Offering costs are specific incremental costs directly attributable to a proposed or actual offering of securities. However, management salaries or other general and administrative expenses are not considered costs of the offering. [340-10-S99-1]

Offering costs include all of the following: [946-20 Glossary]

- legal fees pertaining to the investment company's shares offered for sale;
- Securities and Exchange Commission and state registration fees;
- underwriting and other similar costs;
- costs of printing prospectuses for sales purposes;
- initial fees paid to be listed on an exchange;
- tax opinion costs related to offering of shares; and
- initial agency fees of securing the rating for bonds or preferred stock issued by closed-end funds.

See section 5.10 of KPMG Handbook, Debt and equity financing, for guidance on costs relating to share issuance.

Question 4.6.20 Are travel costs to meet with prospective investors classified as offering costs?

Interpretive response: It depends. We believe that travel costs to meet with prospective investors in connection with the launch of an investment company (e.g. road show costs) should be expensed as incurred because they relate to the start-up activities of the investment company instead of being direct and incremental to an offering. Similarly, other travel costs that would have been incurred regardless of a successful offering being completed are not direct and incremental to an offering and should be expensed as incurred. [720-15-25-1]

However, in limited circumstances, we believe travel costs may be direct and incremental to an offering, such as travel costs incurred by management to meet directly with investors to execute subscription documents. We believe it would be appropriate for an investment company to account for such travel costs as offering costs.

Question 4.6.30 How are offering costs accounted for?

Interpretive response: Certain investment companies recognize offering costs as a deferred charge and amortize them to expense over 12 months on a straight-line basis when operations begin. We believe operations begin on the date the investment company commences any of its principal activities (see Question 2.3.10). [946-20-25-6, 35-5]

Offering costs that remain unamortized at the end of the year are reviewed for impairment. If the offering period terminates earlier than expected, the remaining deferred balance is charged to expense. [946-20-25-6, 35-6]

The types of investment companies that treat offering costs in this way are: [946-20-25-6, TQA 6910.23]

- registered open-end funds;
- registered closed-end funds with a continuous offering period (see Question 4.6.40); and
- nonregistered funds (e.g. partnerships or similar entities) with a continuous offering period.

In contrast, if they do not have a continuous offering period, registered closed-end funds and nonregistered funds charge offering costs to paid-in capital upon the sale of the shares or units. [946-20-25-5]

Offerings through shelf registration statements

Some registered closed-end funds offer shares through shelf registration statements. Offering costs incurred for these shares are capitalized as a prepaid expense. As shares are sold, a portion of the offering costs attributable to the shares sold are charged to paid-in-capital. If the filing is withdrawn, the related capitalized costs are charged to expense. [340-10-S99-1, AAG-INV 8.31]

Question 4.6.40 What is a continuous offering period?

Interpretive response: A continuous offering period is the period of time in which an investment company continually offers its ownership interests. An investment company continually offers its interests if an eligible, new investor may enter into an agreement to purchase an interest in the investment company on any business day or on a series of specified business days over a continuous period of time. A new investor is one that does not already own any interest in the investment company at the time of purchase.

Some investment companies may offer their interests at a single point in time and require new investors to commit to providing capital contributions over a period of time. Because interests are not available for purchase over a continuous period, such investment companies would not be deemed to have a continuous offering period. [TQA 6910.24]

Question 4.6.50 Does a registered closed-end fund with a continuous offering period expense its offering costs incurred after operations begin?

Background: Registered closed-end funds with a continuous offering period recognize offering costs as a deferred charge and amortize them to expense over 12 months on a straight-line basis *when operations begin* (see Questions 4.6.30 and 4.6.40). However, a fund may increase the amount of its securities available to shareholders and incur additional offering costs related to its securities filings. These costs may be incurred during a period beyond the initial 12 months.

Interpretive response: It depends. Topic 946 does not address the accounting for offering costs in connection with subsequent continuous offerings. The SEC staff indicated that they generally would not object if a closed-end fund defers offering costs that are both incurred after a registered fund commences investment operations and related to a new continuous offering and amortizes them to expense over 12 months. However, the SEC staff recommends consultation on specific fact patterns, as facts and circumstances may differ. [AICPA IC EP 1/2017]

4.7 Distribution costs

Excerpt from ASC 946-20

> Certain Distribution Costs

05-4 Open-end investment companies, also known as funds, are permitted to finance the distribution of their shares under a plan pursuant to Rule **12b-1** in Chapter 17 of the Code of Federal Regulations. (Rule 12b-1 is one of the regulations implementing the Investment Company Act of 1940.) Under Rule 12b-1, a fund's board of directors is required to perform an annual review of the plan and determine whether to continue or terminate it. Under a **traditional 12b-1 plan**, a fund's **distributor** may be compensated or reimbursed for its **distribution costs** or efforts through any of the following methods:

a. A 12b-1 fee, payable by the fund, based on an annual percentage of the fund's average net assets (a **compensation plan**) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting **contingent-deferred sales loads** received by the distributor (a **reimbursement plan**). Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid. Fees for both kinds of plans are treated as expenses in a fund's statement of operations.
b. A front-end load, which is assessed on purchasing shareholders at the time fund shares are sold.
c. A contingent-deferred sales load imposed directly on redeeming shareholders. The contingent-deferred sales load usually is expressed as a percentage, which declines with the passage of time, of the lesser of redemption proceeds or original cost. The contingent-deferred sales load normally ranges from 4 percent to 6 percent and typically is reduced by 1 percent (for example, from 6 percent to 5 percent) a year until the sales charge reaches 0 percent.

05-5 Rule **12b-1** plans historically have provided that a fund's board of directors may terminate the plan with no penalty to the fund. (Termination of the plan does not necessitate termination of the fund.) Redeeming shareholders still would be subject to the contingent-deferred sales load, which would be paid to the distributor that sold the shares to those shareholders. However, with a traditional 12b-1 plan, the 12b-1 fees normally would be discontinued on plan termination. Some traditional reimbursement 12b-1 plans provide that, when the plan is terminated, the fund's board of directors has the option, but not the requirement, to pay the distributor for any costs incurred by the distributor in excess of the cumulative contingent-deferred sales load and 12b-1 fees the distributor has received. Such a plan is referred to as a **board-contingent plan**. Under traditional reimbursement 12b-1 plans, including board-contingent plans, contingent-deferred sales load payments by shareholders continue to be remitted to the distributor until **excess costs** are fully recovered, after which the contingent-deferred sales load payments usually are remitted to the fund instead of the distributor.

05-6 With an **enhanced 12b-1 plan**, the fund is required to continue paying the 12b-1 fee after termination of the plan to the extent the distributor has excess costs. Contingent-deferred sales load payments by shareholders would continue to be remitted to the distributor to further offset excess costs. Thus, the major distinction between traditional and enhanced 12b-1 plans is the requirement for the fund to continue such payments upon plan termination.

05-7 The following table summarizes the 12b-1 plan attributes.

	Traditional			Enhanced
	Compensation	Reimbursement		
		Nonboard Contingent	Board Contingent	
Annual review and approval of plan by board, with ability to terminate plan	X	X	X	X
Fund Payment Terms [(a)]				
Payment based on average net assets	X	X	X	X
Annual or cumulative limitation, or both, based on actual distribution costs		X	X	X
Upon termination of 12b-1 plan, board has option, but not obligation, to pay excess costs			X	
Upon termination of 12b-1 plan, fund is required to continue paying 12b-1 fee to the extent the distributor has excess costs				X

(a) Excludes front-end and contingent deferred sales load payments, which are made by shareholders and not the fund.

> Certain Distribution Costs

25-3 The guidance in this paragraph applies to annual and interim financial statements of investment companies that adopt plans that comply with Rule **12b-1**. A liability, with a corresponding charge to expense, shall be recognized by a fund with an **enhanced 12b-1 plan** for **excess costs**. A liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, shall be recorded by a fund with a **board-contingent plan** when the fund's board commits to pay such costs. Example 1 (see paragraph 946-20-55-1) illustrates this guidance.

> Certain Distribution Costs

30-2 The guidance in paragraphs 946-20-30-3 through 30-5 applies to annual and interim financial statements of investment companies that adopt plans that comply with Rule **12b-1**.

30-3 The liability and expense recognized under paragraph 946-20-25-3 shall be measured initially in an amount equal to the cumulative **distribution costs** incurred by the **distributor** less the sum of all of the following:

a. Cumulative 12b-1 fees paid
b. Cumulative **contingent-deferred sales load** payments
c. Future cumulative contingent-deferred sales load payments by **current shareholders**, if reasonably estimable.

30-4 The liability and expense recognized under paragraph 946-20-25-3 shall be measured at its present value, calculated using an appropriate current interest rate, if both of the following criteria are met:

a. The amount and timing of cash flows are reliably determinable.
b. The distribution costs are not subject to a reasonable interest charge.

30-5 If these conditions are not met, the liability recognized under paragraph 946-20-25-3 shall be calculated without discounting to present value.

> Certain Distribution Costs

35-2 The guidance in the following paragraph and paragraph 946-20-35-4 applies to annual and interim financial statements of investment companies that adopt plans that comply with Rule **12b-1**.

35-3 The liability recognized under paragraph 946-20-25-3 shall be subsequently measured using the guidance in paragraphs 946-20-30-4 through 30-5. Changes in the liability shall be recognized in the statement of operations as an expense or reduction in expense.

35-4 Any future cumulative **contingent-deferred sales load** payments shall be based on all of the following:

a. Current **net asset value per share**
b. The number of shares currently outstanding and the number of years that they have been outstanding
c. Estimated shareholder **persistency** based on historical fund data or, if historical fund data are not available, group or industry data for a similar class of shares.

> Certain Distribution Costs

45-2 The guidance in this paragraph applies to annual and interim financial statements of investment companies that adopt plans that comply with Rule **12b-1**. An excess of cumulative 12b-1 fees and **contingent-deferred sales load** payments to date and future contingent-deferred sales load payments by **current shareholders** over the cumulative costs incurred by the **distributor** shall not be reported as an asset.

> Certain Distribution Costs

50-3 The guidance in this paragraph applies to annual and interim financial statements of investment companies that adopt plans that comply with Rule **12b-1**. For both **board-contingent plans** and **enhanced 12b-1 plans**, funds shall disclose in their financial statements the principal terms of such plans and any plan provisions permitting or requiring payments of **excess costs** after plan termination. For board-contingent and enhanced plans, the aggregate amount of **distribution costs** subject to recovery through future payments by the fund pursuant to the plan and through future **contingent-deferred sales load** payments by **current shareholders** shall be disclosed. For enhanced plans, funds shall disclose the methodology used to estimate future contingent-deferred sales load payments by current shareholders.

50-4 If a 12b-1 distribution **reimbursement plan** provides for the carryover of unreimbursed costs to subsequent periods, the terms of reimbursement and the unreimbursed amount shall be disclosed.

20 Glossary

12b-1

Rule 12b-1 in Chapter 17 of the Code of Federal Regulations is one of the regulations implementing the Investment Company Act of 1940.

Board-Contingent Plan

A reimbursement 12b-1 plan that provides that, on the plan's termination, a fund's board of directors has the option, but not the requirement, to pay the distributor for any excess costs incurred by the distributor.

Compensation Plan

A plan that provides for a 12b-1 fee, payable by the fund, based on a percentage of the fund's average net assets. The 12b-1 fee may be more or less than the costs incurred by the distributor.

Contingent-Deferred Sales Load

A sales charge imposed directly on redeeming shareholders based on a percentage of the lesser of the redemption proceeds or original cost. The percentage may decrease or be eliminated based on the duration of share ownership (frequently decreases by 1 percent a year). Also referred to as back-end load.

Current Shareholders

Shareholders of a fund, or a class of shares of a fund, at an evaluation or measurement date. Amounts attributable to current shareholders are based on shares outstanding at that date and do not include estimates of future reinvestments or other share purchases.

Distribution Costs

Costs, as defined in a distribution agreement between a distributor and a fund, incurred by a distributor in distributing a fund's shares. Such costs may include commission payments to sales representatives, promotional materials, overhead allocations, and interest.

Distributor

Usually the principal underwriter that sells the fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at net asset value and selling shares through dealers or to the public (see definition of underwriter in section 2(a)(40) of the Investment Company Act of 1940).

Enhanced 12b-1 Plan

A reimbursement **12b-1** plan that provides that, on termination of the plan, the fund is required to continue paying the 12b-1 fee to the extent the distributor has excess costs.

Excess Costs

The cumulative distribution costs incurred by the distributor less the sum of cumulative 12b-1 fees paid, cumulative contingent-deferred sales load payments, and future cumulative contingent-deferred sales load payments by current shareholders, if reasonably estimable.

Front-End Load

A sales commission or charge payable at the time of purchase of mutual fund shares.

Persistency

The length of time a shareholder owns shares of a particular fund or class of shares of a fund before redemption.

Reimbursement Plan

A plan that provides for a 12b-1 fee, payable by the fund, that may not exceed the lesser of an annual percentage of the fund's average net assets or actual costs incurred by the distributor net of contingent-deferred sales load received by the distributor.

Traditional 12b-1 Plan

A compensation or reimbursement plan pursuant to Rule **12b-1** that permits the use of a fund's assets to pay distribution-related expenses under certain conditions. The 12b-1 fees under traditional 12b-1 plans are normally discontinued upon plan termination, but may continue to be paid after plan termination under a board-contingent plan.

Registered open-end funds may use distributors to sell their shares. These funds impose fees on investors known generally as sales loads, which are used to compensate the distributors. These fees are similar to commissions paid to brokers for purchasing securities. They may be charged when an investor purchases fund shares (i.e. front-end loads) or when an investor redeems fund shares (i.e. back-end loads). Funds with back-end loads may also have annual distribution fees for marketing and other costs for selling fund shares (i.e. 12b-1 fees). An investment company differs from many non-investment companies in its accounting and financial reporting for distribution costs.

Question 4.7.10 What are distribution costs?

Interpretive response: Distribution costs are costs (as defined in a distribution agreement between a distributor and a fund) incurred by a distributor in distributing a fund's shares. Such costs may include commission payments to sales representatives, promotional materials, overhead allocations, and interest. The distributor is usually the principal underwriter that sells the fund's capital shares by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying capital shares from the fund at NAV and selling shares through dealers or to the public. [946-20 Glossary]

Registered open-end funds are permitted to finance the distribution of their shares under a plan pursuant to Rule 12b-1 in Chapter 17 of the Code of Federal Regulations, which is one of the regulations implementing the 1940 Act. Under Rule 12b-1, a fund's board of directors is required to perform an annual review of the plan and determine whether to continue or terminate it. Rule 12b-1 plans historically have provided that a fund's board of directors may terminate the plan with no penalty to the fund. Termination of the plan does not necessitate termination of the fund. [946-20-05-4 – 05-5, 946-20 Glossary]

Question 4.7.20 What are the different types of distribution costs for registered open-end funds?

Interpretive response: A fund's distributor may be compensated or reimbursed for its distribution costs or efforts through any of the following methods. [946-20-05-4, 05-7, 946-20 Glossary]

- **12b-1 fee:** A fee, payable by the fund, based on an annual percentage of the fund's average net assets (a compensation plan) or based on an annual percentage of the fund's average net assets limited to actual costs incurred, after deducting contingent-deferred sales loads received by the distributor (a reimbursement plan). Therefore, a compensation plan differs from a reimbursement plan only in that the latter provides for annual or cumulative limits, or both, on fees paid (see Question 4.7.40).
- **Front-end load:** A fee that is assessed on purchasing shareholders at the time fund shares are sold. These payments are made by shareholders and not the fund (see Question 4.7.30).
- **Contingent-deferred sales load (CDSL):** A fee imposed directly on redeeming shareholders, also referred to as a back-end load. The CDSL usually is expressed as a percentage, which declines with the passage of time, of the lesser of redemption proceeds or original cost. The percentage may be eliminated depending on the duration of share ownership. The CDSL normally ranges from 4% to 6% and typically is reduced by 1% (e.g. from 6% to 5%) a year until the sales charge reaches 0%.

Question 4.7.30 Are front-end loads considered to be offering costs?

Interpretive response: No. Payments for front-end loads are made by shareholders and are deducted from the proceeds received by the fund. Since these payments are not made by the fund, they are not considered to be offering costs. [946-20-05-7, AAG-INV 8.30]

Question 4.7.40 What are the different types of distribution plans for registered open-end funds?

Interpretive response: The different types of distribution plans for registered open-end funds include the following. [946-20-05-5 – 05-6, 946-20 Glossary]

- **Traditional 12b-1 plan:** A compensation or reimbursement plan pursuant to Rule 12b-1 that permits the use of a fund's assets to pay distribution-related expenses under certain conditions. The 12b-1 fees under traditional 12b-1 plans are normally discontinued on plan termination but may continue to be paid after plan termination under a board-contingent plan. Redeeming shareholders still would be subject to the CDSL, which would be paid to the distributor that sold the shares to those shareholders.

- **Compensation plan:** A plan that provides for a 12b-1 fee, payable by the fund, based on a percentage of the fund's average net assets. The 12b-1 fee may be more or less than the costs incurred by the distributor.
- **Reimbursement plan:** A plan that provides for a 12b-1 fee, payable by the fund, that may not exceed the lesser of an annual percentage of the fund's average net assets or actual costs incurred by the distributor net of CDSL received by the distributor. Under traditional reimbursement 12b-1 plans, including board-contingent plans, CDSL payments by shareholders continue to be remitted to the distributor until excess costs are fully recovered, after which the CDSL payments usually are remitted to the fund instead of the distributor (see Question 4.2.90). Excess costs are the cumulative distribution costs incurred by the distributor less the sum of (a) cumulative 12b-1 fees paid, (b) cumulative CDSL payments, and (c) future cumulative CDSL payments by current shareholders, if reasonably estimable.
- **Board-contingent plan:** A reimbursement 12b-1 plan that provides that, on the plan's termination, a fund's board of directors has the option, but not the requirement, to pay the distributor for any costs incurred by the distributor in excess of the cumulative CDSL and 12b-1 fees the distributor has received.
- **Enhanced 12b-1 plan:** A reimbursement 12b-1 plan that provides that, on termination of the plan, the fund is required to continue paying the 12b-1 fee to the extent the distributor has excess costs. CDSL payments by shareholders would continue to be remitted to the distributor to further offset excess costs. Therefore, the major distinction between traditional and enhanced 12b-1 plans is the requirement for the fund to continue such payments on plan termination.

The following table summarizes the 12b-1 plan attributes. [946-20-05-7]

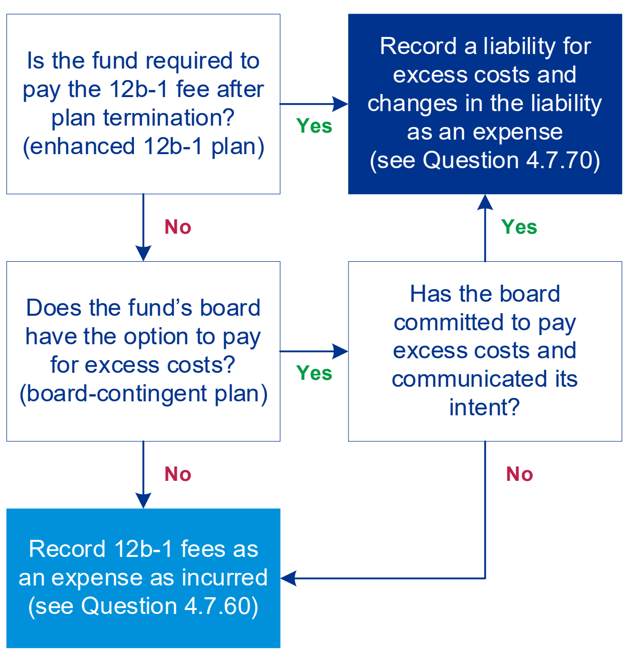
Plan attribute	Traditional 12b-1 plan			Enhanced 12b-1 plan
		Reimbursement plan		
	Compensation plan	Not board contingent	Board contingent	
Annual review and approval of the plan by the fund's board of directors	Yes	Yes	Yes	Yes
Fund payments based on average net assets	Yes	Yes	Yes	Yes
Annual or cumulative limitation of fund payments based on actual distribution costs	No	Yes	Yes	Yes
Ability of the fund's board to terminate the plan	Yes	Yes	Yes	Yes

	Traditional 12b-1 plan			
		Reimbursement plan		
Plan attribute	Compensation plan	Not board contingent	Board contingent	Enhanced 12b-1 plan
On termination, the board has the option, but not the obligation, to pay excess costs	No	No	Yes	No
On termination, fund payments continue to the extent distributor has excess costs	No	No	No	Yes

Question 4.7.50 How are distribution costs accounted for?

Interpretive response: The accounting for distribution costs is primarily impacted by: [946-20-05-4 – 05-6]

- whether the fund has a commitment to reimburse the distributor after the 12b-1 plan has been terminated; and
- whether the 12b-1 fee structure compensates the distributor based on an annual percentage of the fund's net assets or reimburses the distributor for its distribution costs incurred.



Question 4.7.60 Does a registered open-end fund expense its distribution costs?

Interpretive response: Yes. 12b-1 fees for compensation plans and reimbursement plans are treated as expenses in a fund's statement of operations. However, because sales charges in the form of a front-end load or CDSL are charged to shareholders directly, those costs are not recognized as expenses of a fund (see Question 4.7.20). Accounting for distribution costs as expenses is consistent with the way that funds account for other costs of raising capital (such as state registration fees and legal fees). That accounting is based on the principle that raising capital is an integral part of a fund's business. Such costs are analogous to ordinary and necessary period costs in nonfinancial businesses. [946-20-05-4, S-X Rule 6-07.2(f), SOP 95-3.17]

Question 4.7.70 Does a registered open-end fund recognize a liability for distribution costs?

Background: Excess costs are the cumulative distribution costs incurred by the distributor less the sum of (a) cumulative 12b-1 fees paid, (b) cumulative CDSL payments, and (c) future cumulative CDSL payments by current shareholders, if reasonably estimable. [946-20 Glossary]

Interpretive response: It depends. Distribution costs may be contingent for a variety of reasons such that it is not probable those costs will be incurred. A fund would not recognize a liability for excess costs in the following situations:

- fees are discontinued on plan termination (e.g. a traditional 12b-1 plan);
- there are annual or cumulative limitations, or both, of fees based on actual distribution costs (e.g. a reimbursement plan); or
- the board has the option, but not the obligation, to pay certain distribution costs on termination of the plan (e.g. a board-contingent plan) and the board has not committed to pay such costs.

However, a fund may be required to continue paying distribution costs after termination of its distribution plan. A liability, with a corresponding charge to expense, is recognized by a fund in the following situations: [946-20-25-3]

- the fund is required to continue paying the 12b-1 fee after termination of the plan to the extent the distributor has excess costs (e.g. an enhanced 12b-1 plan); or
- the fund has a board-contingent plan and the board commits to pay such distribution costs.

When a fund is unconditionally committed to pay excess costs at the formation of an enhanced 12b-1 plan, a liability for such costs is reported by the fund when the costs are incurred by the distributor. Although an enhanced 12b-1 plan requires annual board approval for its continuance, the payment for excess costs is not contingent on such approval. Termination of the plan by the fund's board would not change the obligations under the plan. Any operational difficulties, such as the daily calculation of NAV per share, does not change the fact that the fund is liable for excess costs. In the case of a terminated 12b-1 plan, future CDSL payments on redemption by shareholders reduce the fund's obligation to the distributor, although the amount of those payments is subject to estimation. [SOP 95-3.15 – .16]

Board-contingent plans provide that on a plan's termination, the fund's board of directors has the option, but not the obligation, to pay the distributor for any excess costs incurred. A liability for excess costs, computed in the same way as for an enhanced 12b-1 plan, is recorded for a board-contingent plan only when the fund's board commits to pay such costs and communicates its intent to do so. A commitment by the board, in effect, converts a board-contingent plan into an enhanced plan. That is, the fund is then obligated to continue to pay the 12b-1 fee after termination of the plan to the extent that the distributor has excess costs. [SOP 95-3.19]

Question 4.7.80 How are liabilities for distribution costs measured?

Interpretive response: The liability for excess costs (see Question 4.7.70) is equal to the cumulative distribution costs incurred by the distributor less the sum of all of the following: [946-20-30-3, 946-20 Glossary]

- cumulative 12b-1 fees paid;
- cumulative CDSL payments; and
- future cumulative CDSL payments by current shareholders, if reasonably estimable (see Question 4.7.90).

The liability for excess costs is measured at its present value if certain criteria are met (see Question 4.7.100). [946-20-30-4]

Changes in the liability for excess costs are recognized in the statement of operations as an expense (or a reduction in expense). However, the liability for excess costs is not reduced below zero (i.e. reported as an asset) when there is an excess of cumulative 12b-1 fees and CDSL payments to date and future CDSL payments by current shareholders over the cumulative costs incurred by the distributor. [946-20-35-3, 45-2]

Question 4.7.90 How are future cumulative CDSL payments reasonably estimated?

Interpretive response: Future cumulative CDSL payments by current shareholders are estimated based on all of the following: [946-20-35-4, 946-20 Glossary]

- current NAV per share of the fund (or class of shares of a fund);
- the number of shares currently outstanding and the number of years that they have been outstanding; and
- estimated shareholder persistency (i.e. the length of time a shareholder owns shares of a particular fund or class of shares of a fund before

redemption) based on historical fund data or, if historical fund data are not available, group or industry data for a similar class of shares.

Amounts attributable to current shareholders are based on shares outstanding at the measurement date and do not include estimates of future reinvestments or other share purchases. [946-20 Glossary]

Question 4.7.100 Does a registered open-end fund measure its liability for distribution costs at its present value?

Interpretive response: It depends. The liability for excess costs is measured at its present value if both of the following criteria are met: [946-20-30-4]

- the amount and timing of cash flows are reliably determinable; and
- the distribution costs are not subject to a reasonable interest charge.

If these conditions are not met, the liability for excess costs is calculated without discounting to present value. [946-20-30-5]

The present value is calculated using an appropriate current interest rate. Subsequently, the difference between the present value and the undiscounted liability is amortized as interest expense over the life of the excess cost liability using the interest method. [946-20-30-4, 835-30-25-12 – 25-13, 835-30-35-2]

Example 4.7.10 SOP 95-3 Example: Measurement of liability for distribution costs

Appendix A of AICPA Statement of Position 95-3 illustrates the calculation of a liability for excess costs.

The following assumptions are made for a fund with an enhanced 12b-1 plan:

Total distribution costs incurred	5,000,000
12b-1 payments	(750,000)
CDSL payments received by distributor	(250,000)
Estimated future CDSL payments to be received by the distributor from current shareholders at current asset levels[1]	(1,000,000)
Total excess costs	3,000,000

Note:

1. Assuming amounts are reasonably estimable.

Assuming that the 12b-1 fee is paid at the end of the year, the following calculation is made:

Current fund net assets (10 million shares at $10.00 per share)	100,000,000
12b-1 fee as a percentage of net assets	.0075
Annual 12b-1 fee payments (75 basis points)	750,000
Estimated number of years to pay excess costs ($3,000,000 ÷ $750,000/year)	4
Present value of 12b-1 payments of $750,000 for 4 years, discounted at an assumed rate of 8%[1]	2,484,000

Note:
1. Assuming discounting is appropriate.

The fund recognizes a liability of $2,484,000 and a corresponding expense.

Question 4.7.110 Is a registered open-end fund required to disclose its distribution plans?

Interpretive response: Yes. A registered open-end fund is required to include the following disclosures in its annual and interim financial statements: [946-20-50-3 – 50-4]

Plan type	Disclosure
Reimbursement plan	• if plan provides for the carryover of unreimbursed costs to subsequent periods, the terms of reimbursement and the unreimbursed amount
Board-contingent plan **Enhanced 12b-1 plan**	• principal terms of such plan • any plan provisions permitting or requiring payments of excess costs after plan termination • aggregate amount of distribution costs subject to recovery through future payments by the fund pursuant to the plan and through future CDSL payments by current shareholders
Enhanced 12b-1 plan	• the methodology used to estimate future CDSL payments by current shareholders

5. Investment adviser transactions

Detailed contents

Example

5.4 Payments by affiliates and other investment adviser transactions

Questions

5.1 How the standard works

Rather than hire employees, investment companies typically engage investment advisers through investment advisory agreements to provide services necessary for their operations. Such services generally include investment management and administrative services. The investment adviser may also use other parties to provide some of these services.

Investment advisers typically charge a management fee or a performance fee.

Management fees	Performance fees
Typically calculated as a percentage of net assets, capital commitments or invested capital at rates set by contractual agreements	Earned based on the performance of the assets under management; may include a normal fee plus a bonus (or less a penalty) if the performance exceeds (or fails to exceed) a preestablished benchmark (e.g. a hurdle rate)

Topic 946 provides guidance on the typical features of such fees.

Feature	Accounting
Loss carryforwards	Loss carryforwards reduce future performance fees for the impact of losses in the current or prior periods. However, an investment company does not recognize an asset for a loss carryforward.
Fee waivers	Fee waivers are arrangements in which the investment adviser (or other service provider) either waives fees owed by the investment company or reimburses other expenses of the investment company. They are presented as a reduction of total expenses and their terms are disclosed.
Expense limitation agreements	Expense limitation agreements limit the expenses that can be paid by the investment company. Costs incurred in excess of an expense limitation agreement are carried over to a future period and reimbursed to the investment adviser to the extent that the total expense ratio falls below the permitted maximum. If specified criteria are met, an investment company recognizes a liability for the costs that are carried over.
Expense offset arrangements	Under an expense offset arrangement an investment adviser (or other third party) reduces its fees by a specified or readily ascertainable amount for services provided to the investment company in exchange for use of the investment company's assets. The amount that would have been incurred had the expenses been paid directly in an arm's-length transaction is reflected in the relevant expense caption, with a corresponding reduction in total expenses (e.g. 'fees paid indirectly').

Related party issues

The investment adviser is generally a related party to the investment company and may also be an equity owner of the investment company. Given the unique relationship between an investment company and its investment adviser (including its affiliates), Topic 946 includes specific guidance on how to account for certain transactions between the two parties, such as payments by the investment adviser to the investment company related to investment losses (see section 5.4).

We believe the goal of this guidance is to increase comparability of investment company financial statements and to provide transparency about the relationship between the two parties, enabling users of the financial statements to make informed investment decisions.

5.2 Investment advisory fees

Excerpt from ASC 946-20

> General Partner Advisory Services

05-10 Investment companies organized as limited partnerships typically receive advisory services from the general partner. For such services, a number of partnerships pay fees chargeable as expenses to the partnership, whereas others allocate net income from the limited partners' capital accounts to the general partner's capital account, and still others employ a combination of the two methods.

> Performance Fees

25-10 Performance fees by an investment adviser under an investment advisory agreement shall be accrued at interim dates based on actual performance through the accrual date.

> General Partner Advisory Services

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

> General Partner Advisory Services

50-5 The method of computing payments or allocations for advisory services from the general partner shall be described in the notes to financial statements.

Excerpt from ASC 946-205

> Financial Highlights

• > Ratios

50-13 The expense and net investment income ratios shall be calculated by nonregistered investment partnerships based on the expenses allocated to each common or investor class (for example, the limited partner class) before the effects of any incentive allocation. Adequate disclosure shall be made to indicate that the net investment income ratio does not reflect the effects of any incentive allocation. Expenses directly related to the total return of the fund, such as incentive fees, and nonrecurring expenses, such as organizational costs, shall not be annualized when determining the expense ratio. Disclosure shall be made of the expenses that have not been annualized.

50-14 Generally, the determination of expenses for computing those ratios shall follow the presentation of expenses in the fund's statement of operations. Accordingly, if the manager's or general partner's incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of an expense ratio. Because an incentive allocation of profits is not presented as an expense, it shall not be considered part of the expense ratio. However, to avoid potentially significant inconsistencies in ratio presentations based solely on the structuring of incentives as fees or allocations, all incentives shall be reflected in the disclosure of financial highlights.

• > Total Return

• • > Investment Companies Not Using Unitized Net Asset Value

50-22 Because incentive allocations or fees may vary among investors within a class, total return for reporting classes subject to an incentive allocation or fee should report total return before and after the incentive allocation or fee for each reporting class taken as a whole. The effect of incentive allocations on total return is computed on a weighted-average aggregate capital basis. That results in an incentive computation less than the maximum if, for example, certain partners had loss carryovers at the beginning of the period.

• • > Certain Limited-Life Investment Companies

50-23 An investment company shall disclose the internal rate of return since inception of the investment company's cash flows and ending net assets at the end of the period (residual values) as presented in the financial statements, net of all incentive allocations or fees, to each investor class, as of the beginning and end of the period, if, by the terms of their offering documents, they meet all of the following criteria:

a. Have limited lives
b. Do not continuously raise capital and are not required to redeem their interests upon investor request (obtaining initial capital commitments from investors at time of organization and subsequently drawing on those commitments to make investments is not considered continuous for this purpose)
c. Have as a predominant operating strategy the return of the proceeds from disposition of investments to investors
d. Have limited opportunities, if any, for investors to withdraw before termination of the entity
e. Do not routinely acquire (directly or indirectly) as part of their investment strategy market-traded securities and derivative instruments.

50-24 A footnote to the financial highlights shall disclose that the internal rate of return since inception of the investment is net of all incentives. The internal rate of return since inception shall be based on a consistent assumption, no less frequently than quarterly, as to the timing of cash inflows and outflows (for example, on actual cash flow dates or cash inflows at the beginning of each month or quarter and cash outflows at the end of each month or quarter). All significant assumptions with respect to the internal rate of return since inception shall be disclosed in the footnotes to the financial highlights.

Excerpt from AICPA TQA 6910

.29 Allocation of Unrealized Gain (Loss), Recognition of Carried Interest, and Clawback Obligations

Inquiry—The governing documents of some nonregistered investment partnerships (as defined in chapter 7 of the AICPA Audit and Accounting Guide

Investment Companies), may contain provisions which do not allow allocations of unrealized gains or losses, or do not require the recognition of carried interest (also referred to as *carry*, *incentive*, or *performance fees and allocations*), and clawback obligations (also referred to as *lookback*, *negative carried interest*, or *general partner giveback*) until a specified date or time (for example, at the time of the partnership's liquidation or termination), or until the occurrence of a specific event (such as the actual disposition of an investment). Often, in these cases, the partnership's investments are either not marketable or are of such limited liquidity that interim valuations are highly subjective, and the intent of the provision is to delay the general partner's receipt of incentive allocations in cash until the gains can be measured objectively. In preparing financial statements of an investment partnership in accordance with U.S. generally accepted accounting principles, in which capital is reported by investor class, how should cumulative unrealized gains (losses), carried interest, and clawback be reflected in the equity balances of each class of shareholder or partner at the balance sheet date? In particular, should cumulative period-end unrealized gains and losses, nonetheless, be allocated as if realized in accordance with the partnership's governing documents prior to the date, time, or event specified in the partnership agreement?

Reply—If a nonregistered investment partnership reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents. Further discussion of the presentation of each item follows.

Certain partnerships record an expense for fees (including incentive fees) due a general partner, whereas others allocate net income from limited partner capital accounts to the general partner capital account. These amounts could either be considered a disproportionate income allocation or a compensation arrangement, and the accounting should conform to the structure of the partnership agreement, with the financial statement disclosures set forth in FASB ASC 946.

A basic premise for the preparation and presentation of the financial statements of an investment company is to reflect each class of shareholders' or partners' interest in the net assets of the reporting entity as of the reporting date. Another objective is to present total return for nonmanaging investor classes after incentive allocations and fees, as expressed in FASB ASC 946.

Other accounting literature related to the presentation of data similar to total return is consistent with FASB ASC 946. FASB ASC 260, *Earnings per Share*, refers to allocating earnings or undistributed earnings for a period to participating securities "as if all of the earnings for the period had been distributed."

Although this guidance does not relate specifically to the presentation of capital accounts, measuring period-end capital balances for those classes under the same methodology appears consistent with this guidance. Accordingly, if an entity reports capital by investor class, cumulative unrealized gains (losses), carried interest, and clawback provisions would be reflected in the equity balances of each class of shareholder or partner at the balance sheet date, as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date consistent with the provisions of the partnership's governing documents. Further discussion of the presentation of each item follows.

Cumulative Unrealized Gains (Losses)

Cumulative unrealized gains (losses) would be included in the ending balances of each class of shareholders' or partners' interest in the reporting entity at the reporting date, and the changes in such amounts would be reported in the changes in net asset value and partners' capital for the reporting period.

Carried Interest

The carried interest generally is due to the investment manager, an affiliated entity, or both, and is either in the form of a fee (usually for offshore funds) or as an allocation from the limited partners' capital accounts, pro rata, to the general partner's capital account (usually for domestic funds). Although many variations exist, the investment manager is often entitled to receive its carry on a "deal-by-deal" basis. On this basis, as individual investments are sold, the investment proceeds are allocated based on a specific methodology defined in the governing documents to determine the amount of carry, if any, to which the investment manager is entitled.

In presenting each class of shareholders' or partners' interest in the net assets as of the reporting date, the financial statements would consider the carry formula as if the investment company had realized all assets and settled all liabilities at their reported fair value, and allocated all gains and losses and distributed the net assets to each class of shareholder or partner at the reporting date.

Clawback

Although all classes of shareholder or partner may be subject to clawback provisions in the governing documents, a clawback most frequently involves an obligation on the part of the investment manager to return previously received incentive allocations to the investment fund due to subsequent losses. Such clawback amounts, when paid, are typically distributed to other investors.

Consistent with the previously discussed principle to reflect each class of shareholders' or partners' interest in the net assets of the reporting entity as of the reporting date, the impact of a clawback would be calculated as of each reporting date under the methodology specified in the fund's governing documents.

Consistent with FASB ASC 310-10-45-14, such an obligation would not be recognized as an asset (receivable) in the entity's financial statements unless substantial evidence exists of ability and intent to pay within a reasonably short period of time. Rather, in most instances, the obligation would be reflected as a deduction from the general partner's capital account.

The specific circumstances, including whether the clawback represents a legal obligation to return or contribute funds to the reporting entity, require consideration before determining whether a clawback, resulting in a negative general partner capital balance (that is, contra-equity), is recognized in the financial statements. A careful reading of the governing documents ordinarily is required. Additionally, it may not be appropriate to reflect a negative general partner capital balance (and a corresponding increase to limited partner capital balances) if the general partner does not have the financial resources to make good on its obligation. It may be helpful to consult with the entity's legal counsel for clarification before recording a negative general partner capital balance.

Even if not recognized within the capital accounts, at a minimum, it would be appropriate to disclose the existence of a clawback in the footnotes to the financial statements because in almost all cases, the existence of the clawback would modify the manner in which future distributions are made.

Investment companies normally enter into an investment advisory agreement under which they receive investment management services. Investment advisers are compensated in different ways for providing investment management services, including a base management fee or a performance fee.

Management fees

Management fees could be calculated as a percentage of net assets, capital commitments or invested capital at rates established by the investment advisory agreement or the governing documents of the investment company.

Performance fees

Performance fees are earned based on the performance of the assets under management. Performance fees may include a normal fee plus a bonus (or less a penalty) if the investment company's performance exceeds (or fails to exceed) a preestablished benchmark (e.g. a hurdle rate). Performance fees may be ‘crystalized’ on a periodic basis (e.g. quarterly or annually), on a specified date or time (e.g. at the time of the investment company's liquidation or termination), or on the occurrence of a specific event (e.g. the actual disposition of an investment).

Limited partnership investment companies

If an investment company is a nonregistered fund organized as a limited partnership, the performance fee may take the form of an allocation of earnings based on a predetermined formula specified in the partnership agreement. These performance fee arrangements are in the form of carried interests, which are based on preferential rights to income or residual assets relative to the different classes of partnership interests (distribution waterfall).

In a typical limited investment partnership agreement, the general partner (i.e. the investment adviser or its affiliate) is entitled to a fixed advisory or management fee (e.g. 1% of net assets) plus an allocation of earnings (e.g. 20% of net realized and unrealized gains). The allocation of earnings may also consider the impact of losses that are carried forward to future years (i.e. loss carryforwards). [SOP 95-2.10, .22]

Other terminology for performance fees

Performance fees may be referred to as carried interest, carry, incentive fees or allocations. Performance fees, as used in this chapter, refer to any performance-based fee arrangement with the investment adviser, regardless of whether structured as a fee or an allocation of earnings.

Question 5.2.10 Are fees paid to the investment adviser recognized as an allocation of income or an expense?

Interpretive response: It depends. Investment companies may recognize advisory fees, such as management fees or performance fees, either as an allocation of income or an expense. The method of recognition (i.e. allocation or expense) is dictated by the legal character of the fee under the investment advisory agreement or the governing documents of the investment company. It may be appropriate to record certain fees as an allocation of income (e.g. carried interest) and other fees as an expense (e.g. management fees). [946-20-05-10, TQA 6910.29]

Nonregistered funds organized as limited partnerships reflect allocations of income through a reallocation of partners' net income from the limited partners to the general partner in the statement of partners' capital rather than as an expense in the statement of operations. This allocation of profits provided for in partnership agreements may be considered a disproportionate partnership income allocation that the general partner earns because it incurred material cost and effort in organizing and managing the partnership and incurred disproportionate risk as the general partner (i.e. unlimited liability). [SOP 95-2.10, .22]

Whether accounted for as an expense or an allocation of income, any fees for advisory services are separately presented in either the statement of operations or the statement of changes in partners' capital. [946-20-45-4]

Question 5.2.20 When are performance fees recognized?

Interpretive response: Performance fees under an investment advisory agreement are accrued by an investment company at interim dates based on actual performance through the accrual date. Whether it accounts for these fees as an expense or an allocation of income (see Question 5.2.10), we believe an investment company should recognize these fees at intervals that correspond with its policies for calculating periodic NAVs. [946-20-25-10]

Question 5.2.30 How are performance fees measured?

Background: Some investment companies may not pay performance fees until investments are sold (i.e. gains and losses are realized). For example, the governing documents of these investment companies may contain provisions that:

- do not provide for allocations of unrealized gains or losses; or
- do not require the recognition of carried interest (also referred to as carry, incentive, or performance fees and allocations) and clawback obligations (also referred to as lookback, negative carried interest, or general partner giveback) until a specified date or time (e.g. at the time of the investment company's liquidation or termination); or
- do not require the recognition of carried interest until the occurrence of a specific event (e.g. the actual disposition of an investment).

Often, in these cases, the investments are either not marketable or are of such limited liquidity that interim valuations are highly subjective, and the intent of the provision is to delay the general partner's receipt of carried interest in cash until the gains can be measured objectively.

The carried interest generally is due to the investment manager, an affiliated entity, or both, and is either:

- in the form of a fee (usually for offshore funds); or
- as an allocation from the limited partners' capital accounts, pro rata, to the general partner's capital account (usually for domestic funds).

Although many variations exist, the investment manager is often entitled to receive its carry on a ‘deal-by-deal’ basis. On this basis, as individual investments are sold, the investment proceeds are allocated based on a specific methodology defined in the governing documents to determine the amount of carry, if any, to which the investment manager is entitled.

Interpretive response: Even if performance fees are not paid until investments are sold, they nonetheless are measured as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements and allocated all gains and losses and distributed the net assets to each class of shares consistent with the provisions of the investment advisory agreement and/or the governing documents of the investment company. [TQA 6910.29]

The performance fee recognized in any given period will generally equal the cumulative performance fee less any fees recognized in prior periods. In certain circumstances, this measurement method could result in a ‘negative expense’ or an allocation back to the limited partners’ capital accounts (see Question 4.3.70).

Disclosure of measurement method required

An investment company discloses the method it uses to measure its advisory fees. [946-20-50-5]

Question 5.2.40 Does an investment company record an asset for loss carryforwards?

Background: The investment advisory agreements or governing documents of some investment companies may contain provisions that reduce future performance fees for the impact of losses in the current or prior periods. These arrangements are commonly called 'loss carryforwards' or 'loss carryovers'.

Interpretive response: No. Performance fees are measured as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements (see Question 5.2.30). The measurement of performance fees does not consider future changes in the fair values of the investment company's assets and liabilities (i.e. future gains in which the loss carryforwards would be realized). In addition, we believe the recognition of an asset for loss carryforwards would be the equivalent to recognizing a gain contingency, which is not permitted under Topic 450 (contingencies). [450-30-25-1, TQA 6910.29]

Question 5.2.50 Are unrealized gains and losses included when measuring performance fees?

Interpretive response: Yes. Performance fees are accrued at interim dates based on actual performance through the accrual date (see Question 5.2.20). We believe actual performance includes unrealized gains and losses. In addition, performance fees are measured as if the investment company had realized all assets and settled all liabilities at the fair values reported in the financial statements (see Question 5.2.30). The reported fair values of investments include unrealized gains and losses. Therefore, an investment company includes unrealized gains and losses when measuring performance fees. [946-20-25-10, TQA 6910.29]

Question 5.2.60 Does a BDC include unrealized gains and losses when measuring performance fees?

Background: The Investment Advisers Act of 1940 contains certain restrictions on an investment adviser receiving payments for performance fees based on unrealized gains of a BDC. [Advisers Act §205(b)(3)]

Interpretive response: Yes. Although the Advisers Act may prohibit the payment of performance fees based on unrealized gains of a BDC, it does not address the accounting for those fees under Topic 946. When measuring performance fees, an investment company includes unrealized gains and losses (see Question 5.2.50). Therefore, a BDC should include the impact of unrealized gains and losses when accruing performance fees. We do not believe it is appropriate for a BDC to limit the accrual based upon the payment restrictions in the Advisers Act. [946-20-25-10, TQA 6910.29]

Question 5.2.70 How does a nonregistered fund present performance fees in its financial highlights?

Interpretive response: The expenses used to compute the financial highlights of a nonregistered fund follows the presentation of expenses in its statement of operations (see section 8.3.30). Accordingly, if the performance fee is accounted for as an expense, it would be factored into the computation of an expense ratio. Because a performance fee accounted for as an allocation of income is not presented as an expense, it is not considered part of the expense ratio. However, to avoid potentially significant inconsistencies in the presentation of overall fund expenses, all performance fees are reflected in the financial highlights of a nonregistered fund as follows. [946-205-50-13 – 50-14, 50-22 – 50-24]

Financial highlight	Presentation
Total return	Gross and net of performance fees[1]
Internal rate of return (IRR)	Net of performance fees[2]
Expense ratio	Gross and net of performance fees[3]
Net investment income ratio	Net of performance fees when accounted for as an expense[3,4]

Notes:

1. Total return is presented for each reporting class taken as a whole. Because performance fees may vary among investors within a class, the effect is computed on a weighted-average aggregate capital basis and may result in a performance fee computation less than the maximum (e.g. certain investors had loss carryforwards at the beginning of the period).
2. If certain criteria are met (see section 8.3.50), IRR is presented instead of total return. The financial highlights include disclosure that the IRR is net of performance fees.
3. Performance fees are not annualized when determining the ratios. The financial highlights include disclosure of the expenses that have not been annualized.
4. The financial highlights include disclosure that the net investment income ratio does not reflect the effects of any performance fee accounted for as an allocation of income.

5.3 Fee reductions

Investment advisers and other service providers may reduce the fees they would otherwise charge to an investment company. These fee reductions can take various forms such as fee waivers, expense reimbursements or offering a discount in conjunction with another service.

Topic 946 includes specific presentation and disclosure requirements for certain reductions in fees. It also includes specific recognition criteria for agreements to limit expenses. These requirements are aimed at providing financial statements users with more information about fees that are charged or are implicitly included in the financial statements.

Given the diversity in the terminology used for fee reductions and the complexity of the contracts that govern these reductions, understanding which presentation and disclosure requirements apply can be challenging. Therefore, this section includes:

- definitions of each type of fee reduction that has additional requirements under Topic 946;
- interpretations and application of those definitions; and
- required presentation and disclosure for each type of fee reduction.

These requirements are in addition to any other disclosures required under other US GAAP, such as Topic 850 (related party disclosures). Topic 850 requires amounts paid to affiliates or related parties to be disclosed - e.g. advisory fees, administration fees, distribution fees, brokerage commissions and sales charges. Significant provisions of related-party agreements (including the basis for determining management, advisory, administration or distribution fees (see section 4.7)) are described in a note to the financial statements, as are other amounts paid to affiliates or related parties. [AAG-INV 7.118]

The additional presentation and disclosure requirements for fee reductions under Topic 946 are summarized in the following table.

Area	Primary implication of Topic 946	Reference
Fee waivers	Presented and disclosed in the statement of operations, financial highlights and the notes to the financial statements.	Section 5.3.10
Expense limitation agreements	In certain circumstances, liability recognized for the repayment of excess expenses to the investment adviser.	Section 5.3.20
Expense offset arrangements	Presented and disclosed in the statement of operations, financial highlights and the notes to the financial statements.	Section 5.3.30

5.3.10 Fee waivers

Excerpt from ASC 946-20

> Fee Waivers

05-11 An adviser or a third party may voluntarily or involuntarily waive its fee and reimburse expenses (waivers). An example of an involuntary waiver is when the advisory agreement (or other regulation or agreements that are either outside the adviser's control or require shareholder approval) provides that the adviser should reimburse the investment company for expenses in excess of a specified percentage of average net assets.

> Fee Waivers

50-7 All voluntary and involuntary fee waivers shall be disclosed on the face of the statement of operations as a reduction of total expenses. The expense ratio in the financial highlights shall be shown net of voluntary and involuntary waivers. The effect of only voluntary waivers on the expense ratio shall be disclosed (either as the basis point effect on the ratio or as the gross expense ratio) in a note to, or as part of, the financial highlights. In addition, the terms of all voluntary and involuntary waivers shall be disclosed in the notes to financial statements.

Excerpt from ASC 946-205

> Financial Highlights

• > Ratios

50-15 Additionally, for the expense ratio, disclosure shall be made of the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 946-20-50-7, and of expense offsets, as described in paragraphs 946-20-45-3 and 946-20-45-5. Agreements to waive a portion or all of certain fees to a specific investor, which do not relate to the share class as a whole, do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements shall disclose that an individual investor's ratio may vary from those ratios.

Question 5.3.10 What are fee waivers?

Interpretive response: Fee waivers are arrangements in which the investment adviser (or other service provider) either:

- waives fees owed by the investment company; or
- reimburses other expenses of the investment company.

Fee waivers can be either:

- voluntary (i.e. the investment adviser elects to waive the fee); or
- involuntary (i.e. the investment adviser is contractually obligated by the investment advisory agreement, regulations, or other agreements that are either outside the adviser’s control or require shareholder approval).

A common involuntary fee waiver occurs when the investment advisory agreement provides that the investment adviser should reimburse the investment company for expenses in excess of a specified percentage of average net assets. [946-20-05-11]

Question 5.3.20 How are fee waivers presented and disclosed?

Interpretive response: Fee waivers are presented and disclosed in the following sections of an investment company’s financial statements depending on whether the fee waivers are voluntary or involuntary (see Question 5.3.10). [946-20-50-7]

Section	Presentation and disclosure	Voluntary	Involuntary
Statement of operations (see section 8.2.30)	Fee waivers are presented as a reduction of total expenses (i.e. expenses are shown gross and net of fee waivers).	✓	✓
Financial highlights (see section 8.3.30)	The expense ratio is presented net of fee waivers, but the effect is included either in a note to the financial highlights (i.e. basis point effect on the expense ratio is disclosed) or as part of the financial highlights (i.e. expense ratio is shown gross and net of fee waivers).	✓	
Notes to the financial statements	The terms of fee waivers are disclosed.	✓	✓

Question 5.3.30 Is a partial fee waiver presented and disclosed in the financial statements?

Background: An investment adviser may voluntarily reduce the advisory fees that it charges to an investment company (e.g. reducing management fee from 2% to 1% of average net assets).

Interpretive response: Yes. An investment company discloses in its expense ratios, the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole. The expenses used to compute those ratios follows the presentation of expenses in the statement of operations.

Accordingly, we believe a partial waiver of fees is presented and disclosed in the financial statements, including financial highlights (see Question 5.3.20).
[946-205-50-14 – 50-15]

Question 5.3.40 Is a fee waiver for a specific investor presented and disclosed in the financial statements?

Background: An investment adviser may voluntarily enter into a side-letter agreement with a specific investor that reduces or waives the advisory fees the adviser charges to an investment company as it relates to that investor's portion of ownership in the investment company (e.g. reducing management fee from 2% to 1% of average net assets owned by the specific investor).

Interpretive response: Generally no. An investment company discloses the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole (see Question 5.3.30). Accordingly, we believe an agreement to waive a portion or all of certain fees to a specific investor, which do not relate to a class as a whole, does not require disclosure in the financial statement statements, including financial highlights. However, an investment company discloses that an individual investor's expense ratio may vary from the ratios calculated for each reporting class taken as a whole. [946-205-50-15]

Additionally, if the specific investors are related parties to the investment company or its investment adviser, it may be necessary to disclose information about the fee waivers under Topic 850 (related party disclosures) so that users of the financial statements can evaluate their significance. [850-10-10-1]

Example 5.3.10 Application of fee waiver guidance

ABC Fund, a limited partnership, is customarily charged a management fee calculated monthly at an annual rate of 1.5% of each limited partner's capital account balance. ABC is a nonregistered open-end fund and there are no restrictions on redemptions for all limited partners.

Scenario 1: Side letter with a single investor

During the reporting period, ABC Fund and its investment adviser enter into a side letter agreement with Investor A, an unrelated new investor, that states Investor A is not charged a management fee for the first year of its investment in ABC Fund. Investor A's ownership interest in ABC Fund is held through the same class as the other limited partners.

ABC Fund does not disclose the reduction in management fees in the statement of operations, the financial highlights or the notes to the financial statements because the reduction in fees does not relate to the class as a whole.

Scenario 2: Reduction in fee rates

During the reporting period, the investment adviser of ABC Fund voluntarily reduces the management fee percentage rate to 0.75% for all limited partners for one year.

ABC Fund discloses the gross and net effects of the reduction in management fees in the statement of operations because the reduction in fees relates to the class as a whole. The effect on the expense ratio is disclosed in the financial highlights because the fee waiver was voluntary. ABC Fund also discloses the terms of the fee waivers.

Question 5.3.50 Are management fee reductions for other services considered fee waivers?

Background: Investment advisory agreements for certain nonregistered funds (e.g. private equity funds) include terms in which the management fee charged to the fund is reduced by all or a portion of fee income earned by the investment adviser for other services provided to the portfolio company investments of the fund (e.g. monitoring fees).

Interpretive response: No. Fee waivers are arrangements in which the investment adviser waives fees owed by the investment company (see

Question 5.3.10). When a management fee is reduced for other services provided by the investment adviser, we do not believe these reductions are fee waivers since the adviser was not contractually entitled to receive such amounts from the fund. These reductions represent a contractual component of the management fee calculation and not a waiver of fees owed by the fund. The substance of this arrangement is providing a discount to the management fee because of multiple services being performed by the investment adviser.

However, when the investment adviser is a related party to the fund and is receiving fee income for other services provided to portfolio company investments of the fund, we believe it is necessary to disclose information about these other services under Topic 850 (related party disclosures) so that financial statement users are informed of such arrangements and can evaluate their significance. [850-10-10-1]

Question 5.3.60 Are management fee reductions for capital contributions considered fee waivers?

Background: Investment advisory agreements for certain nonregistered funds (e.g. private equity funds structured as limited partnerships) include terms in which the management fee charged to the fund is reduced through an offset of amounts owed by the investment adviser for its capital contribution commitment to the fund. These offsets are typically at the discretion of the investment adviser.

Interpretive response: Yes. Fee waivers are arrangements in which the investment adviser waives fees owed by the investment company (see Question 5.3.10). When a management fee is reduced through an offset of amounts owed by the investment adviser for its capital contribution commitment to the fund, we believe these reductions are fee waivers since the adviser was contractually entitled to receive such amounts from the fund. These reductions are a voluntary partial waiver of fees, which are presented and disclosed in the financial statements (see Question 5.3.30).

The capital contribution commitment of the investment adviser may be recognized through an allocation in the statement of changes in partners' capital. However, we believe such amounts should be separately presented from any fees for advisory services accounted for as an allocation of income (see Question 5.2.10).

5.3.20 Expense limitation agreements

Excerpt from ASC 946-20

> Expense Limitation Agreements

05-8 Some expense limitation agreements may provide that reimbursements by the fund adviser of expenses incurred by the fund in excess of the maximum permitted by the prospectus or offering document will be carried over to a future period and reimbursed to the fund adviser when, and to the extent that, the total expense ratio falls below the permitted maximum. Such agreements may provide that reimbursement of excess expenses to the fund adviser is not required after a specified date or upon conclusion of a specified period from the time the fund initially incurred, or the adviser initially reimbursed, the expenses, such as three years. Under most excess expense plans, a fund is obligated to repay a servicer for expenses incurred previously only if, during a defined period, the fund retains the service provider and can reduce its expense ratio to a low enough level to permit payment, and maintain that ratio at a sufficiently low level thereafter. Many substantive conditions could cause the fund to have no obligation to the servicer, including failure to attract assets, significant redemptions of shares by investors, market depreciation, and significant increases in other expenses, all of which could drive expenses up to or beyond the maximum under which payment would otherwise be made.

> Expense Limitation Agreements

25-4 A liability for excess expenses shall be recognized if, and to the extent that, the expense limitation agreement's established terms for repayment of the excess expenses to the adviser by the fund and the attendant circumstances meet all of the following criteria:

a. The excess expense or expenses embody a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.
b. The duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice.
c. The transaction or other event obligating the entity has already happened.
d. The guidance in paragraph 450-20-25-2.

In most instances, a liability will not be recorded because it is not likely that excess expenses under such plans will meet those criteria before amounts are actually due to the adviser under the reimbursement agreement. If an assessment of the specific circumstances (such as an agreement to reimburse for either an unlimited period or a period substantially greater than that necessary for the fund to demonstrate its economic viability or an obligation to reimburse the servicer remains even after the cancellation of the fund's contract with the servicer) indicates that those criteria are met, a liability shall be recorded.

> Expense Limitation Agreements

50-6 The existence of reimbursement agreements and the carryover of excess expenses potentially reimbursable to the adviser but not recorded as a liability shall be disclosed in the notes to financial statements.

Excerpt from ASC 450-20

> General Rule

25-2 An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
b. The amount of loss can be reasonably estimated.

The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. Paragraphs 450-20-55-1 through 55-17 and Examples 1–2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of the conditions. As discussed in paragraph 450-20-50-5, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.

> Assessing Probability of Incurrence of a Loss

25-3 The conditions in the preceding paragraph are not intended to be so rigid that they require virtual certainty before a loss is accrued. Instead, the condition in (a) in the preceding paragraph is intended to proscribe accrual of losses that relate to future periods.

> Assessing Whether a Loss Is Reasonably Estimable

25-4 The condition in paragraph 450-20-25-2(b) is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements.

25-5 That requirement shall not delay accrual of a loss until only a single amount can be reasonably estimated. To the contrary, when the condition in paragraph 450-20-25-2(a) is met and information available indicates that the estimated amount of loss is within a range of amounts, it follows that some amount of loss has occurred and can be reasonably estimated. Thus, when the condition in paragraph 450-20-25-2(a) is met with respect to a particular loss contingency and the reasonable estimate of the loss is a range, the condition in paragraph 450-20-25-2(b) is met and an amount shall be accrued for the loss.

> General

30-1 If some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount. Examples 1-2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of these initial measurement standards.

Question 5.3.70 What are expense limitation agreements?

Interpretive response: Expense limitation agreements between the investment company and the investment adviser (or other service provider) limit the expenses that can be paid by the investment company. If fee waivers or reimbursements by the investment adviser of expenses incurred by the investment company exceed the maximum permitted by the prospectus, offering memorandum or other governing documents, the excess may be carried over to a future period and reimbursed to the investment adviser when, and to the extent that, the total expense ratio falls below the permitted maximum. [946-20-05-8, AAG-INV 8.06]

Such agreements may provide that reimbursement of excess expenses to the investment adviser is not required after either:

- a specified date; or
- a specified period from the time the investment company initially incurred (or the investment adviser initially reimbursed) the expenses (e.g. three years).

Under most excess expense plans, an investment company is obligated to repay the investment adviser for expenses incurred previously only if the investment company: [946-20-05-8]

- retains the investment adviser;
- reduces its expense ratio to a low enough level to permit payment; and
- maintains that ratio at a sufficiently low level thereafter.

Typically, one condition attached to these arrangements is that the investment company agrees to repay the investment adviser (without interest) if, and to the extent that, the investment company's net assets increase sufficiently to permit such payments without exceeding the stated percentage in the expense limitation agreement. Also, typically these agreements:

- are terminable on short notice by either party without a penalty;
- have a fixed expiration date; and
- give the investment adviser no claim against the investment company for any amounts not reimbursed upon termination or expiration.

The economic result of these agreements is to defer payment of the expenses until the investment company is financially able to bear them or, upon termination or expiration, to eliminate them entirely. [AAG-INV 8.07]

Question 5.3.80 Are costs incurred in excess of expense limitation agreements recognized as liabilities?

Interpretive response: It depends. An investment company recognizes a liability for excess expenses to the extent that the expense limitation agreement's established terms for repayment of the excess expenses to the investment adviser and the attendant circumstances meet all of the following criteria. [946-20-25-4]

- The excess expenses embody a present duty or responsibility to the investment adviser that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand (see Question 5.3.90).
- The duty or responsibility for the excess expenses obligates the investment company, leaving it little or no discretion to avoid the future sacrifice (see Question 5.3.100).
- The transaction or other event for the excess expenses has already happened (see Question 5.3.110).
- Information available before the financial statements are issued or are available to be issued indicates that it is probable a liability for excess expenses has been incurred at the date of the financial statements (see Question 5.3.120). [450-20-25-2(a)]
- The amount of the excess expenses can be reasonably estimated (see Question 5.3.130). [450-20-25-2(b)]

In most circumstances, a liability is not recognized because it is not likely that excess expenses under such reimbursement agreements will meet these criteria before amounts are actually due to the investment adviser. Many substantive conditions could cause the investment company to have no obligation to the investment adviser, including: [946-20-05-8]

- failure to attract assets;
- significant redemptions of shares by investors;
- market depreciation; and
- significant increases in other expenses.

Such conditions could drive expenses up to or beyond the maximum under which payment to the investment adviser would otherwise be made.

However, the above criteria may be met under certain circumstances, in which case a liability for excess expenses is recognized. Examples of such circumstances include: [946-20-25-4]

- an agreement to reimburse for either an unlimited period or a period substantially greater than that necessary for the investment company to demonstrate its economic viability; and
- an obligation to reimburse remains even after the cancellation of the agreement.

Actual reimbursement of some expenses does not establish the appropriateness of accrual of additional unreimbursed amounts because conditions must continually be met for the investment company to be further obligated to the investment adviser. [AAG-INV 8.11]

Question 5.3.90 How is the probability determined when recognizing a liability for expense limitation agreements?

Interpretive response: An investment company recognizes a liability for excess expenses if it determines that the excess expenses will be settled by a probable future transfer or use of assets (see Question 5.3.80). We believe an investment company should use Topic 450 (contingencies) when defining 'probable' and recognize a liability when the future event or events are likely to occur. While the probable standard is understood to generally be quite high, this condition is not intended to be so rigid that it requires virtual certainty before an expense is accrued. Instead, this is intended to proscribe accrual of expenses that relate to future periods. [946-20-25-4(a), 450-20 Glossary, 450-20-25-3]

We believe the probable determination can be met when there are multiple scenarios in which the excess expenses are probable of being paid. One such instance may occur when an investment company has an agreement with its investment adviser to reimburse offering costs if certain conditions were met or upon liquidation of the investment company. While it may not be probable that the investment company will be successful in its offering to meet those conditions, the investment company would likely liquidate if unsuccessful. As a result, there is no scenario in which the investment company could avoid paying the organization costs. It would either pay the organization costs if the offering conditions were met or it would pay them upon its liquidation. In this circumstance, the probable determination has been met.

Question 5.3.100 How is the duty or responsibility determined when recognizing a liability for expense limitation agreements?

Interpretive response: An investment company recognizes a liability for excess expenses if it determines that a duty or responsibility for payment of the excess expenses obligates it to the investment adviser (see Question 5.3.80). We believe this is a legal determination based upon the terms of the contract with the investment adviser. For example, an investment adviser may contract with a third party on its own behalf to provide legal services that indirectly benefit the investment company. In this circumstance, the investment company is not directly obligated to the third party. However, if the terms of the expense limitation agreement obligate the investment company to reimburse the investment adviser for these legal services, the duty or responsibility determination has been met. [946-20-25-4(b)]

Question 5.3.110 How is the transaction or other event determined when recognizing a liability for expense limitation agreements?

Interpretive response: An investment company recognizes a liability for excess expenses if the transaction or other event creating the excess expenses has already happened (see Question 5.3.80). For example, an investment company may contract with a third party to provide placement services that are subject to an expense limitation agreement with the investment adviser. The investment company would not accrue a liability before the transaction or other event has occurred (i.e. the purchase of an ownership interest by an investor subject to the placement services). [946-20-25-4(c)]

Question 5.3.120 How is the date of accrual determined when recognizing a liability for expense limitation agreements?

Interpretive response: An investment company recognizes a liability for excess expenses if information available before the financial statements are issued or are available to be issued indicates that it is probable a liability for excess expenses has been incurred at the date of the financial statements (see Question 5.3.80). The date of the financial statements is the end of the most recent accounting period for which financial statements are being presented. Implicit in this condition is that it must be probable one or more future events will occur confirming the fact of the loss. [946-20-25-4(d), 450-20-25-2(a)]

For example, an investment company may enter into an expense limitation agreement with its investment adviser for two years to reimburse organization costs subject to certain maximum expense thresholds. If the reimbursement threshold was not met until Year 2, the investment company would not recognize any excess organization costs in Year 1 if those financial statements were already issued. Instead, the investment company would recognize the excess organization costs at the end of the most recent accounting period for which financial statements are being presented (i.e. Year 2).

Question 5.3.130 How is a reasonable estimate determined when recognizing a liability for an expense limitation agreement?

Interpretive response: An investment company recognizes a liability for excess expenses if the amount can be reasonably estimated (see Question 5.3.80). This condition is intended to prevent accrual in the financial statements of amounts so uncertain as to impair the integrity of those statements. However, this requirement does not delay accrual of an expense until only a single amount can be reasonably estimated. To the contrary, when this condition is met and information available indicates that the estimated amount of expense is within a range of amounts, it follows that some amount of expense has been incurred and can be reasonably estimated. An investment company accrues the amount within the range that is the best estimate of the liability for excess expenses. When no amount within the range is a better estimate than any other amount, the minimum amount in the range is accrued. [946-20-25-4(d), 450-20-25-2(b), 25-4 – 25-5, 30-1]

For example, an investment company may enter into an expense limitation agreement with its investment adviser subject to certain NAV thresholds. In this circumstance, the investment company would need to estimate its NAV in future periods to estimate the liability for excess expenses. Any such estimate would generally not be considered reasonable due to the uncertainty of future market conditions that impact the fair value of investments in determining NAV. When the reasonable estimate criterion is not met, an investment company does not recognize a liability for excess expenses.

Question 5.3.140 Does the duration of expense limitation agreements affect the probability assessment?

Background: Some expense limitation agreements may provide that reimbursement of excess expenses to the investment adviser is not required after a specified date or upon conclusion of a specified period from the time the investment company initially incurred (or the investment adviser initially reimbursed) the expenses (i.e. the recapture period). [946-20-05-8]

Interpretive response: Yes. The duration of an expense limitation agreement is a consideration in determining whether it is probable that a liability for excess expenses has been incurred. Generally, we believe the longer the duration of the agreement, the higher the likelihood of a reimbursement of excess expenses.

The SEC staff generally has not objected to an accounting analysis concluding that the recapture of waived fees or reimbursements does not meet the criteria for accruing a liability if there is no evidence that such recapture is probable and the recapture period is limited to a sufficiently short period of time (which the staff generally believes is three years or less for registered funds). However, an investment company does not accrue a liability based solely on the recapture period. An investment company must also assess the probability of the investment adviser's ability to recover excess waived or reimbursed amounts during the limited recapture period. This evaluation is updated if relevant facts and circumstances change throughout the duration of the expense limitation agreement.

Also, when a registered fund increases its previously defined expense limitation thresholds, the SEC staff does not believe it is appropriate to recapture expenses above the expense limitation threshold under which the expenses were originally waived. [946-20-25-4, IM-DCFO 1995-09]

Question 5.3.150 How are expense limitation agreements presented and disclosed?

Interpretive response: The existence of expense limitation agreements and the carryover of excess expenses potentially reimbursable to the investment adviser but not recognized as a liability are disclosed in the notes to the financial statements. [946-20-50-6]

We believe any fee waivers or reimbursements under an expense limitation agreement are involuntary fee waivers. Such waivers are presented as a reduction of total expenses in the statement of operations, and the terms are disclosed in the notes to the financial statements (see Question 5.3.20). However, some registered funds voluntarily disclose the effect in the expense ratio or in a note to the financial highlights.

5.3.30 Expense offset arrangements

Excerpt from ASC 946-20

> Brokerage Service Arrangements

05-9 An investment company may have a brokerage service arrangement with a broker-dealer or an affiliate of a broker-dealer under which the broker-dealer (or its affiliate), in connection with the investment company's brokerage transactions directed to the broker-dealer, provides or pays for services to the investment company (other than brokerage and research services as those terms are used in section 28(e) of the Securities Exchange Act of 1934).

> Brokerage Service Arrangements

45-3 The relevant expense caption on the statement of operations and the expense ratio in the financial highlights shall include the amount that would have been incurred by the investment company for brokerage services had it paid for the services directly in an arm's-length transaction. Such amounts shall also be shown as a corresponding reduction in total expenses, captioned as fees paid indirectly.

> Expense Offset Arrangements

45-5 Expense offset arrangements, under which a third party explicitly reduces its fees by a specified or readily ascertainable amount for services provided to the investment company in exchange for use of the investment company's assets, shall be presented in the statement of operations, the expense ratio in the financial highlights, and notes to financial statements in the same manner as brokerage service arrangements.

Question 5.3.160 What are expense offset arrangements?

Interpretive response: Under an expense offset arrangement a third party (e.g. investment adviser or broker-dealer) explicitly reduces its fees by a specified or readily ascertainable amount for services provided to the investment company in exchange for use of the investment company's assets. [946-20-45-5]

A brokerage service arrangement is a specific type of expense offset arrangement in which the broker-dealer (or an affiliate of a broker-dealer) provides or pays for services (see Question 5.3.170) to the investment company in connection with the investment company's brokerage transactions directed to the broker-dealer. [946-20-05-9]

Question 5.3.170 Are all services considered to be under a brokerage service arrangement?

Interpretive response: No. Brokerage and research services as defined in Section 28(e) of the Securities Exchange Act of 1934 are not accounted for as a brokerage service arrangement. Section 28(e) provides a safe harbor for breaches of fiduciary duty if investment advisers pay more than the lowest commission rate for brokerage and research services, provided they determine in good faith that the commission is reasonable in relation to the value of these services. This practice is often referred to as a 'soft dollar arrangement'. The assessment of which services qualify for the Section 28(e) exception is a legal determination. All other services are considered to be under a brokerage service arrangement. [946-20-05-9]

Question 5.3.180 How are expense offset arrangements and brokerage service arrangements presented and disclosed?

Interpretive response: Expense offset arrangements and brokerage service arrangements are presented and disclosed in the following sections of the financial statements of an investment company. [946-20-45-3, 45-5]

Section	Presentation and disclosure	Expense offset arrangements	Brokerage service arrangements
Statement of operations (see section 8.2.30)	The relevant expense caption includes the amount that would have been incurred had the expenses been paid directly in an arm's-length transaction. Such amounts are shown as a corresponding reduction in total expenses (e.g. 'fees paid indirectly').	✓	✓

Section	Presentation and disclosure	Expense offset arrangements	Brokerage service arrangements
Financial highlights (see section 8.3.30)	The expenses used to compute the expense ratio follows the presentation of expenses in the statement of operations (i.e. expenses are shown gross and net of arrangements).	✓	✓
Notes to the financial statements	The nature of the arrangements is disclosed.	✓	✓

Question 5.3.190 Can a registered fund consider materiality when presenting and disclosing expense offset arrangements and brokerage service arrangements?

Interpretive response: No. The SEC staff has emphasized S-X Rule 6-07 requires grossing up expenses regardless of materiality (see Question 5.3.180). However, the SEC staff would not object if an investment company that has grossed-up its expenses in the statement of operations omits the expense offset line if the rounded amount is zero. Under these circumstances, the investment company discloses the existence of the arrangements and the total amount of the expenses that were paid under expense offset arrangements and brokerage service arrangements. [IM-DCFO 1998-06, S-X Rule 6-07]

5.4 Payments by affiliates and other investment adviser transactions

Excerpt from ASC 946-20

> Payments by Affiliates

05-2 Affiliates may make payments to a fund related to investment losses for either of the following reasons:

a. Payments by affiliates. To reimburse the effect of a loss (realized or unrealized) on a portfolio investment, often caused by a situation outside the fund's, or its affiliates', direct control, such as an issuer default or a decline in **fair value**.
b. Investment restriction violations (investments not meeting investment guidelines). Occasionally, a fund adviser may purchase an investment for a fund that clearly violates the fund's investment restrictions (investment restrictions are described in the prospectus or statement of additional

information for registered funds and in partnership agreements or offering memorandums for nonregistered funds). The investment held in violation of the fund's investment restrictions may appreciate or depreciate in value. In the case where the investment has depreciated in value and the fund has consequently incurred a loss, the fund adviser may make a payment to the fund in lieu of settlement of a potential claim resulting from the violation of the fund’s investment restrictions. This payment, in effect, makes the fund whole relative to the loss that it has incurred. This type of transaction is in essence a payment to put the fund’s shareholders in the position they would have been in had the violation not occurred.

05-3 Payments by affiliates may take several forms, such as any of the following:

a. A direct cash contribution to the fund to offset the effect of a realized loss on a portfolio investment
b. Purchase of securities from the fund at prices in excess of the securities' current fair value
c. Provision of a credit enhancement to maintain the investment’s value.

> Portfolio Insurance

05-12 Many municipal bond funds, primarily those organized as unit investment trusts with fixed portfolios, arrange for insurance for the payment of principal and interest when due. The insurance applies to portfolio securities only while they are owned by the fund, and its coverage is not transferable to buyers of the securities. That arrangement differs from those in which the issuer of the securities acquires the insurance, making the insurance feature an element of the securities and transferable on changes in ownership.

> Payments by Affiliates

25-2 A credit enhancement provided by an affiliate to maintain an investment's value shall be recognized when the enhancement becomes available to the fund.

> Portfolio Insurance

25-11 If insurance applies only to the fund's portfolio, it does not have a measurable **fair value** in the absence of default of the underlying securities or of indications of the probability of default and, accordingly, the cost of the policy should be treated as an operating expense.

> Payments by Affiliates

30-1 The amount of the payment from a credit enhancement to maintain the investment’s value shall be measured initially by the cost of obtaining a similar enhancement in an arm's-length transaction.

> Payments by Affiliates

35-1 Any subsequent change in the value of a credit enhancement to maintain the investment’s value shall be accounted for as unrealized appreciation or depreciation.

> Payments by Affiliates

45-1 Payments made by affiliates for the two reasons in paragraph 946-20-05-2 shall be combined and reported as a separate line item entitled net increase from payments by affiliates and net gains (losses) realized on the disposal of investments in violation of restrictions in the statement of operations as part of net realized and unrealized gains (losses) from investments and foreign currency. That separate line item would comprise amounts related to all of the following:

a. Voluntary reimbursements by the affiliate for investment transaction losses
b. Realized and unrealized losses on investments not meeting the investment guidelines of the fund
c. Reimbursements from the affiliate for losses on investments not meeting the investment guidelines of the fund
d. Realized and unrealized gains on investments not meeting the investment guidelines of the fund.

> Payments by Affiliates

50-2 The amounts and circumstances of payments by affiliates to reimburse the fund for losses on investment transactions shall be described in the notes to financial statements. The gains and losses on investments not meeting investment guidelines of the fund shall also be disclosed in the notes to financial statements. In addition, the effect on total return of the payments, as well as any gains or losses on investments not meeting investment guidelines of the fund, shall be quantified and disclosed in the financial highlights in a manner similar to disclosure of the effect of voluntary waivers of fees and expenses on expense ratios. (See Subtopic 850-10.) Total return shall be presented in the financial highlights.

• > Example 1: Disclosure of Payments by Affiliates

55-1 This Example illustrates application of the guidance in paragraph 946-20-50-2. An entity might disclose the following.

> In 20XX, a.aa% of the fund's total return consists of a voluntary reimbursement by the adviser for a realized investment loss, and another b.bb% consists of a gain on an investment not meeting the fund's investment restrictions. Excluding these items, total return would have been c.cc%. Additionally, the adviser fully reimbursed the fund for a loss on a transaction not meeting the fund's investment guidelines, which otherwise would have reduced total return by d.dd%.

Excerpt from ASC 946-210

> Credit Enhancements

45-8 Credit enhancements shall be shown as a component of the security description in the schedule of investments.

> Credit Enhancements

50-11 The terms, conditions, and other arrangements relating to a credit enhancement shall be disclosed in the notes to financial statements.

50-12 For a put option provided by an affiliate, the schedule of investments shall describe the put as from an affiliate and the notes to financial statements shall include the name and relationship of the affiliate.

50-13 For a letter of credit, the name of the entity issuing the letter of credit shall be disclosed separately.

An investment company may receive payments from an affiliated entity (such as an investment adviser or a sponsor) related to investment losses incurred from situations outside the control of the investment company or violations of the investment restrictions described in the prospectus, offering memorandum or other governing documents of the investment company. These payments by affiliates may be in the form of a cash contribution to the investment company, a purchase of investments from the investment company in excess of their current fair values, or the provision of a credit enhancement to maintain the investment's value. [946-20-05-3]

An investment adviser may make these payments to maintain its service relationship with the investment company or to make the investment company whole as if the loss had not occurred (e.g. in lieu of settlement of a potential claim).

Question 5.4.10 How are payments by affiliates to reimburse investment losses accounted for?

Interpretive response: Subtopic 946-20 specifically discusses circumstances in which an affiliate may make payments to reimburse an investment company related to investment losses for either of the following reasons: [946-20-05-2]

- losses from a portfolio investment resulting from situations outside the control of the investment company or its affiliates (e.g. default of an issuer or declines in fair value of investments); or
- losses from a portfolio investment that was acquired in violation of the investment restrictions of the investment company (e.g. violations resulting from style drift).

Because the payments by affiliates for those two reasons are ordinarily made to preserve the affiliate's service relationship with the investment company, the investment company reports them as gains in the current period, even if the related losses were incurred in a prior period. We believe an investment company should account for payments received by other service providers (such as sub-advisers) in the same manner. [946-20-45-1, AAG-INV 7.139 – 7.140]

Payments from affiliates for reasons other than to reimburse the investment company for losses as described above are evaluated to determine whether they are capital transactions, and therefore not reflected in the statement of operations (see Question 5.4.20). [AAG-INV 7.143]

Question 5.4.20 How are payments by affiliates for reasons other than to reimburse investment losses accounted for?

Interpretive response: When an investment company receives a payment from an affiliate that is not related to investment losses for the reasons specified in Subtopic 946-20 (see Question 5.4.10), it evaluates the nature of the payment to determine if it primarily arose from the affiliate's shareholder relationship or the service relationship. We believe this evaluation requires significant judgement.

Payments by affiliates that arose from a shareholder relationship

Payments by affiliates that arose from a shareholder relationship are intended to enhance or maintain the value of the affiliate's equity investment in the investment company, and therefore are accounted for on the statement of changes in net assets as a capital contribution. [AAG-INV 7.139, SAB Topic 5.T]

An indicative factor that a payment primarily arose from a shareholder relationship is that the transaction was structured to provide a direct or indirect benefit to the investment company. Another indicative factor involves the significance of the ownership interests. We believe the greater the significance of the ownership interests of the affiliate, the more likely that the payments are attributable to a shareholder relationship.

Payments by affiliates that arose from a service relationship

Payments by affiliates that arose from a service relationship (i.e. as the investment adviser) are intended to maintain or preserve the affiliate's service relationship with the investment company and typically do not enhance the value of the affiliate's equity investment in the investment company beyond a pro rata interest in the payment itself. We believe such payments should be accounted for in the statement of operations. [AAG-INV 7.139]

Payments that primarily arose from a service relationship include those based on transactions that:

- are caused by a relationship or obligation unrelated to an affiliate's shareholder relationship; or
- do not provide a clear benefit to the investment company.

Disclosures for payments by affiliates

Regardless of the type of payment received, we believe an investment company should disclose the payments received in the respective financial statements, the impact on the total return relating to such items in the financial highlights, and the reasons why such payments were made (see Question 5.4.50). [AAG-INV 7.143]

Question 5.4.30 How are investment credit enhancements provided by affiliates accounted for?

Background: A credit enhancement may be provided by an investment adviser (or other affiliate) to maintain the value of an investment, creating an enhanced security. Common forms of credit enhancements include put options and letters of credit, which are often non-transferrable and expire at or prior to the maturity date of the enhanced security. [IM-DCFO 1995-02]

Interpretive response: A credit enhancement provided by an affiliate to maintain the value of an investment is recognized when the enhancement becomes available to the investment company. The credit enhancement is initially measured by the cost of obtaining a similar enhancement in an arm's-length transaction. We believe an investment company should evaluate whether the substance of the credit enhancement primarily arose from the affiliate's shareholder relationship or service relationship and recognize the enhancement accordingly in either the statement of changes in net assets or the statement of operations (see Question 5.4.20). Any subsequent change in the value of the credit enhancement is accounted for as unrealized appreciation or depreciation, regardless of why the enhancement arose. [946-20-25-2, 30-1, 35-1]

Presentation and disclosures for credit enhancements

Credit enhancements are shown as a component of the security description in the schedule of investments. For a put option provided by an affiliate, the schedule of investments describes the put as from an affiliate. [946-210-45-8, 50-12]

The terms, conditions and other arrangements relating to a credit enhancement are disclosed in the notes to the financial statements. For a put option provided by an affiliate, the name and relationship of the affiliate are disclosed. For a letter of credit, the name of the entity issuing the letter of credit is disclosed. [946-210-50-11 – 50-13]

For registered funds, the SEC staff believes the following components of an enhanced security should be valued and presented separately when the credit enhancements are non-transferrable: [IM-DCFO 1995-03]

- the value of the security without the enhancement; and
- the value of the credit enhancement (i.e. the difference between the fair value of the enhanced security and the value of the security without the enhancement).

If the credit enhancement is transferrable, separate valuation and presentation of the components of an enhanced security are not required. [IM-DCFO 1995-04]

Question 5.4.40 Is insurance coverage for an investment portfolio accounted for as a credit enhancement?

Background: Some investment companies with fixed income investment portfolios obtain insurance coverage to guarantee the payment of principal and interest when the amounts become due. Generally, such insurance coverage applies to portfolio investments while they are owned by the investment company and does not transfer when the investments are sold. In other instances, the issuer of the securities obtains the insurance coverage and the insurance feature is transferable upon changes in ownership. [946-20-05-12]

Interpretive response: It depends. If such insurance coverage is not transferrable (i.e. it applies only while the investment portfolio is owned by the investment company), the portfolio insurance does not have a stand-alone fair value absent a default of the underlying investments. Therefore, the cost of the insurance policy is recognized as an operating expense by the investment company. [946-20-25-11]

However, if the insurance coverage is transferrable, we believe the insurance feature is an element of the covered investments that is factored into their fair value. [946-20-05-12]

Question 5.4.50 How are payments by affiliates to reimburse investment losses presented and disclosed?

Interpretive response: Payments by affiliates for investment losses are presented and disclosed in the following sections of the financial statements of an investment company. [946-20-45-1, 50-2, 55-1]

Section	Presentation and disclosure
Statement of operations (see section 8.2)	Payments by affiliates are combined and reported as a separate line item entitled 'Net increase from payments by affiliates and net gains (losses) realized on the disposal of investments in violation of restrictions' as part of net realized and unrealized gains (losses) from investments and foreign currency.[1]
Financial highlights (see section 8.3)	The effect on total return of both the payments by affiliates and any gains or losses on investments not meeting investment guidelines of the investment company are presented and disclosed. Total return is presented net of the effect, but the effect is included either in a note to the financial highlights (i.e. basis point effect on the total return is disclosed) or as part of the financial highlights (i.e. total return is shown gross and net of the effect).[2]
Notes to the financial statements (see section 9.5)	The amounts and circumstances of payments by affiliates are disclosed. In addition, the gains and losses on investments not meeting investment guidelines of the investment company are disclosed.

Notes:

1. The separate line item would comprise amounts related to all of the following:
   - voluntary reimbursements by the affiliate for investment transaction losses;
   - realized and unrealized losses on investments not meeting the investment guidelines of the investment company;
   - reimbursements from the affiliate for losses on investments not meeting the investment guidelines of the investment company; and

- realized and unrealized gains on investments not meeting the investment guidelines of the investment company.

2. The effects are quantified and disclosed in a manner similar to disclosure of the effect of voluntary waivers of fees and expenses on expense ratios (see Question 5.3.20).

6. Financial statements: General requirements

Detailed contents

6.1 How the standard works

Subtopic 946-205 addresses the overall financial statement presentation requirements for investment companies. It provides more detailed requirements specific to investment companies that modify what comprises a full set of financial statements, including financial highlights. The Subtopic also specifies the reporting periods for each of those statements.

There are also specific presentation rules for registered investment companies in Reg S-X.

The following table summarizes the required financial statements, the purpose of each of those statements, and the periods required to be presented for each of those statements when presenting annual financial statements. This chapter contains the details and special circumstances for presenting investment company financial statements.

Financial statement	Objective	Periods required
Reporting financial position		
Statement of assets and liabilities or **Statement of net assets**	Reports an investment company's financial position as of the reporting date	As of the end of the most recent fiscal year
Schedule of investments	Presents information about an investment company's investment portfolio as of the reporting date	For each statement of assets and liabilities presented
Reporting results of operations		
Statement of operations	Presents the results of the investment company's operating and investment activities including investment income from interest and dividends, expenses, and realized and unrealized gains or losses from investments	For the most recent fiscal year
Financial highlights	Provides information to help understand an investment company's financial performance during the period(s) presented	For the latest five fiscal years (only the most recent fiscal year for nonregistered funds)
Other reporting		
Statement of cash flows	Provides relevant information about the cash inflows and outflows of an investment company during the period	For the most recent fiscal year
Statement of changes in net assets	Summarizes results from operations, dividends and distributions to shareholders, capital share transactions, and capital contributions during the period	For the two most recent fiscal years (only the most recent fiscal year for nonregistered funds)

6.2 Overview

Excerpt from ASC 946-205

05-1 This Subtopic addresses the presentation of financial statements for investment companies, including both of the following matters:

a. The statement of changes in net assets
b. Financial highlights.

The guidance in Topic 946 considers the specific needs of investors who generally focus on the composition and performance of an investment company's investments. For this reason, the financial statement requirements of investment companies differ in several respects from the requirements imposed on noninvestment companies under other US GAAP. These differences result in unique financial statement reporting by investment companies, including the reporting of their financial position and results of operations.

For all investment companies, Subtopic 946-205 provides a basis for the composition of a full set of financial statements, including the statements to be provided and the periods to be presented. The overall objective of an investment company's financial statements, including financial highlights, is to present net assets (i.e. financial position), results of operations, changes in net assets, and financial highlights resulting from investment activities and capital transactions. [946-205-05-1, 45-1]

Question 6.2.10 How do the financial statement presentation requirements in Topic 946 interact with other Topics?

Interpretive response: While Topic 946 provides accounting and reporting guidance specific to investment companies in its scope, these entities also are required to apply other Codification Topics to the extent applicable (see Question 2.2.10). [946-10-15-1]

The presentation Topics in the Codification (i.e. Topics 205 to 280) provide baseline requirements that apply to entities reporting under US GAAP, including investment companies in the scope of Topic 946. For additional discussion of the general requirements and practices from the presentation Topics, see KPMG Handbook, Financial statement presentation.

Topic 946 provides more detailed requirements specific to investment companies that modifies what comprises a full set of financial statements, including financial highlights (see Question 6.3.10), and provides incremental guidance for presentation (see chapters 7, 8 and 9).

Question 6.2.20 How does Subtopic 946-205 interact with SEC regulations and other guidance?

Interpretive response: The following table indicates the portions of Reg S-X that specify the types and contents of financial statements and schedules that registered investment companies are required to file with the SEC.

Reg S-X Article	Description
Article 3, General Instructions as to Financial Statements	Specifies the financial statements to be included in filings (but not the content)
Article 4, Rules of General Application	Contains general rules on topics such as materiality, the order of the statements and terminology usage. It also lists several items required to be disclosed in the notes to the financial statements.
Article 6, Registered Investment Companies and Business Development Companies	Contains specific rules that apply to registered investment companies regarding the content of financial statements and required schedules. To the extent that a rule in this Article contradicts rules in Articles 3 or 4, the rule in this Article applies. [S-X Rule 6-03]

The requirements in Article 6 regarding content of financial statements are in addition to the requirements in Subtopic 946-205 and other US GAAP. Further, Reg S-X requires supplemental schedules in support of certain captions presented in the statement of assets and liabilities (see section 7.5). These schedules are considered part of the financial statements and may be presented in a single schedule if the items pertaining to the reporting entity are separately shown and the schedule provides a properly summarized presentation of the facts.

See KPMG Handbook, Financial statement presentation, for additional guidance on general instructions and rules of general application under Reg S-X.

Question 6.2.30 Do the requirements under Article 5 of Reg S-X apply to registered funds?

Background: Article 5 of Reg S-X prescribes the minimum financial statement presentation and disclosure requirements for commercial and industrial registrants.

Interpretive response: No. Registered funds and BDCs are exempt from the requirements of Article 5 of Reg S-X. Instead, registered funds follow the financial statement requirements under Article 6 of Reg S-X, as explained in Question 6.2.20. [S-X Rules 5-01(a), 6-01]

6.3 Composition of financial statements

Excerpt from ASC 946-205

45-1 The overall objective of financial statements, including financial highlights, of investment companies is to present net assets, results of operations, changes in net assets, and financial highlights resulting from investment activities and, if applicable, from capital share transactions. In reporting to shareholders, investment companies and investment companies registered with the Securities and Exchange Commission (SEC) shall present financial statements and financial highlights as follows.

Nonregistered Investment Companies	Registered Investment Companies
A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein, as of the close of the latest period. At a minimum, a condensed schedule of investments (as discussed in paragraphs 946-210-50-4 through 50-10) should be provided for each statement of assets and liabilities.	A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein (that is, a detailed list of investments in securities, options written, securities sold short, and other investments) as of the close of the latest period.[b] A schedule of investments should be provided for each statement of assets and liabilities in conformity with SEC Regulation S-X, Rule 12-12 or 12-12C[a].
A statement of operations for the latest period.	A statement of operations for the latest year.[b], [c]
A statement of cash flows for the latest period (if not exempted by Subtopic 230-10).	A statement of cash flows for the latest year (if not exempted by Subtopic 230-10).[b], [c]
A statement of changes in net assets for the latest period.	A statement of changes in net assets for the latest two years (for semiannual reports, the most recent semiannual period and preceding fiscal year). [b], [c]
Financial highlights for the latest period consisting of per share operating performance, net investment income, and expense ratios and total return for all investment companies organized in a manner using unitized net asset value.[d]	Financial highlights for the latest five fiscal years [b], [c], [e] (for semiannual reports, the semiannual period and generally the preceding five fiscal years).

(a) In 2004, the SEC adopted rule and form amendments that among other matters amended Article 6 and Article 12 of SEC Regulation S-X to permit a registered management investment company to include, under Regulation S-X, Rule 12-12C, a summary schedule of investments in securities of unaffiliated issuers in its reports to shareholders, provided that the complete portfolio schedule required by Rule 12-12 is filed with the Securities and Exchange Commission semi-annually and is provided to shareholders upon request free of charge. All other complete portfolio schedules required by Regulation S-X (Rule 12-12A-Investments-securities sold short, Rule 12-12B-Open option contracts written, Rule 12-13-Investments other than securities, and Rule 12-14-Investments in and advances to affiliates) continue to be required in both shareholder reports and SEC Form N-CSR. The amendments also exempt money market funds (which utilize the exemptive requirements of Rule 2a-7 under the 1940 Act) from including a portfolio schedule in reports to shareholders, provided that this information is filed with the SEC on Form N-CSR semi-annually and provided to shareholders upon request, free of charge. See SEC Release No. IC-26372 under the Investment Company Act of 1940 (1940 Act) for additional information and for effective date and compliance date information.

Although that SEC rule allows a money market fund to exclude its portfolio of investments from its shareholder reports, the generally accepted accounting principles (GAAP) requirement in this Guide that a money market fund present, at a minimum, a condensed schedule of investments for each statement of assets and liabilities (see paragraphs 946-210-50-1 through 50-3), has not been modified.

(b) If the most current statement of assets and liabilities included in a registration statement is as of a date more than 245 days prior to the date the filing is expected to become effective, then the financial statements, which may be unaudited, included in such filing are to be updated to a date within 245 days of the expected effective date. A statement of assets and liabilities as of such date must be provided as well as a statement of operations, cash flows (if applicable), and statement of changes in net assets for the interim period from the end of the most recent fiscal year for which a statement of assets and liabilities is presented and the date of the most recent interim statement of assets and liabilities.

(c) The Securities and Exchange Commission staff currently requires that sufficient fiscal periods be presented to cover at least twelve calendar months' results of operations ending on the most recent fiscal year-end date (twenty-four calendar months' changes in net assets; sixty months' financial highlights).

(d) For investment companies not using unitized net asset value, financial highlights should be presented and consist of net investment income and expense ratios and total return, or the internal rate of return since inception if applicable.

(e) Item 13(a) of SEC Form N-1A requires financial highlights to be presented for the latest five years in the fund's prospectus. Item 4 of SEC Form N-2 requires financial highlights to be presented for the latest ten years in the fund's prospectus.

Question 6.3.10 What comprises a full set of investment company financial statements?

Interpretive response: The following table lists the financial statements, including financial highlights, required by Subtopic 946-205, which collectively comprise a full set of investment company financial statements. The table also explains the objectives of each financial statement and references additional discussion in this Handbook. [946-205-45-1]

Financial statement	Objective	Reference
Reporting financial position		
Statement of assets and liabilities or **Statement of net assets**[1]	Reports an investment company's financial position as of the reporting date [210-10-05-5]	Sections 7.2 and 7.3
Schedule of investments[2]	Presents information about an investment company's investment portfolio as of the reporting date[3]	Section 7.4
Reporting results of operations		
Statement of operations	Presents the results of the investment company's operating and investment activities including investment income from interest and dividends, expenses, and realized and unrealized gains or losses from investments [946-220-45-1]	Section 8.2
Financial highlights[4]	Provides information to help understand an investment company's financial performance during the period(s) presented [SEC Form N-1/A Item 13, Form N-2 Item 4]	Section 8.3
Other reporting		
Statement of cash flows[5]	Provides relevant information about the cash inflows and outflows of an investment company during the period [230-10-10-1]	Sections 9.2 and 9.3
Statement of changes in net assets	Summarizes results from operations, dividends and distributions to shareholders, capital share transactions, and capital contributions during the period [946-205-45-3]	Section 9.4

Notes:

1. A statement of net assets includes a schedule of investments on its face. See section 7.3 for additional guidance on the format of a statement of net assets.
2. A schedule of investments is presented separately when a statement of assets and liabilities (as opposed to a statement of net assets) is used to report an investment company's financial position.
3. This objective also applies when a statement of net assets is used to report an investment company's financial position.

4. Financial highlights are considered to be a financial statement disclosure rather than a separate financial statement. They may be presented either as a separate schedule or in the notes to the financial statements. [946-205-50-1, AAG-INV 5.39]
5. Investment companies are exempt from the requirements to provide a statement of cash flows when certain conditions are met. See Question 2.3.40 in KPMG Handbook, Statement of cash flows.

In addition to the full set of financial statements for an investment company described above, notes to the financial statements that provide relevant disclosures under Topic 946 and other US GAAP are required to achieve the objective of general purpose financial reporting. [CON 8.PR20]

Question 6.3.20 How do an investment company's financial statements differ from financial statements of other entities?

Interpretive response: Topic 946's financial statement requirements differ in several respects from the requirements applicable to noninvestment companies under other US GAAP. These differences include the following.

- Investment companies typically report financial position under a statement of assets and liabilities format rather than presenting a conventional balance sheet (see section 7.2).
- When reporting financial position, investment companies provide a schedule of investments for each statement of assets and liabilities presented. [946-205-45-1]
- When reporting results of operations, investment companies separately report components of investment income, expenses and gain or loss from investments and foreign currency transactions (see Question 8.2.10).
- Investment companies are required to present financial highlights, either as a separate schedule or in the notes to the financial statements. [946-205-45-1, 50-1]
- Investment companies are exempt from the requirement to provide a statement of cash flows when certain conditions are met. [230-10-15-4(b)]
- Investment companies that have master-feeder structures have specialized financial statement presentation requirements when reporting financial position (see Question 7.2.250) and results of operations (see Question 8.2.220).
- Generally, an investment company does not consolidate an investee that is not an investment company (see Question 2.3.130 in KPMG Handbook, Consolidation). Instead, an investment company generally measures controlling ownership interests in noninvestment company investees at fair value. [946-810-45-2]
- Although investment companies are not excluded from the scope of Topic 270, the interim reporting requirements generally do not apply because registered funds, including BDCs, present interim financial statements in

the same detail as required by Article 6 of Reg S-X for annual financial statements (see Question 6.4.40).

- Investment companies are exempt from the requirement to present earnings per share information (see Question 2.2.90 in KPMG Handbook, Earnings per share). However, some BDCs voluntarily present such information. If a BDC voluntarily presents earnings per share information, it follows all of the applicable requirements set out in Topic 260 (see section 2.3 in KPMG Handbook, Earnings per share). [260-10-15-3]

- Registered funds and BDCs are exempt from the requirements of Article 5 of Reg S-X, and apply the requirements of Article 6 instead (see Questions 6.2.20 and 6.2.30).

6.4 Reporting periods

Question 6.4.10 What are the reporting periods for registered funds?

Interpretive response: Registered funds are required to present financial statements and financial highlights for the following periods.

Annual financial statements

Topic 946 and S-X Rule 3-18 require registered funds to present annual financial statements as follows. [946-205-45-1, S-X Rule 3-18]

Statement	Period(s)	Section
Statement of assets and liabilities or statement of net assets	As of the end of the most recent fiscal year	Sections 7.2 and 7.3
Schedule of investments[1]	For each statement of assets and liabilities presented	Section 7.4
Statement of operations	For the most recent fiscal year	Section 8.2
Statement of cash flows[2]	For the most recent fiscal year	Sections 9.2 and 9.3
Statement of changes in net assets	For the two most recent fiscal years	Section 9.4
Financial highlights	For the latest five fiscal years[3]	Section 8.3

Notes:

1. If a statement of net assets is presented, a separate schedule of investments is not required.
2. If required under Topic 230.
3. Although Subtopic 946-205 requires financial highlights for the latest five years, registered funds are also subject to SEC requirements to provide shareholder reports which include financial highlights for the periods specified by the applicable registration statement form under the 1940 Act. [CFR 270.30e-1]

In addition to the annual financial statement requirements under Topic 946, registered funds are subject to additional SEC financial reporting requirements prescribed by SEC regulations and applicable SEC forms.

Interim financial statements

In addition to the annual financial statement requirements under Topic 946, registered funds are required under the 1940 Act to provide reports to shareholders at least semiannually that include financial statements. For the semiannual period, interim financial statements are presented as of the semiannual period reporting date and for the most recent semiannual period, except as follows. [1940 Act §30(e)]

- The statement of changes in net assets is presented for the most recent semiannual period and preceding fiscal year.
- Financial highlights are presented for the semiannual period and the preceding five fiscal years. [946-205-45-1]

S-X Rule 3-18 requires registered funds' interim financial statements to be presented in the same level of detail as required for their annual financial statements.

Question 6.4.20 What are the reporting periods for BDCs?

Interpretive response: BDCs are subject to the periodic reporting requirements under the 1934 Act to file annual reports on Form 10-K and quarterly reports on Form 10-Q. As a result, BDCs are subject to different reporting periods for annual and quarterly financial statements filed on Forms 10-K and 10-Q than the reporting periods prescribed under Topic 946 and S-X Rule 3-18. [SEC Form 10-K Item 8, Form 10-Q Item 1]

Annual financial statements

BDCs that file annual reports on Form 10-K generally present financial statements for the following periods specified under S-X Rules 3-01, 3-02 and 3-04. However the reporting periods differ for BDCs that are smaller reporting companies or emerging growth companies. [S-X Rules 3-01, 3-02, 3-04]

Statement	Period(s)	Section
Statement of assets and liabilities or statement of net assets	As of the end of the two most recent fiscal years	Sections 7.2 and 7.3
Schedule of investments	For each statement of assets and liabilities presented	Section 7.4
Statement of operations	For each of the three most recent fiscal years	Section 8.2
Statement of cash flows	For each of the three most recent fiscal years	Sections 9.2 and 9.3

Statement	Period(s)	Section
Statement of changes in net assets	For each of the three most recent fiscal years[1]	Section 9.4
Financial highlights	For the latest five fiscal years[2]	Section 8.3

Notes:

1. Although a statement of changes in net assets presented in accordance with S-X Rule 6-09 differs in form from a statement of changes in stockholders' equity, we believe BDCs generally present the statement of changes in net assets for the periods stated under S-X Rule 3-04.
2. Subtopic 946-205 requires financial highlights to be presented for the latest five years. However, a BDC that has filed a short-form registration statement generally presents financial highlights for the latest ten years. This is because financial statements filed on Form 10-K are forward incorporated by reference into the prospectus of a short-form registration statement, and therefore these BDCs present financial highlights for ten years to satisfy both the financial statement requirements under Topic 946 and the prospectus requirements under Form N-2. [IM-DCFO 2023-01]

Interim financial statements

BDCs that file quarterly reports on Form 10-Q generally present interim financial statements as follows. [S-X Rule 10-01]

Statement	Period(s)	Section
Statement of assets and liabilities or statement of net assets	As of the end of the most recent fiscal quarter and at the end of the preceding fiscal year end	Sections 7.2 and 7.3
Schedule of investments	For each statement of assets and liabilities presented	Section 7.4
Statement of operations	For the most recent fiscal quarter, the year-to-date period through the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year	Section 8.2
Statement of cash flows	For the year-to-date period through the end of the most recent fiscal quarter, and for the corresponding period of the preceding fiscal year	Sections 9.2 and 9.3
Statement of changes in net assets	For the most recent fiscal quarter, the year-to-date period through the end of the most recent fiscal quarter, and for the corresponding periods of the preceding fiscal year[1]	Section 9.4
Financial highlights	See Note 2 below	Section 8.3

Notes:

1. Although Article 10 of Reg S-X does not require a statement of changes in net assets to be included in interim financial statements, we believe BDCs generally

present a statement of changes in net assets for the same reporting periods as the statement of operations.

2. Article 10 of Reg S-X does not address the presentation of financial highlights. We believe BDCs generally present financial highlights for the year-to date period through the end of the most recent fiscal quarter, however we have observed diversity in practice. The requirement in Form N-2 to present financial highlights for the latest five fiscal years only applies to annual reports filed by BDCs. [Form N-2 Item 24 (Instruction 10)]

S-X Rule 3-18 requires interim financial statements to be presented in the same level of detail as required for their annual financial statements.

Question 6.4.30 What are the reporting periods for nonregistered funds?

Interpretive response: Nonregistered funds are required to present financial statements and financial highlights for the following periods. [946-205-45-1]

Statement	Period	Section
Statement of assets and liabilities or statement of net assets	As of the end of the most recent fiscal year	Sections 7.2 and 7.3
Schedule of investments[1,2]	For each statement of assets and liabilities presented	Section 7.4
Statement of operations	For the most recent fiscal year	Section 8.2
Statement of cash flows[3]	For the most recent fiscal year	Sections 9.2 and 9.3
Statement of changes in net assets	For the most recent fiscal year	Section 9.4
Financial highlights	For the most recent fiscal year	Section 8.3

Notes:

1. If a statement of net assets is presented, a separate schedule of investments is not required.
2. At minimum, a condensed schedule of investments is presented.
3. If required under Topic 230.

Question 6.4.40 Are interim financial statements required?

Interpretive response: No. Topic 946 does not explicitly require the presentation of interim financial statements. [946-205-45-1]

However, registered funds are subject to SEC requirements to provide shareholder reports, which include financial statements required by Reg S-X, at least semiannually. In addition, BDCs are subject to quarterly reporting requirements under the 1934 Act, and therefore file quarterly financial statements under Form 10-Q. Interim financial statements provided in accordance with Reg S-X are presented in the same detail as required for annual financial statements by Article 6 of Reg S-X. [CFR 270.30e-1, S-X Rule 3-18(d)]

Question 6.4.50 Are comparative financial statements required?

Interpretive response: Except for the requirement for registered funds to present a statement of changes in net assets for the two most recent fiscal years, comparative financial statements are not required by Topic 946. However, if an investment company elects to provide comparative financial statements, it must comply with requirements in Topic 205 (see Question 6.4.60). [946-205-45-1]

SEC requirements

BDCs are subject to SEC requirements that require comparative financial statements (see Question 6.4.20).

Question 6.4.60 What periods are presented if an investment company elects to prepare comparative financial statements?

Interpretive response: If an investment company elects to prepare comparative financial statements, it should apply the following general guidance in Topic 205.

The statement of assets and liabilities, the statement of operations, and the statement of changes in net assets should be presented for one or more preceding years, as well as for the current year. Disclosures in the notes to financial statements for the preceding periods should be repeated to the extent that they continue to be of significance. [205-10-45-2 – 45-4]

Because the guidance in Topic 205 does not contemplate the specialized industry financial statement presentation requirements for investment companies (namely, the presentation of a schedule of investments and financial highlights), we believe an investment company should include the following when it elects to prepare comparative financial statements:

- a schedule of investments for each statement of assets and liabilities presented because such information is significant related to the prior statement of assets and liabilities; and
- comparative financial highlights for each corresponding period comparative statements of operations are presented because the financial highlights disclosures are considered significant to the prior results of operations. [TQA 6910.19]

7. Reporting financial position

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7.1 How the standard works

The reporting of financial position provides information about an investment company's economic resources and the claims against them. Information about assets, liabilities and equity, and their relationships to one another as of the reporting date, helps users to assess the investment company's liquidity, financial flexibility, net resources available, the capability of generating future net cash flows, exposure to risk, and ability to meet long-term financial obligations.

There are two elements to reporting financial position – the primary statement (either a statement of assets and liabilities or a statement of net assets) and a schedule of investments.

Primary statements reporting financial position

There are two types of statements investment companies use to report their financial position.

Statement of assets and liabilities	Statement of net assets
Used unless an investment company elects to use a statement of net assets	• Registered funds: can elect to use if at least 95% of amount of total assets are represented by investments in securities of unaffiliated issuers • Nonregistered funds: election is unrestricted

The main difference between these statements is that a statement of net assets includes a schedule of investments on the face of the statement while the statement of assets and liabilities presents such information in a separate schedule.

Subtopic 946-210 addresses reporting of financial position. In addition, Subtopics 946-310 and 946-405 include incremental presentation requirements for receivables and payables when reporting financial position.

For registered funds and BDCs, Rule 6-04 of Reg S-X prescribes more detailed presentation and disclosure requirements for reporting assets, liabilities and net assets.

Schedule of investments

An integral component of reporting an investment company's financial position is providing a schedule of investments, either as a separate schedule or on the face of a statement of net assets. The schedule is deemed integral because of the significance of the investment portfolio to an investment company's economic resources and investment operations.

How a schedule of investments is presented depends on the nature of the investment company.

Nature of investment company	Source of requirements for schedule of investments
Registered funds and BDCs	Reg S-X Article 12
Nonregistered investment partnerships	Section 946-210-50 (Investment Companies That Are Nonregistered Investment Partnerships subsection)
Other nonregistered investment companies	Section 946-210-50 (Investment Companies Other than Nonregistered Investment Partnerships subsection)

7.2 Statement of assets and liabilities

7.2.10 Overview

Excerpt from ASC 946-210

> Reporting financial position

45-1 Investment companies report financial position by presenting either a statement of assets and liabilities or a statement of net assets.

Many investment companies report their financial position by presenting a statement of assets and liabilities, which lists an investment company's assets and liabilities. The statement reports the amount of net assets as the difference between total assets and total liabilities. [S-X Rule 6-04, AAG-INV 7.20]

This section discusses the general presentation requirements for reporting assets, liabilities and net assets on a statement of assets and liabilities.

Question 7.2.10 What requirements do investment companies follow when presenting a statement of assets and liabilities?

Interpretive response: Investment companies follow the general requirements of Subtopic 946-210 when presenting a statement of assets and liabilities. In addition, other Subtopics in Topic 946 address requirements for certain other financial statement captions that are separately presented on the statement of assets and liabilities – e.g. Subtopic 946-310 (receivables).

Registered funds and BDCs are also required to comply with the incremental guidance in Reg S-X Rule 6-04 when presenting a statement of assets and liabilities.

Question 7.2.20 Are separate classifications of current assets and current liabilities required?

Interpretive response: No.

Topic 946 does not require investment companies to present separate classifications of current assets and current liabilities (i.e. classified balance sheet presentation). In addition, registered funds and BDCs are not subject to the requirements under Article 5 of Reg S-X for commercial and industrial registrants to present a classified balance sheet. [S-X Rule 6-04]

Question 7.2.30 Is there a prescribed order of captions on the statement of assets and liabilities?

Interpretive response: No. Topic 946 does not prescribe how investment companies are to order captions on the statement of assets and liabilities. However, investment companies typically list their investments first due to the investments' relative importance to investment operations and reporting of financial position. [AAG-INV 7.48]

It is common practice to present assets and liabilities other than investments in descending order of liquidity (i.e. order of the amount of time to convert to cash).

Registered funds and BDCs generally follow the order of required assets and liabilities captions as listed in Reg S-X Rule 6-04; however, following such order is not explicitly required. [S-X Rule 6-04]

7.2.20 Assets

Excerpt from ASC 946-210

> Cash and Cash Equivalents

45-20 Cash on hand and demand deposits shall be included under the general caption *cash*.

45-21 Amounts held in foreign currencies shall be presented separately at value, with acquisition cost shown parenthetically.

Excerpt from ASC 946-310

> Statement of Assets and Liabilities or Statement of Net Assets

• > Receivables

45-1 Receivables shall be listed separately at net realizable value for all of the following categories, among others:

a. Dividends and interest
b. Investment securities sold
c Capital stock sold
d. Other accounts receivable, such as receivables from **related parties**, including expense reimbursement receivables from affiliates, and variation margin on open futures contracts.

45-2 Receivables denominated in foreign currencies shall be converted into the functional currency at current exchange rates and may be categorized with the corresponding functional currency receivables.

Excerpt from Reg S-X Rule 6-04

Balance sheets.

This section is applicable to balance sheets filed by registered investment companies and business development companies except for persons who substitute a statement of net assets in accordance with the requirements specified in § 210.6-05, and issuers of face-amount certificates which are subject to the special provisions of § 210.6-06. Balance sheets filed under this rule shall comply with the following provisions:

Assets

1. *Investments in securities of unaffiliated issuers*.
2. *Investments in and advances to affiliates.* State separately investments in and advances to: (a) Controlled companies and (b) other affiliates.
3. *Other investments.* State separately amounts of assets related to (a) variation margin receivable on futures contracts, (b) forward foreign currency contracts; (c) swap contracts; and (d) investments—other than those presented in §§ 210.12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B, and 12-13C.
4. *Cash.* Include under this caption cash on hand and demand deposits. Provide in a note to the financial statements the information required under § 210.5-02.1 regarding restrictions and compensating balances.
5. *Receivables.* (a) State separately amounts receivable from (1) sales of investments; (2) subscriptions to capital shares; (3) dividends and interest; (4) directors and officers; and (5) others.
   (b) If the aggregate amount of notes receivable exceeds 10 percent of the aggregate amount of receivables, the above information shall be set forth separately, in the balance sheet or in a note thereto, for accounts receivable and notes receivable.
6. *Deposits for securities sold short and other investments.* State separately amounts held by others in connection with: (a) Short sales; (b) open option contracts (c) futures contracts, (d) forward foreign currency contracts; (e) swap contracts; and (f) investments—other than those presented in §§ 210.12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B, and 12-13C.
7. *Other assets.* State separately (a) prepaid and deferred expenses; (b) pension and other special funds; (c) organization expenses; and (d) any other significant item not properly classified in another asset caption.

8 *Total assets*.

[81 FR 82011, Nov. 18, 2016, as amended at 83 FR 50202, Oct. 4, 2018]

Question 7.2.40 Which financial statement captions for assets are presented on a statement of assets and liabilities?

Interpretive response: Topic 946 does not prescribe all of the captions required to be separately presented on an investment company's statement of assets and liabilities. However, Topic 946 and Reg S-X Rule 6-04 require certain financial statement captions to be presented separately on the statement of assets and liabilities. The following table summarizes those requirements for assets.

Financial statement caption	Reference
Investments in securities[1,2]	Question 7.2.50
Investments in and advances to affiliates[3]	Question 7.2.60
Investments other than securities	Question 7.2.70
Cash	Question 7.2.90
Receivables	Question 7.2.110
Deposits for investment activities	Question 7.2.130
Other assets	Question 7.2.140

Notes:

1. Reg S-X requires registered funds to present investments in securities of unaffiliated issuers separately from investments in affiliates and other investments. [S-X Rule 6-04.1]
2. General industry practice is to present investments first because of their importance to total assets. [AAG-INV 7.48]
3. Registered funds are required to state separately investments in and advances to: (a) controlled companies and (b) other affiliates. [S-X Rule 6-04.2]

Question 7.2.50 What types of investments does a registered fund include under investments in securities of unaffiliated issuers?

Interpretive response: Although not specifically defined under Reg S-X, the instructions for the schedule of investments in support of the caption for investments in securities of unaffiliated issuers describe the types of investments as including the following: [S-X Rule 12-12]

- common stocks
- preferred stocks
- convertible securities
- fixed income securities
- government securities
- options purchased
- warrants
- loan participations and assignments
- commercial paper
- bankers' acceptances
- certificates of deposit
- short-term securities
- repurchase agreements
- investments in other investment companies.

We believe only investments that meet the definition of a security under the 1940 Act should be included in this caption. [1940 Act §2(36)]

The caption for investments in securities of unaffiliated issuers excludes securities issued by an affiliate, which Reg S-X defines as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." [S-X Rule 1-02(b)]

Question 7.2.60 How are investments in and advances to affiliates presented?

Interpretive response: An investment company presents investments in and advances to affiliates on a statement of assets and liabilities as follows.

Registered funds

Registered funds separately list investments in and advances to: [S-X Rule 6-04.2]

- controlled companies; and
- other affiliated entities.

Nonregistered funds

Topic 946 does not require investments in affiliates to be presented separately. We believe it is acceptable for nonregistered funds to either present a separate caption for investments in affiliates or to include those amounts with its other investments, provided that adequate disclosure of the affiliated nature of the investments is included elsewhere in the financial statements.

However, nonregistered funds present receivables from affiliates separately (see Question 7.2.110). Further, they should consider whether their investments in or receivables from affiliates create any additional disclosure obligations under Topic 850 (related party transactions).

Question 7.2.70 How are investments other than securities presented?

Interpretive response: An investment company presents investments other than securities ('other investments') on a statement of assets and liabilities as follows.

Registered funds

Registered funds are required to present separate categories of assets that represent other investments as follows.

Caption	Reference
Variation margin receivable on futures contracts	S-X Rule 6-04.3
Forward foreign currency contracts	
Swap contracts	
Investments other than those presented under §§ 210.12-12, 12A, 12B, 13, 13A, 13B and 13C ('investments in other asset classes')[1]	
Note: 1. See section 7.5.80.	

Nonregistered funds

Topic 946 does not prescribe separate captions to be presented for investments other than securities. We believe it is acceptable for nonregistered funds to either present separate descriptive captions for such investments (e.g. derivative instruments, real estate) or to include all under a single caption for investments. Under either approach, these assets that represent other investments should be categorized by type in the schedule of investments and the totals presented in the schedule of investments should reconcile to the corresponding financial statement line items presented on the statement of assets and liabilities. [946-210-50-6]

Question 7.2.80 Are registered funds required to present derivative assets and liabilities on a gross basis?

Background: Reg S-X requires registered funds to separately state amounts of assets and liabilities related to variation margin on open futures contracts, open forward foreign currency contracts and open swap contracts. Derivatives reported in the schedules required by Reg S-X Article 12 may include contracts that have both unrealized appreciation (derivative asset) and unrealized depreciation (derivative liability) positions. [S-X Rules 6-04.3, 6-04.9]

Interpretive response: No. Reg S-X Rule 6-04 does not require gross presentation of derivative assets and liabilities on the statement of assets and liabilities when netting is allowed under US GAAP. [SEC Rel 33-10231 sec II.C.6]

See section 3.4 of KPMG Handbook, Financial statement presentation, and section 14.2.20 of KPMG Handbook, Derivatives and hedging, for additional guidance the criteria for balance sheet offsetting.

Example 7.2.10 Presenting derivative assets and liabilities when netting is allowed

As of December 31 (the reporting date), Fund A holds:

- forward foreign currency contract A (Contract A), which is in an unrealized appreciation position, and;

- forward foreign currency contract B (Contract B), which is in an unrealized depreciation position.

Contract A and Contract B are reported separately in the schedule of investments as required by Reg S-X Rule 12-13B (open forward foreign currency contracts).

However, these Contracts meet the criteria under Subtopic 210-20 for netting. Therefore, Fund A has elected to present Contract A and Contract B on a net basis on its statement of assets and liabilities. Although Reg S-X Rules 6-04.3(b) and 6-04.9(d) address presentation of forward foreign currency contracts in asset and liability positions, those rules do not require such contracts to be presented gross on the balance sheet.

Question 7.2.90 What does an investment company include as cash?

Interpretive response: Amounts presented under cash include cash on hand as well as demand deposit balances. [946-210-45-20]

However, amounts held in foreign currencies are required to be presented separately at their translated amounts, with the acquisition cost of the foreign currencies presented parenthetically. [946-210-45-21]

In addition, an investment company may also present on the same line as cash any short-term, highly liquid investments that are eligible to be classified as cash equivalents.

See chapter 6 in KPMG Handbook, Statement of cash flows, for additional guidance on the classification of cash and cash equivalents.

Question 7.2.100 Are registered funds required to present restricted cash or cash held as compensating balances separately?

Interpretive response: No. Reg S-X does not require registered funds to present restricted cash or cash held as compensating balances separately from other cash balances on the statement of assets and liabilities. Instead, a registered fund discloses the following in the notes to the financial statements: [S-X Rules 6-04.1, 5-02.1]

- amounts restricted as to withdrawal or usage;
- the provisions of any restrictions;
- compensating balances arrangements that do not legally restrict the use of cash, and the amounts involved; and
- compensating balances that are maintained under an agreement to assure future credit availability, along with the amount and terms.

See section 6.4 of KPMG Handbook, Statement of cash flows, for additional guidance on restricted cash balances.

Question 7.2.110 Which categories of receivables are investment companies required to present separately?

Interpretive response: Subtopic 946-310 and Reg S-X Rule 6-04 contain the requirements for presenting receivables:

Registered funds

Registered funds present separate categories of receivables as follows.

Caption	Reference
Receivables for pending investment transactions[1]	946-310-45-1, S-X Rule 6-04.5(a)(1)
Dividends and interest receivable	946-310-45-1, S-X Rule 6-04.5(a)(3)
Capital stock sold[2]	946-310-45-1, S-X Rule 6-04.5(a)(2)
Receivables from directors and officers	946-310-45-1, S-X Rule 6-04.5(a)(4)
Other receivables[3]	946-310-45-1, S-X Rule 6-04.5(a)(5)

Notes:

1. See section 3.3 for additional guidance on pending investment transactions.
2. See Question 4.2.20 for related guidance on the accounting for receivables for the issuance of equity.
3. Other receivables presented separately may also include receivables from other related parties (including expense reimbursement receivables from affiliates) and variation margin receivable. [946-310-45-1(d), 850-10-50-2, S-X Rule 6-04.5(a)(5)]

In addition, Reg S-X requires registered funds to present notes receivable separately if the aggregate balance exceeds 10% of total receivables. [S-X Rule 6-04.5(b)]

Nonregistered funds

Nonregistered funds present separate categories of receivables as follows.

Caption	Reference
Receivables for pending investment transactions[1]	946-310-45-1(b)
Dividends and interest receivable	946-310-45-1(a)
Capital stock sold[2]	946-310-45-1(c)
Other receivables[3]	946-310-45-1

Notes:

1. See section 3.3 for additional guidance on pending investment transactions.
2. See Question 4.2.20 for related guidance on the accounting for receivables for the issuance of equity.

3. Other receivables presented separately may also include receivables from related parties (including expense reimbursement receivables from affiliates) and variation margin receivable. [946-310-45-1(d), 850-10-50-2]

Foreign currency receivables

Receivables denominated in foreign currencies may be categorized together with corresponding receivables denominated in the functional currency of the investment company. [946-310-45-2]

Question 7.2.120 Is it appropriate to present cash and receivable balances held with brokers as a single line item within due from brokers?

Background: Some nonregistered funds present a line item called *due from brokers* on the statement of assets and liabilities. Amounts presented as due from brokers may include cash balances held with brokers, receivables for pending investment transactions and deposits for securities sold short.

Interpretive response: It depends. Subtopic 946-310 requires investment companies to present receivables for investment securities sold (including proceeds from unsettled sales and proceeds from securities sold short) and receivables for variation margin from derivative contracts separately on the statement of assets and liabilities (see Question 7.2.110). [946-310-45-1]

Because Reg S-X prescribes specific categories of receivables and deposits held with others to be presented separately on the statement of assets and liabilities, we do not believe it is appropriate for registered funds to present those as combined balances under due from brokers.

However, we understand it is a common industry practice for nonregistered funds to present cash and receivable amounts held with brokers together as due from brokers on the statement of assets and liabilities. We believe it is an acceptable practice for nonregistered funds to present the amounts in a single line item for due from brokers, provided the information that would be presented separately in accordance with Subtopic 946-310 is disclosed in the notes to the financial statements.

In addition to the requirements under Subtopic 946-310, amounts held with brokers that are pledged as collateral should be disclosed as required under Topic 440. [440-10-50-1]

Question 7.2.130 What categories of deposits are registered funds required to present?

Interpretive response: Registered funds separately present deposits held by others in connection with securities sold short and other investments. Amounts are separately stated for the following.

Caption	Reference
Short sales	S-X Rule 6-04.6
Open option contracts	
Futures contracts	
Forward currency contracts	
Swap contracts	
Deposits for investments in other asset classes	

Question 7.2.140 What categories of other assets are registered funds required to present?

Interpretive response: Registered funds separately present certain prepaid and other expenses. Amounts are separately stated for the following.

Caption	Reference
Prepaid and deferred expenses	S-X Rule 6-04.7
Pension and other special funds	
Organization expenses[1]	
Any other significant item not properly classified in another asset caption	
Note: 1. Although included under the captions for assets under Reg S-X Rule 6-04, organization costs are expensed as incurred under US GAAP. [720-15-25-1]	

7.2.30 Liabilities

Excerpt from ASC 946-405

> Statement of Assets and Liabilities or Statement of Net Assets

• > Accounts Payable

45-1 Accounts payable shall be listed separately for investment securities purchased and capital stock reacquired.

• > Other Liabilities

45-2 The line item other liabilities includes amounts due to counterparties for collateral on return of securities loaned, deferred income, and dividends and distributions payable. Payables denominated in foreign currencies shall be converted into the functional currency at current exchange rates and may be categorized within the corresponding functional currency payables.

Excerpt from Reg S-X Rule 6-04

Balance sheets.

This section is applicable to balance sheets filed by registered investment companies and business development companies except for persons who substitute a statement of net assets in accordance with the requirements specified in § 210.6-05, and issuers of face-amount certificates which are subject to the special provisions of § 210.6-06. Balance sheets filed under this rule shall comply with the following provisions:…

Liabilities

9. *Other investments.* State separately amounts of liabilities related to: (a) Securities sold short; (b) open option contracts written; (c) variation margin payable on futures contracts, (d) forward foreign currency contracts; (e) swap contracts; and (f) investments—other than those presented in §§ 210.12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B, and 12-13C.
10. *Accounts payable and accrued liabilities.* State separately amounts payable for: (a) Other purchases of securities; (b) capital shares redeemed; (c) dividends or other distributions on capital shares; and (d) others. State separately the amount of any other liabilities which are material.
11. *Deposits for securities loaned.* State the value of securities loaned and indicate the nature of the collateral received as security for the loan, including the amount of any cash received.
12. *Other liabilities.* State separately (a) amounts payable for investment advisory, management and service fees; and (b) the total amount payable to: (1) Officers and directors; (2) controlled companies; and (3) other affiliates, excluding any amounts owing to noncontrolled affiliates which arose in the ordinary course of business and which are subject to usual trade terms.
13. *Notes payable, bonds and similar debt.* (a) State separately amounts payable to: (1) Banks or other financial institutions for borrowings; (2) controlled companies; (3) other affiliates; and (4) others, showing for each category amounts payable within one year and amounts payable after one year.
    (b) Provide in a note the information required under § 210.5-02.19(b) regarding unused lines of credit for short-term financing and § 210.5-02.22(b) regarding unused commitments for long-term financing arrangements.
14. *Total liabilities.*
15. *Commitments and contingent liabilities.*

[81 FR 82011, Nov. 18, 2016, as amended at 83 FR 50202, Oct. 4, 2018]

Question 7.2.150 Which liability financial statement captions are required to be presented on a statement of assets and liabilities?

Interpretive response: Topic 946 does not prescribe all of the captions required to be separately presented on an investment company's statement of assets and liabilities. However, Topic 946 and Reg S-X Rule 6-04 require certain financial statement captions to be presented separately on the statement of assets and liabilities. The following table summarizes those requirements for liabilities.

Financial statement caption	Reference
Other investments	Question 7.2.160
Accounts payable and accrued liabilities	Question 7.2.170
Deposits for securities loaned	Question 7.2.190
Other liabilities	Question 7.2.170
Notes payable and other debt	Question 7.2.200

Question 7.2.160 How are liability-classified investments presented?

Interpretive response: An investment company presents liability-classified investments on a statement of assets and liabilities as follows.

Registered funds

Registered funds are required to present separate categories of liabilities related to the following investments.

Caption	Reference
Securities sold short	S-X Rule 6-04.9
Open option contracts written	
Variation margin payable on futures contracts	
Forward foreign currency contracts	
Swap contracts	
Investments in other asset classes[1]	

Note:
1. See section 7.5.80.

Nonregistered funds

Topic 946 does not prescribe separate captions to be presented for liability-classified investments. We believe nonregistered funds generally present separate captions for securities sold short and derivative liabilities.

Question 7.2.170 Which categories of payables and other liabilities are presented separately?

Interpretive response: Subtopic 946-405 and Reg S-X Rule 6-04 contain requirements for presenting payables and other liabilities.

Registered funds

Registered funds present separate categories of payables and other liabilities as follows.

Categories	Reference
Payables for pending investment transactions[1]	946-40-45-1, S-X Rule 6-04.10(a)
Capital stock redeemed or reacquired	946-405-45-1, S-X Rule 6-04.10(b)
Dividends or distributions payable on its own capital shares	946-405-45-2, S-X Rule 6-04.10(c)
Amounts payable for advisory fees and services	S-X Rule 6-04.12(a)
Related party payables[2,3]	S-X Rule 6-04.12(a)
Other payables[4]	S-X Rule 6-04.10(d)

Notes:

1. See section 3.3 for additional guidance on pending investment transactions.
2. The following related party payables are presented separately: (1) officers and directors, (2) controlled companies and (3) other affiliates.
3. Excludes amounts payable to noncontrolled affiliates from the ordinary course of business and subject to usual trade terms.
4. Other liabilities that are material should be stated separately. [S-X Rule 6-04.10]

Nonregistered funds

Nonregistered funds present separate categories of payables and other liabilities as follows.

Categories	Reference
Payables for pending investment transactions[1]	946-405-45-1
Capital stock redeemed or reacquired	946-405-45-1
Other liabilities[2]	946-405-45-2

Notes:

1. See section 3.3 for additional guidance on pending investment transactions.

2.	Other liabilities may include amounts due to counterparties for collateral on return of securities loaned, deferred income, and dividends and distributions payable. Topic 946 does not specify any requirements to present those items separately; however, we believe a nonregistered fund should consider additional disclosure when separate presentation of such items is meaningful to financial statement users.

Question 7.2.180 How are reverse repurchase agreements presented?

Interpretive response: As discussed in Question 3.2.80, reverse repurchase agreements are not investments, but instead are borrowings that represent financing activities. Accordingly, reverse repurchase agreements are presented at their amounts payable and are commonly presented separately on the statement of assets and liabilities. [TQA 6910.22]

Question 7.2.190 What information does a registered fund present for deposits for securities loaned?

Interpretive response: A registered fund is required to present deposits held for securities loaned separately on the statement of assets and liabilities.

In addition, a registered fund discloses the following for securities loaned: [S-X Rule 6-04(11)]

- the value of the securities loaned;
- the nature of any collateral received as security, including amounts of any cash received.

Question 7.2.200 How does a registered fund present notes payable and other debt?

Interpretive response: Registered funds present separate categories of notes payable; bonds and similar debt as follows.

Categories[1]	Reference
Amounts payable to banks or other financial institutions	S-X Rule 6-04.13(a)
Amounts payable to controlled companies	
Amounts payable to other affiliates	
Amounts payable to others	

Note:

1. For each category, separately present amounts payable within one year and amounts payable after one year. [S-X Rule 6-04.13(a)]

In addition, information relating to unused lines of credit for short-term financing and unused commitments for long-term financing arrangements is disclosed in the notes to the financial statements. [S-X Rule 6-04.13(b)]

For unused lines of credit for short-term financing, separately disclose: [S-X Rule 5-02.19(b)]

- the amount and terms, including commitment fees and the conditions under which lines may be withdrawn, if significant;
- the weighted average interest rate on short term borrowings outstanding as of the date of each statement of assets and liabilities presented; and
- the amount of short-term lines of credit that support a commercial paper borrowing arrangement or similar arrangements.

For unused commitments for long-term financing arrangements, separately disclose the amount and terms, including commitment fees and the conditions under which commitments may be withdrawn, if significant. [S-X Rule 5-02.22(b)]

7.2.40 Net assets

Excerpt from Reg S-X Rule 6-04

Balance sheets.

This section is applicable to balance sheets filed by registered investment companies and business development companies except for persons who substitute a statement of net assets in accordance with the requirements specified in § 210.6-05, and issuers of face-amount certificates which are subject to the special provisions of § 210.6-06. Balance sheets filed under this rule shall comply with the following provisions:…

Net assets

16. *Units of capital*. (a) Disclose the title of each class of capital shares or other capital units, the number authorized, the number outstanding, and the dollar amount thereof.
    (b) Unit investment trusts, including those which are issuers of periodic payment plan certificates, also shall state in a note to the financial statements: (1) The total cost to the investors of each class of units or shares; (2) the adjustment for market depreciation or appreciation; (3) other deductions from the total cost to the investors for fees, loads and other charges, including an explanation of such deductions; and (4) the net amount applicable to the investors.
17. *Total distributable earnings (loss)*. Disclose total distributable earnings (loss), which generally comprise:
    (a) Accumulated undistributed investment income-net,
    (b) accumulated undistributed net realized gains (losses) on investment transactions, and (c) net unrealized appreciation (depreciation) in value of investments at the balance sheet date.
18. *Other elements of capital*. Disclose any other elements of capital or residual interests appropriate to the capital structure of the reporting entity.

19. *Net assets applicable to outstanding units of capital*. State the net asset value per share.

[81 FR 82011, Nov. 18, 2016, as amended at 83 FR 50202, Oct. 4, 2018]

Question 7.2.210 Which components of net assets are required to be presented on a statement of assets and liabilities?

Interpretive response: Topic 946 generally requires only two components of capital to be presented on an investment company's statement of assets and liabilities: [946-20-50-11]

- shareholder capital (i.e. paid-in capital); and
- distributable earnings.

Registered funds

For registered funds, Reg S-X also requires presentation of other elements of capital that are not included in paid-in capital or distributable earnings. [S-X Rule 6-04.19]

In addition, registered funds are required to state the NAV per share for each class of shares outstanding. [S-X Rule 6-04.19]

The following table summarizes the components of net assets that registered funds present on a statement of assets and liabilities.

Caption	Reference
Paid-in capital	Question 7.2.220
Total distributable earnings (loss)[1]	Question 4.5.10
Other elements of capital[2]	Question 7.2.230

Notes:

1. Distributable earnings are presented in the aggregate on the statement of assets and liabilities. The tax basis components of distributable earnings are disclosed in the notes to the financial statements (see Question 4.5.10).
2. Registered funds are required to present any other elements of capital or residual interests appropriate to the capital structure. [S-X Rule 6-04.18]

Nonregistered investment partnerships

Investment partnerships and other passthrough entities aggregate all elements of equity into a single financial statement line for partners' capital because the results of operations are deemed to be distributed to each partner. [946-20-50-14]

Other nonregistered funds

Although the presentation of paid-in capital and distributable earnings is applicable to other nonregistered funds (i.e. those other than investment partnerships and other passthrough entities), we believe those funds may evaluate whether information on distributable earnings is meaningful to investors and consider whether presentation of a single financial statement line for net assets is appropriate.

Question 7.2.220 What information does a registered fund disclose for units of capital?

Interpretive response: A registered fund presents the following for each class of capital shares or other capital units.

Disclosure	Reference
Title of each class	S-X Rule 6-04.16(a)
Number of shares or units authorized	
Number of shares or units outstanding	
Amount of paid-in capital	

Question 7.2.230 What are other elements of capital?

Interpretive response: As discussed in Question 7.2.210, investment companies generally disclose components of net assets for shareholder capital and distributable earnings on the statement of assets and liabilities. However, Reg S-X requires disclosure of any other elements of capital that are appropriate to the capital structure of a registered fund. Although uncommon in practice, examples of equity accounts that may be considered other elements of capital include AOCI and noncontrolling interest in a consolidated subsidiary. [S-X Rule 6-04.18]

Question 7.2.240 Does a registered fund classify redeemable preferred stock as a component of net assets on the statement of assets and liabilities?

Interpretive response: No. Redeemable preferred stock (i.e. shares conditionally redeemable upon events outside the control of the fund) issued by registered closed-end funds is classified outside of permanent equity. As such, redeemable preferred stock is presented in a 'mezzanine' section between liabilities and net assets on the statement of assets and liabilities (see Question 4.2.80).

7.2.50 Master-feeder funds

Excerpt from ASC 946-210

• > Master-Feeder Funds

• • > Master Funds

45-5 Master funds usually are organized as trusts with flow-through accounting treatment to their feeder funds. As such, the statement of assets and liabilities of the master fund usually shall not report the components of net assets, shares outstanding, or net asset value per share. The portfolio of investments shall be included only in the master fund's financial statements.

• • > Feeder Funds

45-6 Each feeder fund's statement of assets and liabilities shall show an investment in the master fund, which is the sole or principal investment of the feeder fund. The total of all feeder funds' investments in the master fund shall equal the total net assets of the master fund. A schedule of portfolio investments shall not be presented at the feeder level. The net asset value per share, total shares outstanding, and the components of net assets shall be reported. Should the feeder fund have a multiple-class structure, it would report the multiple-class information specified in this Subtopic.

Question 7.2.250 How do investment companies that are part of a master-feeder structure present a statement of assets and liabilities?

Interpretive response: Investment companies that are part of a master-feeder structure present statements of assets and liabilities as follows.

Master fund

A master fund is usually organized to provide flow-through accounting activity to the feeder funds. As such, the statement of assets and liabilities of the master fund generally does not present the components of net assets, shares outstanding or NAV per share.

The schedule of investments is generally included only in the financial statements of the master fund. [946-210-45-5]

Feeder funds

For feeder funds, the standard reporting format for an investment company with a simple capital structure is used. [946-205-45-4]

A feeder fund's statement of assets and liabilities presents its investment in the master fund, which is generally the sole or principal investment of the feeder fund.

When the interests of the master fund are held solely by its feeder funds, the total of all feeder funds' investments in the master fund should reconcile to the net assets of the master fund.

Because the financial statements of the master fund are typically attached to the financial statements of each feeder fund, a schedule of investments is usually not presented at the feeder-fund level. [AAG-INV 5.41, 946-210-45-6, IM-DCFO 1998-03]

If a feeder fund has a multiple class structure (see section 4.3), the composition of net assets is reported in total, with NAV per share and shares outstanding reported for each class. [946-210-45-4, 45-6]

7.2.60 Fund of funds

Excerpt from ASC 946-210

• > Fund of Funds

45-7 The reporting fund may list the investee (portfolio) funds directly on the statement of assets and liabilities. Additional disclosures may be required for those funds that hold a mixture of investments in other investment companies and direct investments in securities. However, there is usually no need for a separate schedule of investments. Fund management shall consider if an investment in a single **underlying** fund is so significant to the fund of funds as to make the presentation of financial statements in a manner similar to a master-feeder fund more appropriate.

Question 7.2.260 How are investments in other investment companies presented?

Background: A fund of funds is a type of investment company whose strategy is to invest in other investment companies.

Interpretive response: An investment company generally presents investments in other investment companies in a similar manner as investments in securities on the statement of assets and liabilities and discloses additional information about the investments in the schedule of investments (see section 7.6.40).

However, the following describes other circumstances that may result in differences in the statement of assets and liabilities presentation.

Direct presentation

An investment company may list its investee funds directly on the statement of assets and liabilities. Provided the required schedule of investments disclosures are included on the face of the statement of assets and liabilities, a separate schedule of investments is not necessary. Additional disclosure may be required for those funds that hold a mixture of investments in other investment companies and direct investments in securities. [946-210-45-7]

Presentation similar to a master-feeder fund

When a substantial portion of the net assets is in a single underlying fund, a fund of funds should consider whether the investment is so significant that presentation of the financial statements in a manner similar to a master-feeder fund (see section 9.6) would be more appropriate. [946-210-45-7]

Access funds

An access fund is a type of nonregistered fund that is created to hold a single investment in another investment company that the access fund's investors would otherwise be unable to invest in on their own (see Question 2.6.30). When an access fund invests in an unaffiliated investee, it may not be feasible for the access fund to present the financial statements in a similar manner as a master-feeder fund, particularly if it is unable to obtain consent to attach the financial statements of the investee fund.

In such situations, at a minimum, an access fund should present the required condensed schedule of investment disclosures for an investee that meets the 5% test (see Question 7.6.190). However, we believe an access fund should also include sufficient disclosures to provide additional transparency over the investment strategy, redemption terms, risks and uncertainties and underlying investments of the investee fund. [946-210-50-6(g), 50-9 – 50-10]

7.2.70 Foreign currency transactions

Excerpt from ASC 946-830

> Cash

45-7 Foreign currency cash balances and movements shall be accounted for in the same way that foreign-currency-denominated securities are. Every receipt of a foreign currency shall be treated as a purchase of a security and recorded in the functional currency at the **spot rate** on the cash receipt date. Similarly, every disbursement of a foreign currency shall be treated as a sale of a security and the appropriate functional currency cost shall be released, depending on whether a specific identified cost, the first-in, first-out (FIFO) method, or an average cost is used.

45-8 The acquisition of a foreign currency does not result in any foreign currency gain or loss. However, the disbursement of a foreign currency shall result in a realized foreign currency gain or loss that is the difference between the functional currency equivalent of the foreign currency when it was acquired and the foreign currency disbursement translated at the spot rate on the disbursement date.

45-9 Also, as is the case with all other assets and liabilities denominated in a foreign currency, foreign currency cash balances shall be translated on each valuation date at the spot rate on that date, resulting in unrealized foreign currency gain or loss.

> Receivables and Payables

45-23 All receivables and payables that are denominated in a foreign currency and that may relate to income or expense, or to securities sold or purchased, shall be translated into the functional currency each valuation date at the spot rate on that date. The difference between that amount and the functional currency amount that was recorded at various spot rates for income and expense items, and at the trade date spot rate in the case of sales and purchases of securities, is unrealized foreign currency gain or loss. Upon liquidation of the receivable or payable balance in a foreign currency, the difference shall be reclassified as realized foreign currency gain or loss.

20 Glossary

Spot Rate

The exchange rate for immediate delivery of currencies exchanged.

Subtopic 946-830 provides guidance on accounting for foreign currency transactions by investment companies. The following section discusses the translation of cash, receivables and payables denominated in foreign currency.

See section 3.9 for the accounting for investment transactions denominated in foreign currency.

Question 7.2.270 How is cash denominated in foreign currency accounted for?

Interpretive response: An investment company treats the receipt of foreign currency as a purchase and initially measures it in the functional currency at the spot rate on the acquisition date.

A disbursement of foreign currency is recorded as a sale, resulting in a relief of functional currency acquisition cost that is determined using a specific identification, FIFO, or average cost method. [946-830-45-7]

Upon disbursement, a resulting realized gain or loss is calculated as the difference between: [946-830-45-8]

- the amount of the functional currency cost being relieved; and
- the amount of foreign currency disbursed translated at the disbursement date spot rate.

Foreign currency balances are translated at each valuation date at the spot rate, resulting in an unrealized gain or loss. [946-830-45-9]

Question 7.2.280 How are receivables and payables denominated in foreign currency accounted for?

Interpretive response: An investment company translates all receivables and payables that are denominated in a foreign currency into the functional currency each valuation date at the valuation-date spot rate.

Unrealized foreign currency gain or loss is recognized for the difference between that amount and the functional currency amount that was recorded at various spot rates for income and expense items (or at the trade-date spot rate in the case of sales and purchases of securities).

Upon liquidation of the receivable or payable balance in a foreign currency, the difference is reclassified to realized foreign currency gain or loss. [946-830-45-23]

7.3 Statement of net assets

Excerpt from ASC 946-210

> Reporting Financial Position

45-2 A statement of net assets includes a schedule of investments (see Section 946-210-50). Details of **related-party** balances and other assets and liabilities shall be presented in the statement of net assets or in the notes to financial statements.

Excerpt from Reg S-X Rule 6-05

Statements of net assets.

In lieu of the balance sheet otherwise required by § 210.6-04, persons may substitute a statement of net assets if at least 95 percent of the amount of the person's total assets are represented by investments in securities of unaffiliated issuers. If presented in such instances, a statement of net assets shall consist of the following:

Statements of net assets

1. A schedule of investments in securities of unaffiliated issuers as prescribed in § 210.12-12.
2. The excess (or deficiency) of other assets over (under) total liabilities stated in one amount, except that any amounts due from or to officers, directors, controlled persons, or other affiliates, excluding any amounts owing to noncontrolled affiliates which arose in the ordinary course of business and which are subject to usual trade terms, shall be stated separately.
3. Disclosure shall be provided in the notes to the financial statements for any item required under §210.6-04.3 and §§210.6-04.9 to 210.6-04.13.
4. The balance of the amounts captioned as *net assets*. The number of outstanding shares and net asset value per share shall be shown parenthetically.

5. The information required by (i) § 210.6-04.16, (ii) § 210.6-04.17 and (iii) § 210.6-04.18 shall be furnished in a note to the financial statements.

[81 FR 82012, Nov. 18, 2016]

Under certain circumstances, a statement of net assets may be used instead of a statement of assets and liabilities to present the financial position of an investment company.

Question 7.3.10 How does a statement of net assets differ from a statement of assets and liabilities?

Interpretive response: The primary difference between a statement of net assets and a statement of assets and liabilities is that a statement of net assets includes a schedule of investments on the face of the statement, rather than presenting such information as a separate schedule.

Details of related party balances and other assets and liabilities are presented on the statement of net assets or in the notes to the financial statements. [946-210-45-2]

Question 7.3.20 When is it appropriate for a registered fund to present a statement of net assets?

Interpretive response: A registered fund may substitute a statement of net assets if at least 95% of the amount of its total assets are represented by investments in securities of unaffiliated issuers. [S-X Rule 6-05]

Because the condition on the use of a statement of net assets is based on total assets rather than net assets, a registered fund that has significant borrowings is not explicitly prohibited from presenting a statement of net assets. However, in that situation a statement of assets and liabilities may provide more transparent information about the fund's borrowings by presenting them on the face of the statement.

Question 7.3.30 How does a registered fund present a statement of net assets?

Interpretive response: When presenting a statement of net assets, a registered fund includes information about its investments in securities of unaffiliated issuers as prescribed under Reg S-X Rule 12-12 (see section 7.5.10). [S-X Rule 6-05.1]

Instead of presenting specific captions for other assets and liabilities, a single amount is presented for the net excess (or deficiency) of other assets over (under) total liabilities. However, amounts due from or to related parties are stated separately unless they are amounts owed to noncontrolled affiliates in the ordinary course of business and are subject to usual trade terms. [S-X Rule 6-05.2]

The amount of net assets is presented, with the number of outstanding shares and NAV per share shown parenthetically. [S-X Rule 6-05.4]

A registered fund is also required to disclose the following information in the notes to the financial statements.

Disclosure	Requirements
Amounts of other investments	List separately amounts related to: • variation margin on futures contracts • foreign forward currency contracts • swap contracts • investments in other asset classes
Liabilities balances of other investments	List separately amounts related to: • securities sold short • open option contracts written • variation margin on futures contracts • foreign forward currency contracts • swap contracts • investments in other asset classes
Accounts payable and accrued liabilities	List separately amounts related to: • other purchases of securities • capital shares redeemed • dividends or other distributions on capital shares • other payables
Deposits for securities loaned	
Other liabilities	List separately amounts related to: • amounts payable for investment advisory, management and service fees • related parties
Notes payable, bonds and similar debt	
Paid-in capital	For each class of capital shares or units, disclose: • title • number authorized • number outstanding • dollar amount
Total distributable earnings	
Other elements of capital	

Question 7.3.40 When is it appropriate for a nonregistered fund to present a statement of net assets?

Interpretive response: Topic 946 does not specify any conditions that would prohibit an investment company from presenting a statement of net assets. [946-210-45-2]

We believe a nonregistered fund may present a statement of net assets provided it:

- presents the asset and liability captions prescribed in Topic 946; and
- presents schedule of investments information on the statement of net assets in accordance with the applicable requirements under Subtopic 946-210.

Although Reg S-X allows a registered fund to present the excess (or deficiency) of other assets over (under) total liabilities as a single amount, it also places conditions on when a registered fund can present a statement of net assets (see Question 7.3.20). Because nonregistered funds are not subject to these conditions, we do not believe it is appropriate for a nonregistered fund to present the excess (or deficiency) of other assets over (under) total liabilities as a single amount, as Topic 946 does not provide for such presentation for nonregistered funds.

7.4 Schedule of investments – overview

Excerpt from ASC 946-205

45-1 The overall objective of financial statements, including financial highlights, of investment companies is to present net assets, results of operations, changes in net assets, and financial highlights resulting from investment activities and, if applicable, from capital share transactions. In reporting to shareholders, investment companies and investment companies registered with the Securities and Exchange Commission (SEC) shall present financial statements and financial highlights as follows.

Nonregistered Investment Companies	Registered Investment Companies
A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein, as of the close of the latest period. At a minimum, a condensed schedule of investments (as discussed in paragraphs 946-210-50-4 through 50-10) should be provided	A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein (that is, a detailed list of investments in securities, options written, securities sold short, and other investments) as of the close of the latest period.(b) A schedule of investments should be provided for

for each statement of assets and liabilities.	each statement of assets and liabilities in conformity with SEC Regulation S-X, Rule 12-12 or 12-12C[a].
A statement of operations for the latest period.	A statement of operations for the latest year.[b], [c]
A statement of cash flows for the latest period (if not exempted by Subtopic 230-10).	A statement of cash flows for the latest year (if not exempted by Subtopic 230-10).[b], [c]
A statement of changes in net assets for the latest period.	A statement of changes in net assets for the latest two years (for semiannual reports, the most recent semiannual period and preceding fiscal year). [b], [c]
Financial highlights for the latest period consisting of per share operating performance, net investment income, and expense ratios and total return for all investment companies organized in a manner using unitized net asset value.[d]	Financial highlights for the latest five fiscal years [b], [c], [e] (for semiannual reports, the semiannual period and generally the preceding five fiscal years).

(a) In 2004, the SEC adopted rule and form amendments that among other matters amended Article 6 and Article 12 of SEC Regulation S-X to permit a registered management investment company to include, under Regulation S-X, Rule 12-12C, a summary schedule of investments in securities of unaffiliated issuers in its reports to shareholders, provided that the complete portfolio schedule required by Rule 12-12 is filed with the Securities and Exchange Commission semi-annually and is provided to shareholders upon request free of charge. All other complete portfolio schedules required by Regulation S-X (Rule 12-12A-Investments-securities sold short, Rule 12-12B-Open option contracts written, Rule 12-13-Investments other than securities, and Rule 12-14-Investments in and advances to affiliates) continue to be required in both shareholder reports and SEC Form N-CSR. The amendments also exempt money market funds (which utilize the exemptive requirements of Rule 2a-7 under the 1940 Act) from including a portfolio schedule in reports to shareholders, provided that this information is filed with the SEC on Form N-CSR semi-annually and provided to shareholders upon request, free of charge. See SEC Release No. IC-26372 under the Investment Company Act of 1940 (1940 Act) for additional information and for effective date and compliance date information.

Although that SEC rule allows a money market fund to exclude its portfolio of investments from its shareholder reports, the generally accepted accounting principles (GAAP) requirement in this Guide that a money market fund present, at a minimum, a condensed schedule of investments for each statement of assets and liabilities (see paragraphs 946-210-50-1 through 50-3), has not been modified.

(b) If the most current statement of assets and liabilities included in a registration statement is as of a date more than 245 days prior to the date the filing is expected to become effective, then the financial statements, which may be unaudited, included in such filing are to be updated to a date within 245 days of the expected effective date. A statement of assets and liabilities as of such date must be provided as well as a statement of operations, cash flows (if applicable), and statement of changes in net assets for the interim period from the end of the most recent fiscal year for which a statement of assets and liabilities is presented and the date of the most recent interim statement of assets and liabilities.

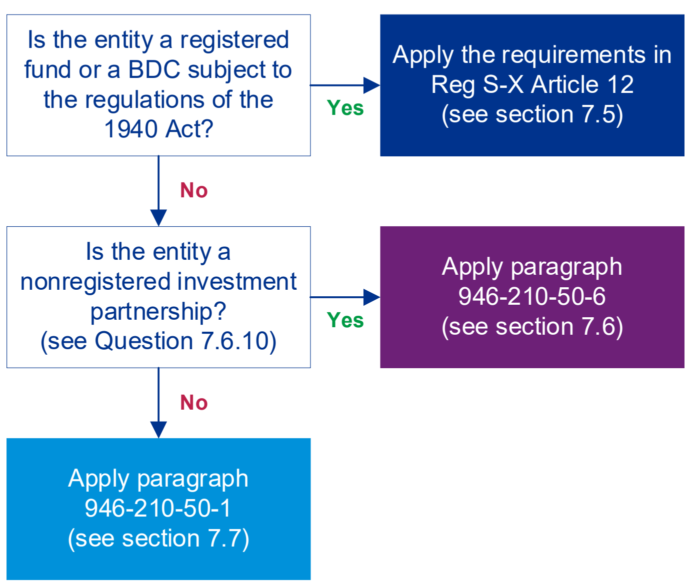
(c) The Securities and Exchange Commission staff currently requires that sufficient fiscal periods be presented to cover at least twelve calendar months' results of operations ending on the most recent fiscal year-end date (twenty-four calendar months' changes in net assets; sixty months' financial highlights).

(d) For investment companies not using unitized net asset value, financial highlights should be presented and consist of net investment income and expense ratios and total return, or the internal rate of return since inception if applicable.

(e) Item 13(a) of SEC Form N-1A requires financial highlights to be presented for the latest five years in the fund's prospectus. Item 4 of SEC Form N-2 requires financial highlights to be presented for the latest ten years in the fund's prospectus.

Investment company financial statements prepared under US GAAP must include a schedule of investments. A schedule of investments, either presented as a separate schedule or included on the face of a statement of net assets (see section 7.3), is typically integral to reporting the financial position of an investment company.

The following decision tree indicates the applicable guidance for an investment company's presentation of a schedule (or a condensed schedule) of investments.



A nonregistered fund that is not an investment partnership is called an '*other nonregistered investment company*'. The primary differences in the presentation requirements under Subtopic 946-210 for nonregistered investment partnerships versus other nonregistered investment companies relate to the format of the schedule (i.e. a schedule of investments or a condensed schedule of investments) and the disclosure thresholds for presenting individual investments on the schedule.

7.5 Schedule of investments – registered investment companies

Registered funds and BDCs follow the requirements under Reg S-X Article 12 when presenting schedules of investments. The following table summarizes the schedules required by Article 12.

Reg S-X Rule	Schedule	Reference
Investments in securities of unaffiliated issuers		
Rule 12-12	Investments in securities of unaffiliated issuers	Section 7.5.10
Rule 12-12B	Summary schedule of investments in securities of unaffiliated issuers[1]	Section 7.5.20
Other investments		
Rule 12-12A	Investments—securities sold short	Section 7.5.30
Rule 12-13	Open option contracts written	Section 7.5.40
Rule 12-13A	Open futures contracts	Section 7.5.50
Rule 12-13B	Open forward foreign currency contracts	Section 7.5.60
Rule 12-13C	Open swap contracts	Section 7.5.70
Rule 12-13D	Investments other than those presented in §§210.12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B, and 12-13C ('investments in other asset classes')	Section 7.5.80
Investments in and advances to affiliates		
Rule 12-14	Investments in and advances to affiliates	Section 7.5.90

Note:

1. A registered fund may include a summary schedule of investments in securities in its reports to shareholders in lieu of a full schedule of investments when certain conditions are met (see Question 7.5.130).

7.5.10 Investments in securities of unaffiliated issuers

Excerpt from Reg S-X Rule 12-12

Investments in securities of unaffiliated issuers.

[For management investment companies only]

Col. A	Col. B	Col. C
Name of issuer and title of issue[1 2 3 4]	Balance held at close of period. Number of shares—principal amount of bonds and notes[7]	Value of each item at close of period.[5 6 8 9 10]

[1] Each issue shall be listed separately: *Provided*, however, that an amount not exceeding five percent of the total of Column C may be listed in one amount as "Miscellaneous securities," provided the securities so listed are not restricted, have been held for not more than one year prior to the date of the related balance sheet, and have not previously been reported by name to the shareholders of the person for which the schedule is filed or to any exchange, or set forth in any registration statement, application, or annual report or otherwise made available to the public. If any securities are listed as "Miscellaneous securities," briefly explain in a footnote what the term represents.

[2] Categorize the schedule by (i) the type of investment (such as common stocks, preferred stocks, convertible securities, fixed income securities, government securities, options purchased, warrants, loan participations and assignments, commercial paper, bankers' acceptances, certificates of deposit, short-term securities, repurchase agreements, other investment companies, and so forth); and (ii) the related industry, country, or geographic region of the investment. Short-term debt instruments (i.e., debt instruments whose maturities or expiration dates at the time of acquisition are one year or less) of the same issuer may be aggregated, in which case the range of interest rates and maturity dates shall be indicated. For issuers of periodic payment plan certificates and unit investment trusts, list separately: (i) Trust shares in trusts created or serviced by the depositor or sponsor of this trust; (ii) trust shares in other trusts; and (iii) securities of other investment companies. Restricted securities shall not be combined with unrestricted securities of the same issuer. Repurchase agreements shall be stated separately showing for each the name of the party or parties to the agreement, the date of the agreement, the total amount to be received upon repurchase, the repurchase date and description of securities subject to the repurchase agreements.

[3] For options purchased, all information required by § 210.12-13 for options contracts written should be shown. Options on underlying investments where the underlying investment would otherwise be presented in accordance with §§ 210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D should include the description of the underlying investment as would be required by §§ 210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D as part of the description of the option.

[4] Indicate the interest rate or preferential dividend rate and maturity date, as applicable, for preferred stocks, convertible securities, fixed income securities,

government securities, loan participations and assignments, commercial paper, bankers' acceptances, certificates of deposit, short-term securities, repurchase agreements, or other instruments with a stated rate of income. For variable rate securities, indicate a description of the reference rate and spread and: (1) The end of period interest rate or (2) disclose the end of period reference rate for each reference rate described in the Schedule in a note to the Schedule. For securities with payment in kind income, disclose the rate paid in kind.

[5] The subtotals for each category of investments, subdivided both by type of investment and industry, country or geographic region, shall be shown together with their percentage value compared to net assets. (§§ 210.6-04.19 or 210.6-05.4.)

[6] Column C shall be totaled. The total of Column C shall agree with the correlative amounts shown on the related balance sheet.

[7] Indicate by an appropriate symbol each issue of securities which is non-income producing. Evidences of indebtedness and preferred shares may be deemed to be income producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no cash or in kind dividends declared, the issue shall not be deemed to be income producing. Common shares shall not be deemed to be income producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

[8] Indicate by an appropriate symbol each issue of restricted securities. State the following in a footnote: (a) As to each such issue: (1) Acquisition date, (2) carrying value per unit of investment at date of related balance sheet, *e.g.*, a percentage of current market value of unrestricted securities of the same issuer, etc., and (3) the cost of such securities; (b) as to each issue acquired during the year preceding the date of the related balance sheet, the carrying value per unit of investment of unrestricted securities of the same issuer at: (1) The day the purchase price was agreed to; and (2) the day on which an enforceable right to acquire such securities was obtained; and (c) the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets.

[9] Indicate by an appropriate symbol each issue of securities whose value was determined using significant unobservable inputs.

[10] Indicate by an appropriate symbol each issue of securities held in connection with open put or call option contracts, loans for short sales, or where any portion of the issue is on loan.

[81 FR 82014, Nov. 18, 2016]

Question 7.5.10 What does a registered fund include in the schedule of investments when presenting investments in securities of unaffiliated issuers?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting investments in securities of unaffiliated issuers. [S-X Rule 12-12]

Caption	Additional SEC instructions
Name of issuer and title of issue	• Generally list each security issue separately[1,2] (see Question 7.5.20). • Categorize investments by (1) type[3], and (2) related industry, country or geographic region (see Question 7.5.30). • For options purchased, include detailed information about the underlying investments (see Question 7.5.50). • Indicate interest or dividend rates and maturity dates for debt instruments and preferred shares[4]. • For securities with payment-in-kind income, disclose the rate paid in-kind.
Balance held at close of period; Number of shares – principal amount of bonds and notes	• Indicate with an appropriate symbol each issue of securities that non-income producing (see Question 7.5.80).
Value of each item at close of period[5,6]	• Indicate with an appropriate symbol each issue of restricted securities and provide additional information in a footnote to the schedule (see Questions 7.5.100 and 7.5.110). • Indicate with an appropriate symbol each issue of securities valued using significant unobservable inputs (see Question 7.5.120). • Indicate with an appropriate symbol each issue of securities held in connection with open options, loans for short sales, or where any portion of the issue is on loan.

Notes:

1. Restricted securities are presented separately from unrestricted securities of the same issuer.
2. Repurchase agreements are reported separately with detailed descriptions for each investment (see Question 7.5.40).
3. See Question 7.2.50 for discussion on the types of investments included as investments in securities of unaffiliated issuers.
4. Additional information is required when disclosing interest rate information for variable rate securities (see Question 7.5.70).
5. For each category, present subtotals for value and the percentage of net assets each category represents.

6. Present total value of investments, which should agree to the correlative amounts presented on the statement of assets and liabilities (see section 7.2.20).

Question 7.5.20 Is a registered fund permitted to aggregate investments in securities?

Interpretive response: It depends. A registered fund is generally required to separately list each issue of investments in securities of unaffiliated issuers. However, there are certain exceptions that permit registered funds to aggregate investments.

Miscellaneous securities

A registered fund is permitted to aggregate securities presented as a single amount as 'miscellaneous securities' on the schedule of investments if all of the following conditions are met. [S-X Rule 12-12]

- The total of miscellaneous securities must not exceed 5% of the total value of Investments in securities of unaffiliated issuers.
- The securities are not restricted.
- The securities have been held for one year or less prior to the reporting date.
- The securities have not been previously reported by name to shareholders of the registered fund or set forth in any registration statement, application or annual report or otherwise made publicly available.

If a registered fund presents any securities as miscellaneous securities, it should provide a brief explanation in a footnote of what the term represents.

Short-term debt instruments

A registered fund is also permitted to aggregate short-term debt instruments (i.e. debt instruments whose maturities or expiration dates at the time of acquisition are one year or less) of the same issuer, with ranges of interest rates and maturity dates presented. [S-X Rule 12-12]

US government and agency securities

The SEC staff has indicated it would not object to registered funds presenting ranges of interest rates and maturity dates for US government or agency securities instead of listing each individual security. However, it would object to such application to other debt securities. [AICPA IC EP 3/2005, 9/2021]

Question 7.5.30 Are registered funds required to categorize investments by both related industry and related country or geographic region?

Interpretive response: No.

Registered funds are required to categorize the schedule of investments by: [S-X Rule 12-12]

- type of investment; and
- related industry, country *or* geographic region of the investment

In its final release, *Investment Company Reporting Modernization*, the SEC indicated that requiring categorization of *both* the related industry *and* the related country or geographic region would add unnecessary length and confusion to the schedule of investments, which could ultimately undermine the schedule's usefulness to investors. Therefore, the SEC decided to retain its existing instructions to categorize investments by related industry *or* related country or geographic region. [SEC Rel 33-10231 sec II.C.6]

However, registered funds should consider US GAAP requirements that may affect the disclosures presented in the schedule of investments. For example, Topic 825 (financial instruments) requires certain disclosures of significant concentrations of credit risk that may be incremental to the schedule of investments requirements.

Question 7.5.40 What information is a registered fund required to include for repurchase agreements?

Interpretive response: For repurchase agreements, a registered fund is also required to separately present for each agreement: [S-X Rule 12-12]

- the name of the party or parties to the agreement;
- the date of the agreement;
- the total amount to be received upon repurchase;
- the repurchase date; and
- a description of the securities subject to the repurchase agreement.

Question 7.5.50 What information is a registered fund required to include for open purchased options?

Interpretive response: For options purchased, a registered fund is required to include both: [S-X Rule 12-12]

- the information required for investments in securities of unaffiliated issuers (Reg S-X Rule 12-12); and
- all of the information required to be presented for open option contracts written (Reg S-X Rule 12-13).

In addition, when the underlying investment of a purchased option would otherwise be subject to disclosure under another schedule required by Reg S-X Article 12, the description of the option also includes a description of the underlying investment that would be required by those provisions. [S-X Rule 12-12]

See section 7.5.40 for schedule of investments requirements for open option contracts written, including interpretive guidance on the following related topics:

- determining notional amounts;
- determining whether the components of an underlying that is an index or a basket of investments are publicly available as of the reporting date; and
- disclosing the components of an underlying that is an index or a basket of investments.

Question 7.5.60 Are underlying investment disclosures for open option contracts required for nonderivative instruments that contain optionality features?

Background: For open option contracts where the underlying investment would otherwise be subject to disclosure under another schedule required by Reg S-X Article 12, the description of the option also includes a description of the underlying investment required by the applicable schedule (see Question 7.5.50).

Interpretive response: No. The additional disclosure requirements of underlying investments for open option contracts were not intended to extend to convertible bonds or other nonderivative instruments that contain optionality features. [SEC Rel 33-10231 sec II.C.2.a (FN 553)]

Question 7.5.70 What information does a registered fund present for variable rate securities?

Interpretive response: A registered fund is required to present the following information for each of its variable rate securities: [S-X Rule 12-12]

- the reference rate and spread; and
- either:
  - — the interest rate as of the end of the period; or
  - — the reference rate as of the end of the period for each reference rate described.

Disclosure of the reference rate and spread is intended to allow investors to better understand the economics of a registered fund’s investments in variable rate debt securities. Information about the period-end interest rate is also important to help investors understand the investment’s current return and how interest rate changes could affect the investment’s future returns. [SEC Rel 33-10231 sec II.C.3]

In a February 20, 2018, conference call with the AICPA Investment Companies Expert Panel, the SEC staff shared the following observations about registrant disclosures of variable rate securities from their review of financial statement filings. [AICPA IC EP 2/2018]

Step bonds

A step bond has coupon rates that either increase (step-up) or decrease (step-down) according to a pre-determined schedule over the life of the bond or through its call date. For those investments, disclosure of only the period-end rate without disclosure of how the interest rate changes over the life of the bond may not provide investors with adequate information to understand the future returns of the investment, particularly when the period-end rate is not indicative of the interest earned throughout the life of the bond.

The SEC staff discussed how the variable rate disclosure requirements apply to step bonds by suggesting that effective disclosures may include:

- the current rate of a step bond;
- the dates when the rate steps up or down; and
- information about how the coupon rate changes as it steps-up or steps-down over the life of the bond and, if known, what the rates would be at those dates.

In circumstances when a bond has multiple steps and the registered fund determines that disclosure of each individual step would not provide additional significant information about the future returns of the investment, effective disclosure may include a description of the direction of rate changes and a range of expected future rates.

Securities with interest rate caps and floors

The SEC staff suggested that effective disclosures include information on the existence, description and amounts of caps and floors on variable interest rates. It indicated that such information is useful to investors to understand differences in the future returns of the investment.

Asset-backed securities

The SEC staff also discussed how the variable rate disclosure requirements apply to asset-backed securities (ABS). It acknowledged that an ABS may not have a stated interest rate when the effective interest rate constantly changes based on the performance of the underlying assets. However, it gave examples of effective disclosure that it believes may provide useful information to understand the future returns of ABS investments. Its suggestions included disclosing the current interest rate and describing how payments are determined.

Bank debt

The SEC staff noted that a registered fund might present as a single unit of account investments in multiple tranches of bank debt of a particular obligor, with each tranche having a different interest rate. Although an investment in bank debt may represent a single unit of account, the SEC staff observed that including additional information about the various interest rates would be more useful to investors than presenting only a weighted average rate.

Question 7.5.80 How does a registered fund determine when securities are considered non-income producing?

Background: A registered fund is required to indicate by an appropriate symbol each issue of securities that is non-income producing on the schedule of investments. [S-X Rule 12-12]

Interpretive response: A registered fund evaluates whether debt securities and preferred stock are non-income producing as follows.

Debt securities and preferred stock

An issue of a debt security or preferred stock is considered non-income producing if no interest was paid or dividends were declared on the most recent interest or dividend date. [S-X Rule 12-12]

Common stock

An issue of common stock is considered non-income producing if no dividends were paid on the shares during the most recent fiscal year. [S-X Rule 12-12]

Question 7.5.90 Is a debt security or preferred stock considered non-income producing if a partial payment or a declaration of a partial amount of dividends was made?

Interpretive response: No. A debt security or preferred stock issue would still be considered income-producing even though a partial payment or declaration of a partial amount of accumulated dividends was made as of the most recent interest payment date or dividend declaration date prior to the reporting date. However, an appropriate footnote that explains the partial payment should be added to the schedule of investments. [S-X Rule 12-12]

Question 7.5.100 Are investments that cannot be sold due to market conditions marked as restricted?

Background: The instructions common to the schedule of investments under Article 12 require funds to indicate by an appropriate symbol whether an investment cannot be sold because of restrictions or conditions applicable to the investment. [S-X Rule 12-12]

Interpretive response: No. The above requirement is intended to apply to legal or contractual restrictions applicable to the investment itself.

For example, restricted securities subject to Rule 144A of the 1933 Act are required to be indicated as restricted only if:

- the security has restrictions; and
- a registered fund cannot sell the security to qualified institutional buyers at the report date because of those restrictions.

This requirement does not apply to investments that cannot be sold as a result of market conditions, such as illiquidity in the marketplace. [SEC Rel 33-10231 sec II.C.6]

Question 7.5.110 What information is a registered fund required to disclose for restricted securities?

Interpretive response: A registered fund is required to disclose the following for each issue of restricted securities: [S-X Rule 12-12]

- acquisition date;
- carrying value per unit as of the reporting date; and
- cost amount.

In addition, the following should be disclosed for restricted securities acquired during the year preceding the reporting date: [S-X Rule 12-12]

- the date the purchase price was agreed upon;
- the date an enforceable right to acquire the securities was obtained; and
- aggregate value of all restricted securities and the percentage relative to net assets.

Question 7.5.120 Are investments classified as Level 3 in the fair value hierarchy marked as investments determined using significant unobservable inputs?

Background: The schedules of investments prescribed under Reg S-X Article 12 require funds to indicate by an appropriate symbol whether an investment's value was determined using significant unobservable inputs. The instructions common to the schedules of investments (common instructions) refer to the term *value* as defined in the 1940 Act, rather than *fair value* as defined under Topic 820.

Interpretive response: Yes. Although the common instructions do not refer to the fair value hierarchy under Topic 820, we believe that the requirement to indicate if an investment's value was determined using significant unobservable inputs will generally apply to investments classified as Level 3 in the fair value hierarchy because those investments are classified in their entirety based on the lowest level input that is significant to the entire measurement. [S-X Rule 12-12]

7.5.20 Summary schedule of investments in securities of unaffiliated issuers

Excerpt from Reg S-X Rule 12-12B

Summary schedule of investments in securities of unaffiliated issuers.

Col. A	Col. B	Col. C	Col. D
Name of issuer and title of issue[1 3 4 5 6 7 8]	Balance held at close of period. Number of shares—principal amount of bonds and notes [10]	Value of each item at close of period[2 9 11 12 13]	Percentage value compared to net assets.

[1] Categorize the schedule by (a) the type of investment (such as common stocks, preferred stocks, convertible securities, fixed income securities, government securities, options purchased, warrants, loan participations and assignments, commercial paper, bankers' acceptances, certificates of deposit, short-term securities, repurchase agreements, other investment companies, and so forth); and (b) the related industry, country or geographic region of the investment.

[2] The subtotals for each category of investments, subdivided both by type of investment and industry, country, or geographic region, shall be shown together with their percentage value compared to net assets.

[3] Indicate the interest rate or preferential dividend rate and maturity date, as applicable, for preferred stocks, convertible securities, fixed income securities, government securities, loan participations and assignments, commercial paper, bankers' acceptances, certificates of deposit, short-term securities, repurchase agreements, or other instruments with a stated rate of income. For variable rate securities, indicate a description of the reference rate and spread and: (1) The end of period interest rate or (2) disclose the end of period reference rate for each reference rate described in the Schedule in a note to the Schedule. For securities with payment in kind income, disclose the rate paid in kind.

[4] Except as provided in note 6, list separately the 50 largest issues and any other issue the value of which exceeded one percent of net asset value of the registrant as of the close of the period. For purposes of the list (including, in the case of short-term debt instruments, the first sentence of note 4), aggregate and treat as a single issue, respectively, (a) short-term debt instruments (*i.e.*, debt instruments whose maturities or expiration dates at the time of acquisition are one year or less) of the same issuer (indicating the range of interest rates and maturity dates); and (b) fully collateralized repurchase agreements (indicate in a footnote the range of dates of the repurchase agreements, the total purchase price of the securities, the total amount to be received upon repurchase, the range of repurchase dates, and description of securities subject to the repurchase agreements). Restricted and

unrestricted securities of the same issue should be aggregated for purposes of determining whether the issue is among the 50 largest issues, but should not be combined in the schedule. For purposes of determining whether the value of an issue exceeds one percent of net asset value, aggregate and treat as a single issue all securities of any one issuer, except that all fully collateralized repurchase agreements shall be aggregated and treated as a single issue. The U.S. Treasury and each agency, instrumentality, or corporation, including each government-sponsored entity, that issues U.S. government securities is a separate issuer.

[5] For options purchased, all information required by § 210.12-13 for options contracts written should be shown. Options on underlying investments where the underlying investment would otherwise be presented in accordance with §§ 210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D should include the description of the underlying investment as would be required by §§ 210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D as part of the description of the option.

[6] If multiple securities of an issuer aggregate to greater than one percent of net asset value, list each issue of the issuer separately (including separate listing of restricted and unrestricted securities of the same issue) except that the following may be aggregated and listed as a single issue: (a) Fixed-income securities of the same issuer which are not among the 50 largest issues and whose value does not exceed one percent of net asset value of the registrant as of the close of the period (indicating the range of interest rates and maturity dates); and (b) U.S. government securities of a single agency, instrumentality, or corporation, which are not among the 50 largest issues and whose value does not exceed one percent of net asset value of the registrant as of the close of the period (indicating the range of interest rates and maturity dates). For each category identified pursuant to note 1, group all issues that are neither separately listed nor included in a group of securities that is listed in the aggregate as a single issue in a sub-category labeled "Other securities," and provide the information for Columns C and D.

[7] Any securities that would be required to be listed separately or included in a group of securities that is listed in the aggregate as a single issue may be listed in one amount as "Miscellaneous securities," provided the securities so listed are eligible to be, and are, categorized as "Miscellaneous securities" in the registrant's Schedule of Investments in Securities of Unaffiliated Issuers required under § 210.12-12. However, if any security that is included in "Miscellaneous securities" would otherwise be required to be included in a group of securities that is listed in the aggregate as a single issue, the remaining securities of that group must nonetheless be listed as required by notes 4 and 5 even if the remaining securities alone would not otherwise be required to be listed in this manner (*e.g.*, because the combined value of the security listed in "Miscellaneous securities" and the remaining securities of the same issuer exceeds one percent of net asset value, but the value of the remaining securities alone does not exceed one percent of net asset value).

[8] If any securities are listed as "Miscellaneous securities" pursuant to note 6 or "Other securities" pursuant to note 5, briefly explain in a footnote what those terms represent.

[9] Total Column C. The total of Column C should equal the total shown on the related balance sheet for investments in securities of unaffiliated issuers.

[10] Indicate by an appropriate symbol each issue of securities which is non-income producing. Evidences of indebtedness and preferred shares may be deemed to be income producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no cash or in kind dividends declared, the issue shall not be deemed to be income producing. Common shares shall not be deemed to be income producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

[11] Indicate by an appropriate symbol each issue of restricted securities. State the following in a footnote: (a) As to each such issue: (1) Acquisition date, (2) carrying value per unit of investment at date of related balance sheet, e.g., a percentage of current market value of unrestricted securities of the same issuer, etc., and (3) the cost of such securities; (b) as to each issue acquired during the year preceding the date of the related balance sheet, the carrying value per unit of investment of unrestricted securities of the same issuer at: (1) The day the purchase price was agreed to; and (2) the day on which an enforceable right to acquire such securities was obtained; and (c) the aggregate value of all restricted securities and the percentage which the aggregate value bears to net assets.

[12] Indicate by an appropriate symbol each issue of securities whose value was determined using significant unobservable inputs.

[13] Indicate by an appropriate symbol each issue of securities held in connection with open put or call option contracts, loans for short sales, or where any portion of the issue is on loan.

[81 FR 82015, Nov. 18, 2016]

Question 7.5.130 When is a registered fund permitted to present a summary schedule of investments?

Interpretive response: Certain registered funds are permitted to include a summary schedule of investments in securities of unaffiliated issuers ('summary schedule of investments') in its shareholder reports provided that it files a complete schedule of investments with the SEC on a semiannual basis and the complete schedule of investments is made available to shareholders upon request without charge. [S-X Rule 6-10, Form N-2 Item 24(7)]

Question 7.5.140 How does a summary schedule of investments differ from a complete schedule of investments?

Interpretive response: Instead of presenting all of a registered fund's investments in securities of unaffiliated issuers, a summary schedule generally includes the 50 largest holdings and each investment in unaffiliated issuers that exceeds 1% of the registered fund's NAV as of the reporting date. [S-X Rule 12-12B]

Question 7.5.150 What does a registered fund include when presenting a summary schedule of investments?

Interpretive response: A registered fund includes the following information in a summary schedule of investments. [S-X Rule 12-12B]

Caption	Additional SEC instructions
Name of issuer and title of issue	• Categorize investments by (1) type, and (2) related industry, country or geographic region[1,2] (see Question 7.5.30). • List separately[3]: — the 50 largest investments[4] ('Top 50 investments'); — any investment individually exceeding 1% of NAV ('1% test') (see Question 7.5.160); — any securities of any one issuer that meet the 1% test in the aggregate[5]. • Indicate the interest or dividend rates and maturity dates for debt instruments and preferred shares[6]. • For securities with payment-in-kind income, disclose the rate paid in-kind. • For options purchased, include detailed information about the underlying investments (see Question 7.5.50).
Balance held at close of period; Number of shares – principal amount of bonds and notes	• Indicate with an appropriate symbol each issue of securities that is non-income producing (see Question 7.5.80).
Value of each item at close of period[7,8]	• Indicate with an appropriate symbol each issue of restricted securities and provide additional information in a footnote to the schedule (see Questions 7.5.100 and 7.5.110). • Indicate with an appropriate symbol each issue of securities valued using significant unobservable inputs (see Question 7.5.120).

Caption	Additional SEC instructions
	• Indicate with an appropriate symbol each issue of securities held in connection with open options, loans for short sales, or where any portion of the issue is on loan.
Percentage value compared to net assets	Not applicable.

Notes:

1. See Question 7.2.50 for discussion on the types of investments included as investments in securities of unaffiliated issuers.
2. For each category identified, any investments that are not listed separately or presented in the aggregate as a single issue (see Questions 7.5.160 and 7.5.170) are grouped into a sub-category for 'other securities', and the corresponding value and percentage of net assets is presented (also see Question 7.5.170).
3. See Question 7.5.170 for discussion of conditions under which investments in securities are aggregated.
4. Restricted securities and unrestricted securities of the same issuer are aggregated for purpose of determining Top 50 investments but are not to be combined in the schedule (see Question 7.5.170).
5. Multiple securities from the same issuer that meet the 1% test in the aggregate are listed separately, except as provided in the instructions (see Question 7.5.170).
6. Additional information is required when disclosing interest rate information for variable rate securities (see Question 7.5.70).
7. Present for each category, subtotals and the percentage of net assets each category represents.
8. Present total value of investments, which should agree to the correlative amounts presented on the statement of assets and liabilities (see section 7.2.20).

Question 7.5.160 How does a registered fund evaluate whether an investment meets the 1% test?

Interpretive response: When presenting a summary schedule of investments, a registered fund is required to list separately any investment whose value exceeds 1% of the registered fund's NAV as of the reporting date.

For purposes of determining whether an investment meets the 1% test, all of the securities in any one issuer are aggregated and treated as a single issue. When multiple securities of the same issuer meet the 1% test in the aggregate, each security for that issuer should generally be listed separately (see Question 7.5.170). [S-X Rule 12-12B]

Question 7.5.170 What are the conditions for a registered fund to aggregate securities in a summary schedule of investments?

Interpretive response: The following discusses the conditions under which a registered fund aggregates securities in a summary schedule of investments. [S-X Rule 12-12B]

Short-term debt instruments

When presenting a summary schedule of investments, a registered fund aggregates short-term debt instruments (i.e. debt instruments whose maturities or expiration dates at the time of acquisition are one year or less) of the same issuer, with ranges of interest rates and maturity dates presented. [S-X Rule 12-12B]

Fully collateralized repurchase agreements

Fully collateralized repurchase agreements are aggregated and treated as a single issue, with a corresponding footnote that indicates:

- range of dates of the repurchase agreements;
- total purchase price of the securities;
- total amount to be received upon repurchase;
- range of repurchase dates; and
- description of the securities subject to the repurchase agreements.

The aggregation of fully collateralized repurchase agreements is without regard to the size of the position or their issuer. [S-X Rule 12-12B]

Restricted securities

Restricted and unrestricted securities of the same issuer are aggregated for purposes of determining whether the issue is a Top 50 investment. However, restricted and unrestricted securities are not to be presented on a combined basis in the summary schedule of investments. [S-X Rule 12-12B]

Multiple securities of the same issuer

When multiple securities of the same issuer meet the 1% test in the aggregate, each security for that issuer generally should be listed separately.

However, the instructions to the summary schedule of investments indicate that the following types of securities may be aggregated and listed as a single issue:

- fixed-income securities of the same issuer; and
- US government securities of a single agency, instrumentality, or corporation.

This exception that permits aggregation does not apply to securities that individually are either a Top 50 investment or meet the 1% test.

For each group of such aggregated securities listed as a single issue, the range of interest rates and maturity dates is disclosed. [S-X Rule 12-12B]

Other securities

For each category identified, any investments that are not listed separately or presented in the aggregate as a single issue are grouped into a sub-category for 'other securities', along with the corresponding value and percentage of net assets.

If a registered fund presents any securities as other securities, it provides a brief explanation in a footnote about what the term represents. [S-X Rule 12-12B]

Miscellaneous securities

A registered fund that presents a summary schedule of investments is permitted to apply the exclusion for 'miscellaneous securities' for any issue that would otherwise be required to be listed separately or presented in the aggregate as a single issue if those securities meet the eligibility requirements to present miscellaneous securities on a complete schedule of investments (see Question 7.5.20).

If a security included in miscellaneous securities would otherwise be required to be included in a group of securities that is evaluated as a single issue under the summary schedule of investments presentation requirements, a registered fund continues to present the remaining securities within that group in the same manner as if that particular security was still included in the group. [S-X Rule 12-12B]

For example, if multiple securities of the same issuer otherwise meet the 1% test in the aggregate and a particular issue within that group is designated to be presented in miscellaneous securities, the remaining securities from the same issuer are listed separately even if the value of those remaining securities is less than 1% of NAV.

If a registered fund presents any securities as miscellaneous securities, it should provide a brief explanation in a footnote about what the term 'miscellaneous securities' represents. [S-X Rule 12-12B, SEC Rel 33-8393 sec II.B.1]

Question 7.5.180 Are all securities issued by US federal government agencies considered to be from the same issuer?

Interpretive response: No. The US Treasury and any other agency, instrumentality or corporation, including each government-sponsored entity (e.g. Fannie Mae, Freddie Mac), that issues US government securities is each considered a separate issuer. [S-X Rule 12-12B, SEC Rel 33-8393 sec II.B.1]

7.5.30 Securities sold short

Excerpt from Reg S-X Rule 12-12A

Investments—securities sold short.

[For management investment companies only]

Col. A	Col. B	Col. C
Name of issuer and title of issue[1 2 3]	Balance of short position at close of period (number of shares)	Value of each open short position[4 5 6]

[1] Each issue shall be listed separately.

[2] Categorize the schedule as required by instruction 2 of § 210.12-12.

[3] Indicate the interest rate or preferential dividend rate and maturity date, as applicable, for preferred stocks, convertible securities, fixed income securities, government securities, loan participations and assignments, commercial paper, bankers' acceptances, certificates of deposit, short-term securities, repurchase agreements, or other instruments with a stated rate of income. For variable rate securities, indicate a description of the reference rate and spread and: (1) The end of period interest rate or (2) disclose the end of period reference rate for each reference rate described in the Schedule in a note to the Schedule. For securities with payment in kind income, disclose the rate paid in kind.

[4] The subtotals for each category of investments, subdivided both by type of investment and industry, country, or geographic region, shall be shown together with their percentage value compared to net assets.

[5] Column C shall be totaled. The total of Column C shall agree with the correlative amounts shown on the related balance sheet.

[6] Indicate by an appropriate symbol each issue of securities whose value was determined using significant unobservable inputs.

[81 FR 82015, Nov. 18, 2016]

Question 7.5.190 What does a registered fund include in the schedule of investments when presenting securities sold short?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting securities sold short. [S-X Rule 12-12A]

Caption	Additional SEC instructions
Name of issuer and title of issue	• Generally list each issue separately (see Question 7.5.20). • Categorize securities sold short by (1) type, and (2) related industry, country, or geographic region (see Question 7.5.30). • Indicate interest or dividend rates and maturity dates for debt instruments and preferred shares[1]. • For securities with payment-in-kind income, disclose the rate paid in-kind.
Balance of short position at close of period (number of shares)	Not applicable.
Value of each open short position[2,3]	• Indicate with an appropriate symbol each issue of securities valued using significant unobservable inputs (see Question 7.5.120).

Notes:

1. Additional information is required when disclosing interest rate information for variable rate securities (see Question 7.5.70).
2. For each category, present subtotals for value and the percentage of net assets each category represents.
3. Present total value of securities sold short, which should agree to the correlative amounts presented on the statement of assets and liabilities (see section 7.2.30).

7.5.40 Open option contracts written

Excerpt from Reg S-X Rule 12-13

Open option contracts written.

[For management investment companies only]

Col. A	Col. B	Col. C	Col. D	Col. E	Col. F	Col. G
Description[1 2 3]	Counterparty[4]	Number of contracts[5]	Notional amount	Exercise price	Expiration date	Value.[6 7 8]

[1] Information as to put options shall be shown separately from information as to call options.

[2] Options where descriptions, counterparties, exercise prices or expiration dates differ shall be listed separately.

[3] Options on underlying investments where the underlying investment would otherwise be presented in accordance with §§ 210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D should include the description of the underlying investment as

would be required by §§ 210.12-12, 12-13A, 12-13B, 12-13C, or 12-13D as part of the description of the option.

If the underlying investment is an index or basket of investments, and the components are publicly available on a Web site as of the balance sheet date, identify the index or basket. If the underlying investment is an index or basket of investments, the components are not publicly available on a Web site as of the balance sheet date, and the notional amount of the option contract does not exceed one percent of the net asset value of the registrant as of the close of the period, identify the index or basket. If the underlying investment is an index or basket of investments, the components are not publicly available on a Web site as of the balance sheet date, and the notional amount of the option contract exceeds one percent of the net asset value of the registrant as of the close of the period, provide a description of the index or custom basket and list separately: (i) The 50 largest components in the index or custom basket and (ii) any other components where the notional value for that components exceeds 1% of the notional value of the index or custom basket. For each investment separately listed, include the description of the underlying investment as would be required by §§ 210.12-12, 12-13, 12-13A, 12-13B, or 12-13D as part of the description, the quantity held (e.g., the number of shares for common stocks, principal amount for fixed income securities), the value at the close of the period, and the percentage value when compared to the custom basket's net assets.

[4] Not required for exchange traded or centrally cleared options.

[5] If the number of shares subject to option is substituted for number of contracts, the column name shall reflect that change.

[6] Indicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment.

[7] Indicate by an appropriate symbol each investment whose value was determined using significant unobservable inputs.

[8] Column G shall be totaled and shall agree with the correlative amount shown on the related balance sheet.

[81 FR 82016, Nov. 18, 2016]

Question 7.5.200 What does a registered fund include in the schedule of investments when presenting open option contracts written?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting open option contracts written. [S-X Rule 12-13]

Caption	Additional SEC instructions
Description[1,2]	• The description of the option includes the description of the underlying investment that would be required for the underlying

Caption	Additional SEC instructions
	investment under the applicable Article 12 schedule[3] (see Question 7.5.50).
Counterparty[4]	Not applicable.
Number of contracts[5]	Not applicable.
Notional amount	Not applicable.
Exercise price	Not applicable.
Expiration date	Not applicable.
Value[6]	• Indicate with an appropriate symbol each investment that cannot be sold because of restrictions or conditions applicable to the investment (see Question 7.5.100). • Indicate with an appropriate symbol each investment valued using significant unobservable inputs (see Question 7.5.120).

Notes:

1. Information about put options is to be presented separately from information about call options.
2. Options where descriptions, counterparties, exercise prices or expiration dates differ are to be listed separately.
3. Disclose additional information when the underlying investment is an index or basket of investments (see Question 7.5.210).
4. Disclosure of counterparty is not required for exchange traded or centrally cleared options.
5. If the number of shares is substituted for number of contracts, the column name must reflect that change.
6. Present the total value of open option contracts written, which should agree to the correlative amounts presented on the statement of assets and liabilities (see section 7.2.30).

Question 7.5.210 What disclosures are required for registered funds when an underlying investment relates to an index or basket of investments?

Background: Some option contracts and swap contracts held by a registered fund may have underlying assets that compose a securities index or a custom basket of investments. The components of the index or basket may not always be publicly available.

Interpretive response: The following disclosure requirements apply when a registered fund has investments in open option contracts or swap contracts where the underlying investment is an index or basket of investments.

Components are publicly available on a website

When the components to the index or basket are 'publicly available on a website' as of the reporting date (see Question 7.5.220), a registered fund identifies only the index or basket, not the components. [S-X Rules 12-13, 12-13C]

Notional amount threshold not met

When the notional amount of the option or swap contract does not exceed 1% of the registered fund's NAV as of the reporting date, only the identity of the index or basket is disclosed, regardless of whether the components are publicly available. [S-X Rules 12-13, 12-13C]

Components are not publicly available

When the components of the index or basket are not publicly available on a website and the notional amount of the option or swap contract exceeds 1% of the registered fund's NAV as of the reporting date, a registered fund discloses: [S-X Rules 12-13, 12-13C]

- a description of the index or basket;
- the 50 largest components in the index or basket (see Question 7.5.230); and
- any other components where the notional value exceeds 1% of the notional value of the index or basket.

For each component that is separately listed, a registered fund discloses: [S-X Rules 12-13, 12-13C]

- the description of the underlying investment as would be required elsewhere under Article 12;
- the quantity held;
- the value at the reporting date; and
- the percentage value compared to the net assets of the index or basket.

During a February 20, 2018, conference call with the AICPA Investment Companies Expert Panel, the SEC staff shared its observations about when disclosures do not provide sufficient information to determine how the components that are disclosed relate to the derivative as a whole. The SEC staff cited an example of effective disclosure as a registrant (1) identifying when disclosed components represent a subset of the index or basket, and (2) providing a reconciliation of other components to agree to the total value of the option or swap. [AICPA IC EP 2/2018]

Question 7.5.220 What is required for components of an index or basket to be considered 'publicly available on a website'?

Interpretive response: To be considered 'publicly available on a website' the components of the index or basket as of a registered fund's reporting date should be made publicly available by the time the registered fund's shareholder reports are transmitted to stockholders. In addition, the components are required to remain publicly available on the website for 70 days after the next fiscal year-end of the registered fund. [SEC Rel 33-10231 sec II.C.2.a. (FN 561), sec II.C.2.d. (FN 619)]

If the sponsor or provider of the index or basket is unable to satisfy these requirements, a registered fund provides the applicable disclosures when components are not publicly available (see Question 7.5.210).

Example 7.5.10 Whether components are publicly available on a website

Fund A is preparing its annual shareholders report, including the financial statements, for the year ending December 31, 20X4. Fund A plans to transmit the shareholders report to its stockholders on February 27, 20X5.

As of December 31, 20X4, Fund A has an investment in an open option contract with an underlying investment in Stock Index XYZ, for which the notional amount exceeds 1% of Fund A's net assets. The components are regularly published on the website of the index provider.

The components of Stock Index XYZ as of December 31, 20X4 are published on the index provider's website on February 20, 20X5. Because the components are published prior to the transmission of Fund A's shareholders report, the components are considered publicly available on a website. Therefore, Fund A is only required to identify Stock Index XYZ as part of the disclosures of the option contract and is not required to disclose any of its components.

In addition, the components must remain publicly available on the index provider's website until March 11, 20X6 (70 days after the next fiscal year-end of Fund A).

Question 7.5.230 What basis does a registered fund use to determine the 50 largest components of the index or basket?

Interpretive response: Consistent with the relevance of notional amounts to other disclosure thresholds when components are not publicly available (see Question 7.5.210), we believe the 50 largest components of an index or basket are generally determined based on the notional amounts of the components. As discussed in the final release, *Investment Company Reporting Modernization,* the SEC considers the notional amounts of the components to be an appropriate measure of the economic exposure of the underlying reference assets. [S-X Rule 12-13, SEC Rel 33-10231 sec II.C.2.a.]

However, the SEC staff also recognizes that the metric used to evaluate the magnitude of components could be determined differently based on the nature of the component. [S-X Rule 12-13, SEC Rel 33-10231 sec II.C.2.a, ICRM FAQ S-X 2]

Question 7.5.240 How are short positions within an index or basket considered when identifying the components to be presented separately?

Interpretive response: The SEC staff believes the absolute values for the notional amounts of short position components should be used when evaluating the components of an index or basket that are listed separately. For purposes of determining the largest components of an index or basket, the SEC staff believes the magnitude of a component does not depend on whether the position is long or short. [S-X Rule 12-13, ICRM FAQ S-X 2]

Question 7.5.250 Does Reg S-X prescribe how a registered fund calculates the notional amount disclosed for open option contracts?

Interpretive response: Reg S-X does not prescribe a method for calculating notional amounts for open option contracts. We believe the SEC intended to permit flexibility among funds to use reasonable calculation methods for notional amounts consistent with methods currently in use by registered funds for risk management or other operating purposes. [SEC Rel 33-10231 sec II.C.2.a]

In our experience, many funds calculate the notional amounts for option contracts based on the contract size multiplied by the share price of the underlying at the reporting date. Further, Table 1 included in SEC proposing release, *Use of Derivatives by Registered Investment Companies and Business Development Companies*, included methods that the SEC staff understands a fund would typically use to calculate notional amounts for risk management, reporting or other purposes. However, we believe it is acceptable for a fund to use another calculation method used for risk management or other purposes provided the method is applied consistently and does not result in a misleading presentation. [SEC Rel No. IC-31933 sec III.B.1.b.i.1]

7.5.50 Open futures contracts

Excerpt from Reg S-X Rule 12-13A

Open futures contracts.

[For management investment companies only]

Col. A	Col. B	Col. C	Col. D	Col. E	Col. F
Description[1 2 3 4 5]	Number of contracts	Expiration date	Notional amount[6]	Value	Unrealized appreciation/ depreciation.

[1] Information as to long purchases of futures contracts shall be shown separately from information as to futures contracts sold short.

[2] Futures contracts where descriptions or expiration dates differ shall be listed separately.

[3] Description should include the name of the reference asset or index.

[4] Indicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment.

[5] Indicate by an appropriate symbol each investment whose value was determined using significant unobservable inputs.

[6] Notional amount shall be the current notional amount at close of period.

[81 FR 82017, Nov. 18, 2016]

Question 7.5.260 What does a registered fund include in the schedule of investments when presenting open futures contracts?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting open futures contracts. [S-X Rule 12-13A]

Caption	Additional SEC instructions
Description[1,2]	• Include in the description the name of the reference asset or index. • Indicate with an appropriate symbol each investment that cannot be sold because of restrictions or conditions applicable to the investment (see Question 7.5.100). • Indicate with an appropriate symbol each investment valued using significant unobservable inputs (see Question 7.5.120).
Number of contracts	Not applicable.
Expiration date	Not applicable.
Notional amount[3]	Not applicable.
Value	Not applicable.
Unrealized appreciation/depreciation	Not applicable.

Notes:

1. Information on long purchases of futures contracts is to be shown separately from information on futures contracts sold short.
2. Futures contracts where descriptions or expiration dates differ are to be listed separately.
3. Represents the current notional amount at the reporting date.

Question 7.5.270 How does a registered fund present amounts for value that equal the unrealized appreciation or depreciation for open futures contracts?

Interpretive response: It depends.

A registered fund should evaluate whether the unit of account for the value of its open futures contracts includes any elements in addition to the unrealized appreciation or depreciation of the open futures contract, such as upfront payments. In our experience, upfront payments in the form of initial margin deposits are typically recorded as collateral receivable and are a separate unit of account from the futures contract.

In some instances, the value and the unrealized appreciation or depreciation of an open futures contract represent the same amount. The SEC staff indicated that in those instances, it is permissible for that information to be presented in a single column, provided that the column heading clearly discloses what the information represents. [ICRM FAQ S-X 1]

However, to the extent that the value and unrealized appreciation or depreciation of the open futures contract represent different units of account, those amounts are presented separately.

7.5.60 Open forward foreign currency contracts

Excerpt from Reg S-X Rule 12-13B

Open forward foreign currency contracts.

[For management investment companies only]

Col. A	Col. B	Col. C	Col. D	Col. E
Amount and description of currency to be purchased[1]	Amount and description of currency to be sold[1]	Counterparty	Settlement date	Unrealized appreciation/ depreciation.[2 3 4]

[1] Forward foreign currency contracts where description of currency purchased, description of currency sold, counterparty, or settlement dates differ shall be listed separately.

[2] Indicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment.

[3] Indicate by an appropriate symbol each investment whose value was determined using significant unobservable inputs.

[4] Column E shall be totaled and shall agree with the total of correlative amount(s) shown on the related balance sheet.

[81 FR 82017, Nov. 18, 2016]

Question 7.5.280 What does a registered fund include in the schedule of investments when presenting open forward foreign currency contracts?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting open forward foreign currency contracts. [S-X Rule 12-13B]

Caption	Additional SEC instructions
Amount and description of currency to be purchased[1]	Not applicable.
Amount and description of currency to be sold[1]	Not applicable.
Counterparty	Not applicable.
Settlement date	Not applicable.
Unrealized appreciation/depreciation[2]	• Indicate with an appropriate symbol each investment that cannot be sold due to restrictions or conditions applicable to the investment (see Question 7.5.100). • Indicate with an appropriate symbol each investment valued using significant unobservable inputs (see Question 7.5.120).

Notes:
1. Forward foreign currency contracts where description of currency purchased or sold, counterparty or settlement dates differ are to be listed separately.
2. The total unrealized appreciation/depreciation should agree with the corresponding net asset or net liability captions on the statement of assets and liabilities (see sections 7.2.20 and 7.2.30).

7.5.70 Open swap contracts

Excerpt from Reg S-X Rule 12-13C

Open swap contracts.

[For management investment companies only]

Col. A	Col. B	Col. C	Col. D	Col. E	Col. F	Col. G	Col. H
Description and terms of payments to be received from another party [1 2 3]	Description and terms of payments to be paid to another party [1 2 3]	Counter-party[4]	Maturity date	Notional amount	Value	Upfront payments/ receipts	Unrealized appreciation/ depreciation.[5 6 7]

[1] List each major category of swaps by descriptive title (*e.g.*, credit default swaps, interest rate swaps, total return swaps). Credit default swaps where protection is sold shall be listed separately from credit default swaps where protection is purchased.

[2] Swaps where description, counterparty, or maturity dates differ shall be listed separately within each major category.

[3] Description should include information sufficient for a user of financial information to understand the terms of payments to be received and paid. (*e.g.*, For a credit default swap, including, among other things, description of reference obligation(s) or index, financing rate to be paid or received, and payment frequency. For an interest rate swap, this may include, among other things, whether floating rate is paid or received, fixed interest rate, floating interest rate, and payment frequency. For a total return swap, this may include, among other things, description of reference asset(s) or index, financing rate, and payment frequency.) If the reference instrument is an index or basket of investments, and the components are publicly available on a Web site as of the balance sheet date, identify the index or basket. If the reference instrument is an index or basket of investments, the components are not publicly available on a Web site as of the balance sheet date, and the notional amount of the swap contract does not exceed one percent of the net asset value of the registrant as of the close of the period, identify the index or basket. If the reference instrument is an index or basket of investments, the components are not publicly available on a Web site as of the balance sheet date, and the notional amount of the swap contract exceeds one percent of the net asset value of the registrant as of the close of the period provide a description of the index or custom basket and list separately: (i) The 50 largest components in the index or custom basket and (ii) any other components where the notional value for that components exceeds 1% of the notional value of the index or custom basket. For each investment separately listed, include the description of the underlying investment as would be required by §§ 210.12-12, 210.12-13, 210.12-13A, 210.12-13B, or 210.12-13D as part of the description, the quantity held (e.g., the number of shares for common stocks, principal amount for fixed income securities), the value at the close of the period, and the percentage value when compared to the custom basket's net assets.

[4] Not required for exchange-traded or centrally cleared swaps.

[5] Indicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment.

[6] Indicate by an appropriate symbol each investment whose value was determined using significant unobservable inputs.

[7] Columns G and H shall be totaled and shall agree with the total of correlative amount(s) shown on the related balance sheet.

[81 FR 82017, Nov. 18, 2016]

Question 7.5.290 What does a registered fund include in the schedule of investments when presenting open swap contracts?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting open swap contracts. [S-X Rule 12-13C]

Caption	Additional SEC instructions
Description and terms of payments to be received from another party[1,2,3,4]	• Description should provide sufficient detail for users to understand the terms of payments to be received (see Question 7.5.300).
Description and terms of payments to be paid to another party[1,2,3,4]	• Description should provide sufficient detail for users to understand the terms of payments to be paid (see Question 7.5.300).
Counterparty[5]	Not applicable.
Maturity date	Not applicable.
Notional amount	Not applicable.
Value	Not applicable.
Upfront payments/receipts[6]	Not applicable.
Unrealized appreciation/depreciation[6]	• Indicate with an appropriate symbol each investment that cannot be sold due to restrictions or conditions applicable to the investment (see Question 7.5.100). • Indicate with an appropriate symbol each investment valued using significant unobservable inputs (see Question 7.5.120).

Notes:
1. List each major category of swap by descriptive title.
2. Credit default swaps where protection is sold are to be listed separately from those where protection is purchased.
3. Swap contracts where descriptions, counterparties or maturity dates differ are to be listed separately.
4. Disclose additional information when the underlying investment is an index or basket of investments (see Question 7.5.210).
5. Disclosure of counterparty is not required for exchange traded or centrally cleared swaps.
6. Present the totals for these captions, which should agree to the correlative amounts presented on the statement of assets and liabilities (see sections 7.2.20 and 7.2.30).

Question 7.5.300 What types of information may be included for the description and terms of open swap contracts?

Background: Within the schedule of investments, registered funds provide descriptions of the open swap contracts that they hold.

Interpretive response: Reg S-X Rule 12-13C does not outline a specific list of information required to be disclosed for swap contracts. Instead, the instructions under Rule 12-13C includes examples of information that may be relevant when describing each swap contract and the terms of payments to be received and paid. [S-X Rule 12-13C]

Credit default swaps

For a credit default swap, a registered fund may include, among other information:

- a description of reference obligation or index;
- the financing rate to be paid or received; and
- the payment frequency.

Interest rate swaps

For an interest rate swap, a registered fund may include, among other information:

- whether the floating rate is paid or received;
- the fixed interest rate;
- the floating interest rate; and
- the payment frequency.

Total return swaps

For a total return swap, a registered fund may include, among other information:

- a description of the reference asset or index;
- the financing rate; and
- the payment frequency.

Question 7.5.310 How does a registered fund determine the notional amounts to present for open swap contracts?

Interpretive response: It depends.

In its release, *Investment Company Reporting Modernization*, the SEC expressed the view that the current notional for a futures contract is more useful information than the notional amount at the time the contract was entered into. We believe the current notional amount may also be useful to depict the notional amount for open swap contracts when such information correlates to the value of the open swap contract. [SEC Rel 33-10231 sec II.C.2.b]

However, the instructions to Reg S-X Rule 12-13C are not prescriptive on the notional amount presented for open swap contracts. Because of the diverse types of swap contracts that may be presented under Rule 12-13C, we believe the SEC intended to provide flexibility in how a registered fund calculates notional amounts that are appropriate to the risk profile and determination of payments for a particular type of swap contract.

7.5.80 Investments in other asset classes

Excerpt from Reg S-X Rule 12-13D

Investments other than those presented in §§ 210.12-12, 12-12A, 12-12B, 12-13, 12-13A, 12-13B, and 12-13C.

[For management investment companies only]

Col. A	Col. B	Col. C
Description[1 2 3]	Balance held at close of period—quantity[4 5]	Value of each item at close of period.[6 7 8 9]

[1] Each investment where any portion of the description differs shall be listed separately.

[2] Categorize the schedule by (i) the type of investment (such as real estate, commodities, and so forth); and, as applicable, (ii) the related industry, country, or geographic region of the investment.

[3] Description should include information sufficient for a user of financial information to understand the nature and terms of the investment, which may include, among other things, reference security, asset or index, currency, geographic location, payment terms, payment rates, call or put feature, exercise price, expiration date, and counterparty for non-exchange-traded investments.

[4] If practicable, indicate the quantity or measure in appropriate units.

[5] Indicate by an appropriate symbol each investment which is non-income producing.

[6] Indicate by an appropriate symbol each investment which cannot be sold because of restrictions or conditions applicable to the investment.

[7] Indicate by an appropriate symbol each investment whose value was determined using significant unobservable inputs.

[8] Indicate by an appropriate symbol investment subject to option. State in a footnote: (a) The quantity subject to option, (b) nature of option contract, (c) option price, and (d) dates within which options may be exercised.

[9] Column C shall be totaled and shall agree with the correlative amount shown on the related balance sheet.

[81 FR 82018, Nov. 18, 2016]

Question 7.5.320 What does a registered fund include in the schedule of investments when presenting investments in other asset classes?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting investments in other asset classes. [S-X Rule 12-13D]

Caption	Additional SEC instructions
Description[1,2]	• Categorize investments in other asset classes by (1) type, and (2) related industry, country, or geographic region as applicable (see Question 7.5.330).
Balance held at close of period—quantity	• If practicable, indicate the quantity or unit of measure. • Indicate with an appropriate symbol each investment that is non-income producing (see Question 7.5.80).
Value of each item at close of period[3]	• Indicate with an appropriate symbol each investment that cannot be sold due to restrictions or conditions applicable to the investment (see Question 7.5.100). • Indicate with an appropriate symbol each investment valued using significant unobservable inputs (see Question 7.5.120). • Indicate with an appropriate symbol each investment subject to option and provide additional information in a footnote to the schedule (see Question 7.5.350).

Notes:

1. Each investment where any portion of the description differs is to be listed separately.
2. Descriptions should include sufficient information for users to understand the nature and terms of the investment (see Question 7.5.330).
3. The total value of all investments in other asset classes must agree with the correlative amounts shown on the statement of assets and liabilities (see sections 7.2.20 and 7.2.30).

Question 7.5.330 What information is provided for the description of investments in other asset classes?

Interpretive response: Investments in other asset classes listed on the schedule of investments includes descriptions that are sufficient for a user of the financial information to understand the nature and terms of the investments being described. This information may include, but is not limited to: [S-X Rule 12-13D]

- reference security, asset or index
- currency
- geographic location
- payment terms
- payment rates
- call or put features
- exercise price
- expiration date
- counterparty (for non-exchange traded investments).

Question 7.5.340 How are investments in physical commodities categorized if information for industry, country or geographic region does not apply to the investments?

Interpretive response: Registered funds are required to categorize investments in other asset classes by (1) the type of investment (such as real estate, commodities and so forth); and as applicable, (2) the related industry, country or geographic region of the investment. [S-X Rule 12-13D]

We do not expect an industry category to apply to a physical commodity; however, a related country or geographic region may be relevant. A registered fund should consider the facts and circumstances to determine whether categorization of physical commodities by related country or geographic region is applicable. We believe factors that may be considered when determining meaningful categorization include:

- whether physical commodities are exchange-traded or are transacted in principal-to-principal markets;
- whether physical commodities are fungible (i.e. they meet standard grades and are denominated as standardized units);
- whether the pricing of physical commodities is determined by global markets or local markets; and
- whether the physical storage or transportation routes of commodities occur in areas subject to significant geopolitical risks.

Question 7.5.350 What information is required for investments in other asset classes subject to option?

Interpretive response: For investments in other asset classes subject to option, the following information is presented in a footnote to the schedule of investments: [S-X Rule 12-13D]

- quantity subject to option;
- nature of the option contract;
- option price; and
- dates within which options may be exercised.

7.5.90 Investments in and advances to affiliates

Excerpt from Reg S-X Rule 12-14

Investments in and advances to affiliates.

[For management investment companies only]

Col. A	Col. B	Col. C	Col. D	Col. E	Col. F
Name of issuer and title of issue or nature of indebtedness[1 2 3]	Number of shares—principal amount of bonds, notes and other indebtedness held at close of period	Net realized gain or loss for the period[4 6]	Net increase or decrease in unrealized appreciation or depreciation for the period[4 6]	Amount of dividends or interest[4 6] (1) Credited to income (2) Other	Value of each item at close of period.[4 5 7 8 9]

[1] (a) List each issue separately and group (1) Investments in majority-owned subsidiaries; (2) other controlled companies; and (3) other affiliates. (b) If during the period there has been any increase or decrease in the amount of investment in and advance to any affiliate, state in a footnote (or if there have been changes to numerous affiliates, in a supplementary schedule) (1) name of each issuer and title of issue or nature of indebtedness; (2) balance at beginning of period; (3) gross additions; (4) gross reductions; (5) balance at close of period as shown in Column F. Include in the footnote or schedule comparable information as to affiliates in which there was an investment at any time during the period even though there was no investment at the close of the period of report.

[2] Categorize the schedule as required by instruction 2 of § 210.12-12.

[3] Indicate the interest rate or preferential dividend rate and maturity date, as applicable, for preferred stocks, convertible securities, fixed income securities, government securities, loan participations and assignments, commercial paper, bankers' acceptances, certificates of deposit, short-term securities, repurchase agreements, or other instruments with a stated rate of income. For variable rate securities, indicate a description of the reference rate and spread and: (1) The end of period interest rate or (2) disclose the end of period reference rate for each reference rate described in the Schedule in a note to the Schedule. For securities with payment in kind income, disclose the rate paid in kind.

[4] Columns C, D, E, and F shall be totaled. The totals of Column F shall agree with the correlative amount shown on the related balance sheet.

[5] (a) Indicate by an appropriate symbol each issue of restricted securities. The information required by instruction 8 of § 210.12-12 shall be given in a footnote. (b) Indicate by an appropriate symbol each issue of securities subject to option. The information required by § 210.12-13 shall be given in a footnote.

[6] (a) Include in Column E (1) as to each issue held at the close of the period, the dividends or interest included in caption 1 of the statement of operations. In addition, show as the final item in Column E (1) the aggregate of dividends and interest included in the statement of operations in respect of investments

in affiliates not held at the close of the period. The total of this column shall agree with the correlative amount shown on the related statement of operations.

(b) Include in Column E (2) all other dividends and interest. Explain in an appropriate footnote the treatment accorded each item.

(c) Indicate by an appropriate symbol all non-cash dividends and interest and explain the circumstances in a footnote.

(d) Indicate by an appropriate symbol each issue of securities which is non-income producing. Evidences of indebtedness and preferred shares may be deemed to be income producing if, on the respective last interest payment date or date for the declaration of dividends prior to the date of the related balance sheet, there was only a partial payment of interest or a declaration of only a partial amount of the dividends payable; in such case, however, each such issue shall be indicated by an appropriate symbol referring to a note to the effect that, on the last interest or dividend date, only partial interest was paid or partial dividends declared. If, on such respective last interest or dividend date, no interest was paid or no cash or in kind dividends declared, the issue shall not be deemed to be income producing. Common shares shall not be deemed to be income producing unless, during the last year preceding the date of the related balance sheet, there was at least one dividend paid upon such common shares.

(e) Include in Column C (1) as to each issue held at the close of the period, the realized gain or loss included in § 210.6-07.7 of the statement of operations. In addition, show as the final item in Column C (1) the aggregate of realized gain or loss included in the statement of operations in respect of investments in affiliates not held at the close of the period. The total of this column shall agree with the correlative amount shown on the related statement of operations.

(f) Include in Column D (1) as to each issue held at the close of the period, the net increase or decrease in unrealized appreciation or depreciation included in § 210.6-07.7 of the statement of operations. In addition, show as the final item in Column D (1) the aggregate of increase or decrease in unrealized appreciation or depreciation included in the statement of operations in respect of investments in affiliates not held at the close of the period. The total of this column shall agree with the correlative amount shown on the related statement of operations.

[7] The subtotals for each category of investments, subdivided both by type of investment and industry, country, or geographic region, shall be shown together with their percentage value compared to net assets.

[8] Indicate by an appropriate symbol each issue of securities whose value was determined using significant unobservable inputs.

[9] Indicate by an appropriate symbol each issue of securities held in connection with open put or call option contracts, loans for short sales, or where any portion of the issue is on loan.

[81 FR 82018, Nov. 18, 2016, as amended at 84 FR 57234, Oct. 24, 2019]

Question 7.5.360 What does a registered fund include in the schedule of investments when presenting investments in and advances to affiliates?

Interpretive response: A registered fund includes the following information in the schedule of investments when presenting investments in and advances to affiliates. [S-X Rule 12-14]

Caption	Additional SEC instructions
Name of issuer and title of issue or nature of indebtedness[1]	• Separately list and group each issue by (1) investments in majority-owned subsidiaries, (2) other controlled companies and (3) other affiliates. • Categorize investments by (1) type and (2) related industry, country or geographic region (see Question 7.5.30). • Indicate interest or dividend rates and maturity dates for debt instruments and preferred shares[2]. • For securities with payment-in-kind income, disclose the rate paid in-kind.
Number of shares—principal amount of bonds, notes, and other indebtedness held at close of period	Not applicable.
Net realized gain or loss for the period[3,4]	• List realized gains or losses for each issue held at the reporting date.
Net increase or decrease in unrealized appreciation or depreciation for the period[3,4]	• List the net increase or decrease in unrealized appreciation or depreciation for each issue held at the reporting date.
Amount of dividends or interest[3,4] **(1) Credited to income** **(2) Other**	• For dividends or dividends credited to income, list the amounts for each issue held at the reporting date. • Include all other dividends and interest, with explanation of their treatment in a footnote. • Indicate with an appropriate symbol all non-cash dividends and interest and explain the circumstances in a footnote to the schedule. • Indicate with an appropriate symbol each issue of securities that is non-income producing (see Question 7.5.80).

Caption	Additional SEC instructions
Value of each item at close of period[5,6]	• Indicate with an appropriate symbol each issue of restricted securities and provide additional information in a footnote to the schedule (see Questions 7.5.100 and 7.5.110). • Indicate with an appropriate symbol each issue of securities subject to option and provide the information required for open option contracts written in a footnote to the schedule (see section 7.5.40). • Indicate with an appropriate symbol each issue of securities valued using significant unobservable inputs (see Question 7.5.120). • Indicate with an appropriate symbol each issue of securities held in connection with open options, loans for short sales, or where any portion of the issue is on loan.

Notes:

1. If there have been changes in investments in or advances to any affiliate during the period, list in a footnote or supplementary schedule the investments or advances and provide a rollforward of the balances (see Question 7.5.380).
2. Additional information is required when disclosing interest rate information for variable rate securities (see Question 7.5.70).
3. Present the total amounts, which should agree with the correlative amounts presented on the statement of operations (see sections 8.2.20 and 8.2.40).
4. Amounts included in the statement of operations, but in respect of investments in affiliates no longer held at the reporting date, are aggregated and presented as the final item in the respective column to agree to the corresponding amount in the statement of operations.
5. The subtotals for each category of investments, subdivided by type of investment and by industry, country or geographic region, are shown along with their percentage value compared to net assets.
6. Present total value of investments, which should agree to the correlative amounts presented on the statement of assets and liabilities (see section 7.2.20).

Question 7.5.370 How is an 'affiliate' defined when a registered fund reports investments in and advances to affiliates?

Interpretive response: The term 'affiliate' means an affiliated person, defined in section 2(a)(3) of the Investment Company Act of 1940 as:

"(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person;

(B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;

(C) any person directly or indirectly controlling, controlled by, or under common control with, such other person;

(D) any officer, director, partner, copartner, or employee of such other person;

(E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and

(F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof."

Although the definition of an affiliate includes similar concepts as the definition of related parties under Topic 850, those terms are not identical, nor are they interchangeable. Therefore, registered funds should apply the 1940 Act definition of affiliate when reporting investments under Reg S-X Rule 12-14. However, to the extent that the fund has transactions with related parties as defined under Topic 850, those transactions should be disclosed in the financial statements per the disclosure requirements in Topic 850. [S-X Rule 6-02]

Question 7.5.380 What information is required when there has been a change in amount of investment in or advance to any affiliate?

Interpretive response: If during the period there has been any increase or decrease in the amount of an investment in or advance to any affiliate, the following items are disclosed in a footnote to the schedule of investments: [S-X Rule 12-14]

- name of each issuer;
- title of issue or nature of indebtedness;
- beginning balance;
- gross additions;
- gross reductions; and
- ending balance.

If there are changes to multiple investments in or advances to affiliates, a supplementary schedule should be used to present such information.

The disclosure also includes comparable information for affiliate amount for which there was an investment during the period, even if the investment was no longer held at the reporting date.

7.6 Condensed schedule of investments – nonregistered investment partnerships

7.6.10 Overview

Excerpt from ASC 946-210

• > Investment Companies That Are Nonregistered Investment Partnerships

50-4 Except as noted in the following paragraph, the guidance in paragraph 946-210-50-6 applies to investment partnerships that are exempt from Securities and Exchange Commission (SEC) registration under the Investment Company Act of 1940, which include all of the following:

a. Hedge funds
b. Limited liability companies
c. Limited liability partnerships
d. Limited duration companies
e. Offshore investment companies with similar characteristics
f. Commodity pools subject to regulation under the Commodity Exchange Act of 1974.

50-5 The guidance in the following paragraph does not apply to investment partnerships that are brokers and dealers in securities subject to regulation under the Securities Exchange Act of 1934 (registered broker-dealers) and that manage funds only for those who are officers, directors, or employees of the general partner. For guidance applicable to those entities, see Topic 940.

Investment companies that are nonregistered investment partnerships, at a minimum, present a condensed schedule of investments that are held as of the reporting date.

Unlike a detailed schedule of investments, which presents a complete listing of securities, a condensed schedule of investments only requires separate listing of investments that meet the specified disclosure threshold applicable to the type of investment. Investments that are not separately listed are condensed into categories by investment type and other relevant concentrations.

In addition to the requirements for investments in securities, separate categories and disclosures apply to investments in derivative instruments and other investment companies.

Question 7.6.10 What are nonregistered investment partnerships?

Interpretive response: Nonregistered investment partnerships represent a subset of nonregistered funds that are not specifically defined in Topic 946, but rather are described as investment partnerships that are exempt from registration under the 1940 Act. Such funds include the following: [946-210-50-4]

- hedge funds;
- limited liability companies;
- limited liability partnerships;
- limited duration companies;
- offshore investment companies with similar characteristics; and
- commodity pools subject to regulation under the Commodity Exchange Act of 1974.

We believe the types of entities included in the description of nonregistered investment partnerships in Topic 946 are consistent with investment companies that meet the characteristics of a 'private fund' as defined in the Advisers Act. [SOP 95-2.05, Advisers Act §202(a)(29)]

Question 7.6.20 What is a condensed schedule of investments?

Interpretive response: A nonregistered investment partnership is required, at a minimum, to present a condensed schedule of investments held as of the reporting date. Rather than providing a complete listing of the investments of a nonregistered investment partnership, a condensed schedule of investments: [946-210-50-6]

- condenses the investments held as of the reporting date by categories, such as investment type, country or geographic regions, industry and underlying; and
- separately discloses investments only when disclosure thresholds based on 5% of net assets are met ('5% test').

See Question 7.6.80 for additional discussion of the 5% test.

Question 7.6.30 Do the requirements for nonregistered investment partnerships apply to broker-dealers?

Interpretive response: It depends.

The condensed schedule of investments requirements under Topic 946 do not apply to a nonregistered investment partnership that is also a registered broker-dealer if it manages funds for only those who are officers, directors or employees of the general partner. Such entities are only required to apply the presentation requirements for broker-dealers under Topic 940. [946-210-50-5]

However, a nonregistered investment partnership that is also a registered broker-dealer and provides investment management to third-party investors is subject to the presentation requirements of both Topics 940 and 946.

7.6.20 Investments in securities

Excerpt from ASC 946-210

• > Investment Companies That Are Nonregistered Investment Partnerships

50-6 The financial statements of an investment partnership meeting the condition in paragraph 946-210-50-4 shall, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule shall do all of the following:

a. Categorize investments by all of the following:
   1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
   2. Country or geographic region, except for derivative instruments for which the **underlying** is not a security (see (a)(4))
   3. Industry, except for derivative instruments for which the underlying is not a security (see (a)(4))

   …
b. Report the percent of net assets that each such category represents and the total fair value and cost for each category in (a)(1) and (a)(2).
c. Disclose the name, number of shares or principal amount, fair value, and type of both of the following:
   1. Each investment (including short sales) constituting more than 5 percent of net assets, except for derivative instruments (see (e) and (f)). In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.
   2. All investments in any one issuer aggregating more than 5 percent of net assets, except for derivative instruments (see (e) and (f)). In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.
d. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments, and categorize them in accordance with the guidance in (a). In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

Question 7.6.40 What does a nonregistered investment partnership include on the condensed schedule of investments for investments in securities?

Interpretive response: A nonregistered investment partnership includes the following information on the condensed schedule of investments when presenting investments in securities. [946-210-50-6]

Disclosure	Requirements
Category[1,2]	Categorize investments by: • type[3] • country or geographic region[3] • industry.
5% test – individual investments	For individual investments whose fair value exceeds 5% of net assets[4], disclose the following: • name of the issuer • number of shares or principal amount • fair value • type.
5% test – aggregate investments of any one issuer	For aggregate investments in any one issuer whose fair value exceed 5% of net assets[4], disclose the following for each aggregated investment: • name of the issuer • number of shares or principal amount • fair value • type.

Notes:

1. Include the percent of net assets each category represents.
2. All other investments not separately listed under the 5% test are aggregated without specifically identifying the issuers of such investments and categorized under these requirements.
3. Include subtotals of cost and fair value amounts for each category presented by (1) type and (2) country or geographic region.
4. When applying the 5% test, total long and total short positions in any one issuer are considered separately.

Question 7.6.50 Are there additional disclosure requirements for investments in private entities?

Interpretive response: No. Topic 946 does not include any additional disclosure requirements for investments in privately held entities on the condensed schedule of investments. Therefore, a nonregistered investment partnership generally presents investments in privately held entities on the condensed schedule of investments in a similar manner as an investment that is publicly traded.

However, a nonregistered investment partnership may consider whether to provide additional information for financial statement users to better understand the risks associated with private investments that are listed individually under the 5% test.

Question 7.6.60 How does an investment company categorize an investment that conducts its principal operations in one country but trades on the exchange of another?

Background: Investment companies may invest in depositary receipts, such as American depositary receipts (ADRs) and global depositary receipts (GDRs), which are negotiable securities that represent securities of companies that are foreign to the markets on which the depositary receipts trade. Depositary receipts allow investment companies to invest in foreign companies in a manner that avoids administrative costs and foreign taxes from cross-border transactions.

Interpretive response: A condensed schedule of investments provides users with information to understand the risks and opportunities associated with the type, geographical area and industry associated with the investees. We believe the risks and opportunities associated with an investment are typically more closely associated with the country or geographic region in which the investee conducts its principal operations, rather than the market in which the investment trades. [SOP 95-2.18]

We believe an investment company should consider the facts and circumstances to determine the risks and opportunities that are the most closely associated with the investment when determining the appropriate country or geographic region presented as the category for a particular investee.

Question 7.6.70 When may an investment be categorized by geographic region instead of by country?

Interpretive response: It depends.

We believe categorizing investments by country will generally provide more meaningful information about the risks and opportunities associated with the issuer than would be provided by geographic area.

However, when an issuer conducts operations in multiple countries, the country the issuer is most closely associated with may not be readily determinable. In those instances, it may be more meaningful to categorize the investment by geographic region; however, an investment company should consider whether the designated geographic region is more representative of the risks and opportunities of the investment than a particular country. An investment company should consider the facts and circumstances of the issuer and its operations, which may include:

- the issuer's principal operations;
- the primary location of the assets used in the issuer's operations;
- the primary location of the issuer's customers;
- the location of the issuer's headquarters;
- the extent to which component countries of the geographic region are comparable, such as having similar geopolitical and economic risks; and

- whether the designated geographic region is widely used and accepted in the marketplace.

Question 7.6.80 What is the 5% test?

Interpretive response: The 5% test is used to determine whether investments in any one investee are required to be listed separately on the condensed schedule of investments as of the reporting date. For nonregistered investment partnerships, the disclosure threshold is based on concentrations in the investment portfolio that exceed 5% of its net assets as of the reporting date.

For investments in securities, a condensed schedule of investments requires separate listing of: [946-210-50-6(c)]

- individual investments exceeding 5% of net assets; and
- aggregate investments in any one issuer exceeding 5% of net assets.

When applying the 5% test, total long and total short positions in any one issuer are considered separately.

For each investment meeting the 5% test (both individually and in the aggregate), the following information is to be disclosed:

- name of the issuer;
- number of shares or principal amount;
- fair value; and
- type.

Investments that do not meet the 5% test are aggregated without identifying the issuers and categorized as required by Topic 946. [946-210-50-6(d)]

Question 7.6.90 Can a nonregistered investment partnership evaluate the components of a boxed position on a net basis when performing the 5% test?

Background: A boxed position comprises of both long and short positions in the same security position. In some circumstances, the quantity of the long and short positions match, resulting in a complete offset in changes in fair value of the boxed position.

Interpretive response: No. Even if the boxed position results in completely offsetting economic exposure between the long position and the short position in the same issuer, it is not appropriate to evaluate the boxed position on a net basis for purposes of disclosure on the condensed schedule of investments. Each component of the boxed position is evaluated separately on a gross basis when performing the 5% test.

If one or both components of the boxed position meet the 5% test, such component(s) are listed on the condensed schedule of investments because of potential market risks if one position is closed before the other, or if settlement costs or losses are incurred upon sale. [TQA 6910.16]

Example 7.6.10 5% test – boxed position

ABC Fund holds the following investments in Company A.

Position	% of net assets
Company A common stock (long)	5%
Company A common stock (short)	(5%)

ABC Fund presents both positions separately on the condensed schedule of investments, because both the long position and the short position in Company A are greater than 5% of net assets. This is regardless of ABC Fund's boxed position resulting in an offsetting economic exposure to Company A.

Question 7.6.100 Is a nonregistered investment partnership required to present both long and short positions of the same issuer if only one meets the 5% test?

Interpretive response: No. Topic 946 states that in applying the 5% test to determine the investments to be disclosed on the condensed schedule of investments, total long and total short positions in any one issuer are considered separately. [946-210-50-6]

Only the position that meets the 5% test is required to be disclosed. An offsetting position in the same issuer that does not meet the 5% test is not required to be disclosed separately. However, a nonregistered investment partnership is not precluded from disclosing both positions. [TQA 6910.17]

7.6.30 Derivative instruments

Excerpt from ASC 946-210

• > Investment Companies That Are Nonregistered Investment Partnerships

50-6 The financial statements of an investment partnership meeting the condition in paragraph 946-210-50-4 shall, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule shall do all of the following:

a. Categorize investments by all of the following:
   1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
   2. Country or geographic region, except for derivative instruments for which the **underlying** is not a security (see (a)(4))
   3. Industry, except for derivative instruments for which the underlying is not a security (see (a)(4))

4. For derivative instruments for which the underlying is not a security, by broad category of underlying (for example, grains and feeds, fibers and textiles, foreign currency, or equity indexes) in place of the categories in (a)(2) and (a)(3).

b. Report the percent of net assets that each such category represents and the total fair value and cost for each category in (a)(1) and (a)(2).

…

d. Aggregate other investments (each of which is 5 percent or less of net assets) without specifically identifying the issuers of such investments, and categorize them in accordance with the guidance in (a). In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.
e. Disclose the number of contracts, range of expiration dates, and cumulative appreciation (depreciation) for open futures contracts of a particular underlying (such as wheat, cotton, specified equity index, or U.S. Treasury Bonds), regardless of exchange, delivery location, or delivery date, if cumulative appreciation (depreciation) on the open contracts exceeds 5 percent of net assets. In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.
f. Disclose the range of expiration dates and fair value for all other derivative instruments of a particular underlying (such as foreign currency, wheat, specified equity index, or U.S. Treasury Bonds) regardless of counterparty, exchange, or delivery date, if fair value exceeds 5 percent of net assets. In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

Question 7.6.110 What does a nonregistered investment partnership include in the schedule of investments for derivative instruments?

Interpretive response: A nonregistered investment partnership includes the following information on the condensed schedule of investments when presenting derivative instruments. [946-210-50-6]

Disclosure	Requirements
Category – when the underlying is a security[1,2]	Categorize derivatives by: • type[3] • country or geographic region[3] • industry
Category – when the underlying is not a security[1,2]	Categorize derivatives by: • type[3] • broad category of underlying (see Question 7.6.150)
5% test – open futures contracts	For open futures contracts of a particular underlying whose cumulative appreciation or depreciation exceed 5% of net assets[4], disclose the following:

Disclosure	Requirements
	• number of contracts • range of expiration dates • fair value
5% test – all other derivative instruments	For all other derivative instruments of a particular underlying whose fair value exceed 5% of net assets[4], disclose the following: • range of expiration dates • fair value

Notes:

1. Include the percent of net assets each category represents.
2. All other investments not separately listed under the 5% test are aggregated without specifically identifying the issuers of such investments and categorized under these requirements.
3. Include subtotals of cost and fair value for each category presented for: (1) type and (2) country or geographic region.
4. Whether derivative instruments of a particular underlying exceed 5% of net assets is determined without regard to different counterparties, exchanges, delivery locations or delivery dates.

Question 7.6.120 Is a nonregistered investment partnership required to specify the directional exposure when categorizing derivative instruments by type?

Interpretive response: No. While Topic 946 requires a nonregistered investment partnership to present all investments by type on the condensed schedule of investments, it does not specify whether derivative instruments should be categorized separately by directional exposure (i.e. long exposure versus short exposure).

We believe there is diversity in practice in how nonregistered investment partnerships categorize derivative instruments on the condensed schedule of investments.

Some entities may view the directional exposure of the derivative instrument as distinct categories for investment type. We believe this is an acceptable approach to categorize derivative instruments because it may provide meaningful information about how a nonregistered investment partnership uses derivative instruments as part of its investment strategies.

As an alternative to categorizing derivative instruments by directional exposure, we believe the classification of derivative positions as assets or liabilities based on their gross fair value amounts as of the reporting date also may be an acceptable approach under the guidance for applying the 5% test to derivative instruments (see Question 7.6.160). However, we believe a nonregistered investment partnership should consider whether the disclosures required under Topic 815 provide sufficient information about the directional exposure of the entity's derivative activities when concluding that it is not necessary to specify the directional exposure of derivative instruments on the condensed schedule of investments.

We believe either approach is acceptable but should be applied consistently by the entity.

Question 7.6.130 What are examples of derivative instruments for which the underlying is a security?

Background: Topic 946 requires a nonregistered investment partnership to categorize its investments when presenting a condensed schedule of investments. For investments in derivative instruments, the categories applied to those investments depend on whether the underlying is a security.

Interpretive response: Examples of derivative instruments for which the underlying is a security include:

- a total return swap that exchanges fixed-rate cash flows for floating-rate cash flows that are indexed to the common stock of a publicly traded issuer;
- a credit default swap used to purchase credit protection against losses incurred on specified credit events involving a single-name debt security; and
- a written call option that obligates the writer of the option to sell a specified security at a predetermined price to the purchaser of the option if exercised.

Question 7.6.140 How does a nonregistered investment partnership categorize a derivative instrument for which the underlying is a security?

Interpretive response: When the underlying is a security, Topic 946 requires disclosure of the country (or geographic region) and industry in which the issuer of the security operates. When the underlying is not a security, derivative instruments are categorized by broad category of underlying. [946-210-50-6(a)]

However, some derivative instruments may contain complex or exotic features, where a derivative has more than one underlying, and therefore it may not be evident whether the primary underlying of a derivative instrument is a security.

When presenting a condensed schedule of investments, the information disclosed about derivative positions should reflect the relevant market risks of an investment company's significant investments. If a derivative instrument has more than one underlying, we believe a nonregistered investment partnership should evaluate which underlyings most significantly impact the economic performance of the derivative position. Based on that assessment, the partnership should apply judgment to determine the appropriate categorization that best represents the market risks for such derivative positions on the condensed schedule of investments. It may also consider supplemental disclosures to provide additional information of other market risks that are significant to the position. [SOP 03-4.A-10]

Question 7.6.150 What is the difference between a broad category of underlying and a particular underlying?

Background: Derivative instruments for which the underlying is not a security are categorized by broad category of underlying on the condensed schedule of investments. In addition, derivative instruments of a particular underlying are aggregated for purposes of the 5% test, regardless of counterparty, exchange, delivery location or delivery date.

Interpretive response: A particular underlying represents the type of underlying that an individual derivative instrument derives its value from. The particular underlying for a derivative instrument can include a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable. [815-10 Glossary]

A broad category of underlying represents the relevant classification of underlyings for the derivative instruments included on the condensed schedule of investments. For derivative instruments for which the underlying is not a security, categorization of derivative positions by broad category of underlying provides relevant information about market risks. [SOP 03-4.A-10]

The following table summarizes examples of broad categories of underlyings and particular underlyings within those broad categories.

Broad underlying	Particular underlying
Grains and feeds	• Corn • Soybeans • Wheat
Energy	• Crude oil • Natural gas
Metals	• Gold • Silver • Copper
Foreign currency	• Euro • Japanese Yen • British Pound • Chinese Renminbi
Reference rates	• Secured Overnight Financing Rate (SOFR) • Sterling Overnight Interbank Average (SONIA)
Equity indices	• S&P 500 • Nasdaq 100 • Russell 2000

Question 7.6.160 How does a nonregistered investment partnership evaluate derivative instruments when performing the 5% test?

Background: When presenting a condensed schedule of investments, investments in securities and securities sold short are presented consistently with their classification on the statement of assets and liabilities. However, derivative instruments may be netted on the statement of assets and liabilities if the right of offset exists under Subtopic 210-20 or Topic 815.

Interpretive response: When disclosing investments that meet the 5% test, either individually or in the aggregate for the same issuer or particular underlying, the classification of investments on the condensed schedule of investments follows the classification of asset and liability positions on the statement of assets and liabilities.

However, the netting guidance under Subtopic 210-20 and Topic 815 when presenting a statement of assets and liabilities is not considered for purposes of applying the 5% test. Therefore, investments in derivative instruments are evaluated based on whether the fair value amounts represent on a gross basis an asset or a liability position, regardless of long or short exposure.

Securities and derivatives associated with the same issuer

A nonregistered investment partnership may hold securities in a particular issuer along with derivative instruments for which the underlying is a security of the same issuer. For purposes of the 5% test, investments in securities of a particular issuer should be assessed together with derivative instruments when:

- the underlying for the derivative is a security of the same issuer; and
- the gross fair value amount as of the reporting date is in an appreciation position (i.e. a derivative asset).

If the sum of securities and derivative assets that are associated with the same issuer exceeds 5% of net assets, both the securities and derivative positions are disclosed separately on the condensed schedule of investments.

Similarly, securities sold short are aggregated with derivative liabilities (i.e. when the gross fair value amount as of the reporting date is in a depreciation position) associated with the same issuer to determine whether those positions are to be disclosed separately under the 5% test. [TQA 6910.18]

Example 7.6.20 5% test – securities and derivatives associated with the same issuer

ABC Fund holds the following investments in Company A.

Position	% of net assets
Corporate bonds of Company A (long)	4%
Common stock of Company A (short)	(3%)
Short exposure equity swap (Company A is the underlying)	2%

Although the equity swap has a short exposure to Company A as the underlying, it is treated as a derivative asset position for purpose of the 5% test, regardless of directional exposure, because the equity swap is in an appreciation position as of the reporting date. Therefore, ABC Fund evaluates the long bond positions in Company A together with the short exposure equity swap as gross asset positions when performing the 5% test.

ABC Fund presents both the long bond positions in Company A as well as the short exposure equity swap contract on the condensed schedule of investments because, in aggregate, the gross asset position meets the 5% test. The short stock position in Company A is not required to be disclosed separately because it does not meet the 5% test.

Question 7.6.170 Can a nonregistered investment partnership present derivative instruments on a net basis?

Interpretive response: It depends.

Topic 946 does not provide specific guidance on the presentation of derivative instruments when the netting guidance under Subtopic 210-20 or Topic 815 is applied. Typically, the presentation on the condensed schedule of investments by a nonregistered investment partnership should align with its classification of asset and liability categories on the statement of assets and liabilities.

For purposes of performing the 5% test for derivative instruments (see Question 7.6.160), the netting concepts allowed by Subtopic 210-20 and Topic 815 are not considered. As a result, individual derivative asset and derivative liability positions are evaluated on a gross basis based on their fair values (or cumulative appreciation or depreciation for open futures contracts). [TQA 6910.18]

Because of the requirements in Topic 946 to aggregate other investments that are not separately listed and to categorize them in accordance with the guidance, we believe that a nonregistered investment partnership is not precluded from applying the netting guidance under Subtopic 210-20 or Topic 815 when aggregating other derivative instruments that do not meet the 5% test, provided that such application of the netting guidance is consistent with the presentation of derivative assets and liabilities on the statement of assets and liabilities. [946-210-50-6(d)]

7.6.40 Investments in other investment companies

Excerpt from ASC 946-210

• > Investment Companies That Are Nonregistered Investment Partnerships

50-6 The financial statements of an investment partnership meeting the condition in paragraph 946-210-50-4 shall, at a minimum, include a condensed schedule of investments in securities owned by the partnership at the close of the most recent period. Such a schedule shall do all of the following:

a. Categorize investments by all of the following:
   1. Type (such as common stocks, preferred stocks, convertible securities, fixed-income securities, government securities, options purchased, options written, warrants, futures, loan participations, short sales, other investment companies, and so forth)
   2. Country or geographic region, except for derivative instruments for which the **underlying** is not a security (see (a)(4))

   …

b. Report the percent of net assets that each such category represents and the total fair value and cost for each category in (a)(1) and (a)(2).
c. Disclose the name, number of shares or principal amount, fair value, and type of both of the following:
   1. Each investment (including short sales) constituting more than 5 percent of net assets, except for derivative instruments (see (e) and (f)). In applying the 5-percent test, total long and total short positions in any one issuer should be considered separately.
   2. All investments in any one issuer aggregating more than 5 percent of net assets, except for derivative instruments (see (e) and (f)). In applying the 5-percent test, total long and total short positions in any one issuer shall be considered separately.

…

g. Provide both of the following additional qualitative descriptions for each investment in another nonregistered investment partnership whose fair value constitutes more than 5 percent of net assets:
   1. The investment objective
   2. Restrictions on redemption (that is, liquidity provisions).

• > Investments in Other Investment Companies—Applicable to All Investment Companies

50-8 Investments in other investment companies (investees), such as investment partnerships, limited liability companies, and funds of funds, shall be considered investments for purposes of applying paragraph 946-210-50-1(a) through (b) and 946-210-50-6.

• > Investments in Other Investment Companies—Applicable Only to Nonregistered Investment Partnerships

50-9 If the reporting investment company's proportional share of any investment owned by any individual investee exceeds 5 percent of the reporting investment company's net assets at the reporting date, each such investment shall be named and categorized as discussed in paragraph 946-210-50-6. These investee disclosures shall be made either in the condensed schedule of investments (as components of the investment in the investee) or in a note to that schedule.

50-10 If information about the investee's portfolio is not available, that fact shall be disclosed.

Investments in other investment companies (e.g. investment partnerships, limited liability companies, and funds of funds) are presented in a similar manner as investments in securities on a condensed schedule of investments. [946-210-50-8]

Disclosure of the name of an investment in another nonregistered investment partnership by itself may not provide financial statement users with sufficient information about the nature of significant investments. Therefore, additional qualitative disclosures are required for investments in other investment companies meeting the 5% test. [SOP 03-4.A-3]

A nonregistered investment partnership is also required to disclose its proportionate share of any individual investment owned by an investee fund that exceeds 5% of net assets ('5% look-through').

Question 7.6.180 What does a nonregistered investment partnership include on the condensed schedule of investments for investments in other investment companies?

Interpretive response: A nonregistered investment partnership includes the following information on the condensed schedule of investments when presenting investments in other investment companies. [946-210-50-6, 50-9]

Disclosure	Requirements
Category[1,2]	Categorize investments by: • type[3] • country or geographic region[3] • industry[4]
5% test	For individual investments whose fair values exceed 5% of net assets, disclose the following: • name of the issuer • number of shares or principal amount • fair value • type • investment objective • restrictions on redemptions
5% look-through	Disclose the name and categorize the proportionate share of any investment owned by an individual investee fund that exceeds 5% of the reporting fund's net assets.[5,6]

Notes:
1. Include the percent of net assets each category represents.
2. All other investments not separately listed under the 5% test are aggregated without specifically identifying the issuers of such investments and categorized under these requirements.
3. Include subtotals of cost and fair value amounts for each category presented by (1) type and (2) country or geographic region.

4.	We believe industry categorization is not relevant to investments in other investment companies. In practice, nonregistered investment partnerships commonly categorize investments by investment strategy.
5.	See Question 7.6.80 for disclosure requirements under the 5% test.
6.	If information about the investee's portfolio is not available, that fact should be disclosed. [946-210-50-10]

Question 7.6.190 What additional disclosures are required for investments in other investment companies that meet the 5% test?

Interpretive response: A nonregistered investment partnership provides the following qualitative descriptions for each investment in another nonregistered investment partnership that meets the 5% test: [946-210-50-6(g)]

- investment objective; and
- restrictions on redemption (i.e. liquidity provisions).

Question 7.6.200 How does a nonregistered investment partnership evaluate whether 5% look-through disclosures are required?

Interpretive response: A nonregistered investment partnership calculates its proportionate share of investments owned by an investee fund based on its percentage ownership of the investee. [TQA 6910.31]

The steps in performing the 5% look-through evaluation are as follows.

Step 1	Determine the *percentage ownership in the investee fund.*[1]
Step 2	Determine the *look-through disclosure threshold*[2] for each investee fund.
Step 3	Report the *proportionate share of investments*[3] that exceed the *look-through disclosure threshold.*[4]

Notes:

1. Divide the investment balance by the net assets of the investee fund.
2. Divide the amount that represents 5% of the nonregistered investment partnership's net assets by the percentage ownership in the investee fund.
3. For investments that exceed the look-through disclosure threshold, multiply the fair value amounts of the underlying investments reported by the investee fund by the percentage ownership in the investee fund.
4. Consistent with the 5% test for direct investments, indirect investments in any one issuer held by the investee fund are aggregated when performing the 5% look-through evaluation. In addition, indirect long and short positions of the same issuer are be evaluated separately.

Example 7.6.30 5% look-through evaluation

Assume the following fact pattern as of December 31.

- ABC Fund has an investment in Fund B of $2,000,000 based on the reported NAV as a practical expedient.
- ABC Fund has net assets of $10,000,000.
- Fund B has net assets of $5,000,000.

Fund B holds the following investments as of the reporting date:

- Common stock - Company DEF (fair value $1,500,000)
- Common stock - Company GHI (fair value $1,000,000)
- Common stock - Company JKL (fair value $1,000,000)
- Corporate bonds - Company JKL (fair value $300,000)

ABC Fund performs the 5% look-through evaluation as follows.

Step 1	The *percentage ownership in the investee fund* (Fund B) is 40%[1]
Step 2	The *look-through disclosure threshold* is $1,250,000[2].
Step 3	The *proportionate share of investments* to be disclosed is as follows: • Common stock – Company DEF: $600,000[3] (6.0% of ABC Fund's net assets) • Common stock – Company JKL: $400,000[4,5] (4.0% of ABC Fund's net assets) • Corporate bonds – Company JKL: $120,000[4,6] (1.2% of ABC Fund's net assets)

Notes:

1. The percentage ownership in the investee fund is calculated as follows:
   [$2,000,000 ÷ $5,000,000] = 40%.
2. The look-through disclosure threshold is calculated as follows:
   [$10,000,000 × 5%] ÷ 40% = $1,250,000.
3. The proportionate share of Common stock – Company DEF is calculated as follows:
   [$1,500,000 × 40%] = $600,000.
4. Although Fund B's positions in Company JKL do not individually meet the look-through disclosure threshold, those positions are disclosed separately because in the aggregate the proportionate share of those investments in the same issuer exceed 5% of ABC Fund's net assets ($520,000 or 5.2% of net assets).
5. The proportionate share of Common stock – Company JKL is calculated as follows:
   [$1,000,000 × 40%] = $400,000.
6. The proportionate share of Corporate bonds – Company JKL is calculated as follows:
   [$300,000 × 40%] = $120,000.

Question 7.6.210 Does the 5% look-through evaluation apply to investments in other investment companies that are less than 5% of net assets?

Interpretive response: Yes. Topic 946 does not provide any threshold for which a nonregistered investment partnership need not perform a 5% look-through evaluation of its investee funds. Even though an investee fund itself may not meet the 5% test, the proportional share of the investee fund's investments in an individual issuer can still exceed 5% of a nonregistered investment partnership as the result of leverage used by the investee fund. Under such circumstances, the 5% look-through disclosures should be presented, because the proportionate share of those investments represents a significant concentration meeting the intent of the disclosure requirements.
[TQA 6910.30]

7.7 Schedule of investments – 'other' nonregistered investment companies

Excerpt from ASC 946-210

> Schedule of Investments

• > Investment Companies Other than Nonregistered Investment Partnerships

50-1 In the absence of regulatory requirements, investment companies other than nonregistered investment partnerships shall do all of the following:

a. Disclose the name, number of shares, or principal amount of all of the following:
   1. Each investment (including short sales, written options, futures contracts, forward contracts, and other investment-related liabilities) whose **fair value** constitutes more than 1 percent of net assets. In applying the 1-percent test, total long and total short positions in any one issuer should be considered separately.
   2. All investments in any one issuer whose fair values aggregate more than 1 percent of net assets. In applying the 1-percent test, total long and total short positions in any one issuer should be considered separately.
   3. At a minimum, the 50 largest investments.
b. Categorize investments by both of the following characteristics:
   1. The type of investment (such as common stocks, preferred stocks, convertible securities, fixed income securities, government securities, options purchased, options written, warrants, futures contracts, loan participations and assignments, short-term securities, repurchase agreements, short sales, forward contracts, other investment companies, and so forth)
   2. The related industry, country, or geographic region of the investment.
c. Disclose the aggregate other investments (each of which is not required to be disclosed by (a)) without specifically identifying the issuers of such

investments and categorize as required by (b). The disclosure shall include both of the following:

1. The percent of net assets that each such category represents
2. The total value for category in (b)(1) and (b)(2).

50-2 For required disclosures about any other significant concentration of credit risk, see Section 825-10-50. For example, an international fund that categorizes its investments by industry or geographic region should also report a summary of its investments by country, if such concentration is significant.

50-3 For required disclosures about certain significant estimates, such as use of estimates by directors, general partners, or others in an equivalent capacity to value securities, see Subtopic 275-10.

In the absence of regulatory requirements, Subtopic 946-210 establishes requirements for investment companies other than nonregistered investment partnerships to present a schedule of investments. The Subtopic provides separate requirements for nonregistered investment partnerships to present such a schedule - see section 7.6.

Because registered investment companies are subject to regulatory requirements regarding a schedule of investments, these requirements in Subtopic 946-210 apply only to '*other nonregistered investment companies*' (i.e. nonregistered investment companies other than nonregistered investment partnerships). See section 7.5 for the regulatory requirements applicable to registered investment companies.

Examples of other nonregistered investment companies may include state-chartered common investment trusts and certain exchange-traded funds exempt from 1940 Act regulation.

Question 7.7.10 What do other nonregistered investment companies include on the schedule of investments?

Interpretive response: Other nonregistered investment companies include the following information on the schedule of investments. [946-210-50-1]

Disclosure	Requirements
Category[1,2]	Categorize investments by: • type[3] • related industry, country *or* geographic region[3]
Top 50 investments	For the Top 50 investments, disclose the following: • name of the issuer • number of shares or principal amount • fair value

Disclosure	Requirements
1% test – individual investments	For individual investments that exceed 1% of net assets[4], disclose the following: • name of the issuer • number of shares or principal amount • fair value
1% test – aggregate investments of any one issuer	For aggregate investments in any one issuer that exceed 1% of net assets[4], disclose the following: • name of the issuer • number of shares or principal amount • fair value

Notes:

1. Include the percent of net assets each category represents.
2. All other investments not separately listed under the 1% test requirements are aggregated without specifically identifying the issuers of such investments and categorized under these requirements.
3. Include subtotals of cost and fair value amounts for each category presented.
4. When applying the 1% test, total long and total short positions in any one issuer are considered separately.

Question 7.7.20 How do other nonregistered investment companies apply the 1% test?

Interpretive response: Similar to the requirements of the 5% test for nonregistered investment partnerships (see Question 7.6.80), the 1% test is used by other nonregistered investment companies to determine whether investments in any one investee are required to be listed separately in the schedule of investments as of the reporting date, except at a 1% disclosure threshold.

For investments in securities, a schedule of investments requires separate listing of: [946-210-50-1(a)]

- individual investments exceeding 1% of net assets; and
- aggregate investments in any one issuer exceeding 1% of net assets.

When applying the 1% test, total long and total short positions in any one issuer should be considered separately.

For each investment meeting the 1% test, the following information should be disclosed:

- name of the issuer;
- number of shares or principal amount;
- fair value; and
- type.

Investments that do not meet the 1% test are aggregated without identifying the issuers and categorized as required by Topic 946. [946-210-50-1(c)]

Question 7.7.30 Do other nonregistered investment companies disclose investments that do not meet the 1% test?

Interpretive response: It depends.

At a minimum, other nonregistered investment companies are required to disclose the Top 50 investments that comprise their investment portfolio as of the reporting date, regardless of whether the 1% test is met. [946-210-50-1(a)]

However, if the minimum disclosure requirements of the Top 50 investments have been met, additional disclosure of investments that do not meet the 1% test is not required.

8. Reporting results of operations

Detailed contents

Question 8.3.190 Is it permissible to not annualize ratios for periods less than a year?

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Question 8.3.320 Does a fund of funds include investment income and expenses allocated from its investee funds when calculating financial highlights ratios?

Example

Example 8.3.10 Presentation for performance fees and allocation

8.1 How the standard works

Investment companies report their results of operations through both a statement of operations and financial highlights.

Statement of operations

A statement of operations provides information about financial performance and the returns on economic resources during the reporting period. Information about an entity's income, expenses, gains and losses helps financial statement users evaluate the ability of an entity to use its assets and other resources and its ability to generate future cash flows.

The primary requirements for presenting a statement of operations and disclosing related items are as follows.

Subtopic 946-220	Applies to investment companies in the scope of Topic 946 (see chapter 2)
Reg S-X Rule 6-07	Provides incremental requirements for registered funds and BDCs

Financial highlights

Financial highlights, presented either as a separate schedule or in the notes to the financial statements, provide information to help users understand an investment company's financial performance during the reporting period.

The primary requirements for presenting financial highlights are as follows.

Subtopic 946-205	Requires financial highlights to include: • per-share information; • ratios to average net assets; and • investment returns.
SEC Forms N-1/A (open-end funds) and N-2 (closed-end funds)	Applies to registered funds and BDCs. Provides incremental presentation requirements and instructions on how to calculate certain financial highlights information.

8.2 Statement of operations

8.2.10 Overview

Excerpt from ASC 946-220

> Statement of Operations

45-1 The objective of the statement of operations is to present the increase or decrease in net assets resulting from all of the company's investment activities, by reporting investment income from dividends, interest, and other income less expenses, the amounts of realized gains or losses from investment and foreign currency transactions, and changes in unrealized appreciation or depreciation of investments and foreign-currency-denominated assets and liabilities for the period. That format helps the user understand the contribution of each aspect of investment activity to the company's overall operations.

45-2 This following provides guidance on presentation of all of the following captioned items in an investment company's statement of operations:

a. Expenses
b. Taxes
c. Net investment income
d. Gain or loss from investments and foreign currency transactions
e. Net increase or decrease in net assets from operations.

A statement of operations presents the results of the investment company’s operating and investment activities, including investment income from interest and dividends, expenses, and realized and unrealized gains or losses from investments.

Question 8.2.10 What does an investment company present in a statement of operations?

Interpretive response: An investment company presents the changes in its net assets resulting from its investment activities by including the following items in a statement of operations. [946-220-45-1]

Category	Description	Reference
Investment income	Represents investment income from dividends, interest, and other income.	Section 8.2.20
Expenses	Represents expenses from investment operations.	Section 8.2.30
Net investment income	Represents the excess of investment income over total expenses. [946-220-45-5]	

Category	Description	Reference
Realized gains or losses	Includes realized gains or losses from investments and foreign currency transactions.	Section 8.2.40
Unrealized gains or losses	Represents changes in unrealized appreciation or depreciation of investments and foreign-currency-denominated assets and liabilities for the period.	Section 8.2.40
Net increase (decrease) in net assets from operations	Represents the sum of net investment income (or loss) and net realized and unrealized gain or loss on investments and foreign currency. [946-220-45-7]	

8.2.20 Investment income

Excerpt from ASC 946-20

> Dividends

50-9 Dividends from affiliates and controlled companies shall be disclosed.

Excerpt from Reg S-X Rule 6-07

Statements of operations.

Statements of operations, or statements of comprehensive income, where applicable, filed by registered investment companies, other than issuers of face-amount certificates, subject to the special provisions of § 210.6-08, and business development companies, shall comply with the following provisions:

Statements of Operations

1. *Investment income.* State separately income from: (a) Dividends; (b) interest on securities; and (c) other income. Any other category of income which exceeds five percent of the total shown under this caption (*e.g.* income from non-cash dividends, income from payment-in-kind interest) shall be stated separately. If income from investments in or indebtedness of affiliates is included hereunder, such income shall be segregated under an appropriate caption subdivided to show separately income from: (1) Controlled companies; and (2) other affiliates. If income from non-cash dividends or payment in kind interest are included in income, the bases of recognition and measurement used in respect to such amounts shall be disclosed.

[81 FR 82012, Nov. 18, 2016; 83 FR 50202, Oct. 4, 2018]

Question 8.2.20 How is investment income presented?

Interpretive response: An investment company presents investment income in a statement of operations as follows.

Registered funds

Registered funds present the following categories of investment income separately.

Caption	Reference
Dividends[1,2,3]	S-X Rule 6-07.1
Interest on securities[1,2,3]	
Other income[1,2]	

Notes:

1. Any other category of income that exceeds 5% of total investment income is stated separately (see Questions 8.2.30 and 8.2.40).
2. Investment income from investments in or advances to affiliates is subdivided to present separately income from (1) controlled companies, and (2) other affiliates.
3. For income from noncash dividends or payment in kind interest, the basis for recognition and measurement in respect to such amounts is disclosed (see Question 8.2.40).

Nonregistered funds

Subtopic 946-220 states that the objective of a statement of operations to present the increase or decrease in net assets resulting from all of the investment activities includes reporting investment income from dividends, interest and other income. Similar to registered funds, we believe nonregistered funds should present separately investment income from dividends, interest and other income. [946-220-45-1]

Nonregistered funds also disclose dividends from affiliates and controlled companies. [946-20-50-9]

Question 8.2.30 What does other income represent?

Interpretive response: Other income represents investment income from sources other than dividends and interest from investments in securities. Examples of other income can include fee income from securities lending, certain recoveries from litigation settlements unrelated to specific portfolio securities, and other miscellaneous sources. Individual amounts of other income that are material should be disclosed separately. [AAG-INV 7.115, 8.36]

Question 8.2.40 Does a registered fund present noncash dividends and payment-in-kind interest separately from amounts received in cash?

Interpretive response: Yes. A registered fund is required to separately disclose noncash dividends and payment-in-kind interest that exceeds 5% of investment income in the statement of operations. Such information provides increased transparency for investors when investment income is earned but not received in the form of cash. [S-X Rule 6-07.1, SEC Rel 33-10231 sec II.C.6]

Question 8.2.50 Does a registered fund present in-kind payments separately if a fund has the option to elect to receive either cash or in-kind payments?

Interpretive response: Yes. Although some in-kind payments resulting from a registered fund's election may have less risk of issuer default, the SEC views all types of income from in-kind payments to be subject to the same disclosure threshold. Therefore, the statement of operations presentation requirements for registered funds do not differentiate income that was elected to be received in-kind from other in-kind payments. [S-X Rule 6-07.1, SEC Rel 33-10231, sec II.C.6]

Question 8.2.60 Does a registered fund present adjustments from amortization and accretion as a separate category of investment income?

Background: Under the interest method, premiums and discounts on debt investments are generally amortized to interest income over the life of the investment to arrive at a periodic interest amount that represents a constant effective interest rate (see Question 3.6.60).

Interpretive response: No. Adjustments to interest income for amortization and accretion represent income statement reclassifications resulting from previous cash transactions, rather than in-kind sources of income. As discussed in its release, *Investment Company Reporting Modernization*, the SEC acknowledged that shareholders generally do not distinguish between cash interest and income adjustments from amortization and accretion, and therefore the SEC does not require separate disclosure for amortization and accretion. [S-X Rule 6-07.1, SEC Rel 33-10231, sec II.C.6 FN 734]

Example 8.2.10 Presentation of investment income – registered funds

At December 31, ABC Mutual Fund presents the following categories of investment income in the statement of operations.

Investment income	
Dividends from non-affiliated/non-controlled companies	41,289,000
Noncash dividends from non-affiliated/non-controlled companies[1]	2,750,000
Dividends from controlled companies[2]	65,000
Dividends from other affiliates[2]	135,000
Interest	2,495,000
Securities lending income[3]	3,034,000
Other income	782,000
Total investment income	50,550,000

Notes:

1. Noncash dividends are presented separately because they exceed 5% of total investment income, calculated as follows:
   [$2,750,000 ÷ $50,550,000] = 5.4%.
2. Income from controlled companies and other affiliates are required to be presented separately.
3. Securities lending income is presented separately because it exceeds 5% of total investment income, calculated as follows:
   [$3,034,000 ÷ $50,550,000] = 6.0%.

8.2.30 Expenses

Excerpt from ASC 946-220

> Statement of Operations

• > Expenses

45-3 All of the following expenses are commonly reported separately:

a. Investment advisory (management) fees (or compensation)
b. Administration fees payable to an affiliate (if accrued under a separate agreement)
c. Shareholder service costs, including fees and expenses for the transfer agent and dividend disbursing agent
d. Distribution (**12b-1**) expenses
e. Custodian fees
f. Cost of reports to shareholders
g. Federal and state income taxes (these expenses shall be shown separately after the income category to which they apply, such as investment income and realized or unrealized gains)
h. Other taxes (foreign withholding taxes shall be deducted from the relevant income item and presented parenthetically or shown as a separate contra item in the income section)
i. Interest (including interest on debt, bank borrowings, and reverse repurchase agreements)

j. Dividends on securities sold short
k. Professional fees
l. Directors' or trustees' fees
m. Registration fees and expenses.

> Complex Capital Structures

• > Multiple-Class Funds

45-9 Class-specific expenses shall be reported for each class of fund in the statement of operations or disclosed in the notes to financial statements. Reporting the amount of fund-level expenses allocated to each class is not required but disclosure of fund-level expenses by class in the statement of operations or in notes to financial statements is permitted. (See paragraph 946-220-50-3.)

> Complex Capital Structures

• > Multiple Class Funds

50-3 Class-specific expenses shall be reported for each class of fund in the statement of operations or disclosed in the notes to financial statements. Reporting the amount of fund-level expenses allocated to each class is not required but disclosure of fund-level expenses by class in the statement of operations or in notes to financial statements is permitted. (See paragraph 946-220-45-9.)

Excerpt from Reg S-X Rule 6-07

Statements of operations.

Statements of operations, or statements of comprehensive income, where applicable, filed by registered investment companies, other than issuers of face-amount certificates, subject to the special provisions of § 210.6-08, and business development companies, shall comply with the following provisions:…

2. *Expenses.* (a) State separately the total amount of investment advisory, management and service fees, and expenses in connection with research, selection, supervision, and custody of investments. Amounts of expenses incurred from transactions with affiliated persons shall be disclosed together with the identity of and related amount applicable to each such person accounting for five percent or more of the total expenses shown under this caption together with a description of the nature of the affiliation. Expenses incurred within the person's own organization in connection with research, selection and supervision of investments shall be stated separately. Reductions or reimbursements of management or service fees shall be shown as a negative amount or as a reduction of total expenses shown under this caption.
   (b) State separately any other expense item the amount of which exceeds five percent of the total expenses shown under this caption.
   (c) A note to the financial statements shall include information concerning management and service fees, the rate of fee, and the base and method of computation. State separately the amount and a description

of any fee reductions or reimbursements representing: (1) Expense limitation agreements or commitments; and (2) offsets received from broker-dealers showing separately for each amount received or due from (i) unaffiliated persons; and (ii) affiliated persons. If no management or service fees were incurred for a period, state the reason therefor.

(d) If any expenses were paid otherwise than in cash, state the details in a note.

(e) State in a note to the financial statements the amount of brokerage commissions (including dealer markups) paid to affiliated broker-dealers in connection with purchase and sale of investment securities. Open-end management companies shall state in a note the net amounts of sales charges deducted from the proceeds of sale of capital shares which were retained by any affiliated principal underwriter or other affiliated broker-dealer.

(f) State separately all amounts paid in accordance with a plan adopted under 17 CFR 270.12b-1 of this chapter. Reimbursement to the fund of expenses incurred under such plan (12b-1 expense reimbursement) shall be shown as a negative amount and deducted from current 12b-1 expenses. If 12b-1 expense reimbursements exceed current 12b-1 costs, such excess shall be shown as a negative amount used in the calculation of total expenses under this caption.

(g)(1) *Brokerage/Service Arrangements*. If a broker-dealer or an affiliate of the broker-dealer has, in connection with directing the person's brokerage transactions to the broker-dealer, provided, agreed to provide, paid for, or agreed to pay for, in whole or in part, services provided to the person (other than brokerage and research services as those terms are used in section 28(e) of the Securities Exchange Act of 1934 [15 U.S.C. 78bb(e)]), include in the expense items set forth under this caption the amount that would have been incurred by the person for the services had it paid for the services directly in an arms-length transaction.

(2) *Expense Offset Arrangements*. If the person has entered into an agreement with any other person pursuant to which such other person reduces, or pays a third party which reduces, by a specified or reasonably ascertainable amount, its fees for services provided to the person in exchange for use of the person's assets, include in the expense items set forth under this caption the amount of fees that would have been incurred by the person if the person had not entered into the agreement.

(3) *Financial Statement Presentation*. Show the total amount by which expenses are increased pursuant to paragraphs (1) and (2) of this paragraph (2)(g) as a corresponding reduction in total expenses under this caption. In a note to the financial statements, state separately the total amounts by which expenses are increased pursuant to paragraphs (1) and (2) of this paragraph (2)(g), and list each category of expense that is increased by an amount equal to at least 5 percent of total expenses. If applicable, the note should state that the person could have employed the assets used by another person to produce income if it had not entered into an arrangement described in paragraph (2)(g)(2) of this section.

3. *Interest and amortization of debt discount and expense*. Provide in the body of the statements or in the footnotes, the average dollar amount of borrowings and the average interest rate.

[81 FR 82012, Nov. 18, 2016; 83 FR 50202, Oct. 4, 2018]

Question 8.2.70 What types of expenses are commonly presented in the statement of operations?

Interpretive response: Subtopic 946-220 provides the following examples of expenses that investment companies commonly report separately in the statement of operations. [946-220-45-3]

Expense categories	
Investment advisory fees[1]	Foreign tax expense[6]
Administration fees paid to affiliates[2]	Interest[7]
Shareholder service costs[3]	Dividends on short positions
12b-1 distribution expenses[4]	Professional fees
Custodian fees	Director or trustee fees
Costs of shareholder reports	Registration fees and expenses[8]
Federal and state expense[5]	

Notes:

1. See section 5.2 for additional discussion of investment advisory fees, which include management and performance fees.
2. If such fees are accrued under a separate agreement.
3. Includes fees and expenses for the transfer agent and dividend disbursing agent.
4. See section 4.7 for additional discussion of distribution costs.
5. Federal and state tax expenses should be shown separately after the income category to which they apply, such as investment income and realized or unrealized gains. See Question 8.2.190. [946-220-45-3(g), 45-4]
6. Foreign withholding tax expense should be deducted from the relevant income item and presented either parenthetically or as a separate contra item to the corresponding income item. See Question 8.2.200. [946-220-45-3(h)]
7. Includes interest on debt instruments, as well as bank borrowings and reverse repurchase agreements.
8. Such expenses may be considered to be offering costs. See section 4.6 for additional discussion on the accounting for offering costs.

When reporting its results of operations, we believe an investment company should apply judgment and consider an appropriate detail of expenses that is meaningful to the users of the financial statements, including consideration of other expense categories not included in the list above.

An investment company should also comply with the applicable disclosure requirements under Topic 850 for related party expenses.

Registered funds should also consider the incremental requirements for presenting expenses in accordance with Reg S-X (see Question 8.2.80)

Question 8.2.80 What information is a registered fund required to provide when presenting expenses in the statement of operations?

Interpretive response: The following discusses the Reg S-X requirements for presenting a registered fund's expenses in the statement of operations, along with related disclosure requirements.

Investment advisory, management and service fees

The total amount of investment advisory, management and service fees are stated separately.

Any reductions or reimbursements of management or service fees are presented as a negative amount or as a reduction of total expenses. [S-X Rule 6-07.2(a)]

Amounts of fee reductions or reimbursements are presented separately, along with a description for the following:

- expense limitation agreements or commitments;
- offsets received from broker-dealers presenting separately each amount received or due from:
  - unaffiliated entities; and
  - affiliated entities

Information on the fee rate, the fee base and method of computing management and service fees is disclosed in the notes to the financial statements.

If no management or service fees were incurred for a period, the reason is disclosed. [S-X Rule 6-07.2(c)]

Certain investing-related costs

Expenses in connection with research, selection, supervision and custody of investments are stated separately. Further, separate detail is required for expenses in connection with research, selection and supervision of investments incurred internally within the registered fund organization complex. [S-X Rule 6-07.2(a)]

Expenses from transactions with affiliates

Expenses incurred from transactions and agreements with affiliates are separately presented.

In addition, if a registered fund has expenses with an individual affiliate that exceed 5% of total expenses, the following is disclosed for each such affiliate: [S-X Rule 6-07.2(a)]

- identity of the affiliate;
- related amount; and
- description of the nature of the affiliation

Other expenses

A registered fund separately presents any other expense item that exceeds 5% of total expenses. [S-X Rule 6-07.2(b)]

Noncash expenses

Detail of any expenses not paid in cash is provided in a footnote. [S-X Rule 6-07.2(d)]

Brokerage commissions and charges

The amount of brokerage commissions paid to affiliates in connection with the purchase and sale of investment securities is disclosed in the notes to the financial statements. [S-X Rule 6-07.2(e)]

However, as discussed in Question 3.4.10, brokerage commissions in connection with purchases and sales of investment securities are included as part of the transaction price of an investment rather than classified as an expense. Nonetheless, the disclosure of brokerage commissions paid to affiliates applies to registered funds.

Open-end registered funds disclose the net amounts of sales charges deducted from the proceeds of sale of capital shares that were retained by any affiliated principal underwriter or other affiliated broker-dealer. [S-X Rule 6-07.2(e)]

12b-1 distribution expenses

Amounts paid in accordance with a 12b-1 distribution plan are presented separately. Any reimbursements received by a registered fund for expenses incurred under a 12b-1 plan are presented as a negative amount and deducted from current 12b-1 expenses. [S-X Rule 6-07.2(f)]

Brokerage service and expense offset arrangements

For brokerage service and expense offset arrangements, the relevant expense caption includes the amount that would have been incurred had the expenses been paid directly in an arm's-length transaction. Such amounts paid indirectly are reflected as a corresponding reduction in total expenses (see Question 5.3.180). [S-X Rule 6-07.2(g)(1) – (3)]

The notes to the financial statements include the total amounts by which expenses are increased under such arrangements and list each category that is increased by at least 5% of total expenses. [S-X Rule 6-07.2(g)(3)]

However, the presentation above does not apply to brokerage and research services that meet the safe harbor provisions under Section 28(e) of the 1943 Act (see Question 5.3.170). [S-X Rule 6-07.2(g)(1)]

Interest and amortization of debt discount and expense

A registered fund provides the average dollar amount and average interest rate for its borrowings on the face of the statement of operations or in a footnote. [S-X Rule 6-07.3]

Question 8.2.90 How does a registered fund present class-specific expenses?

Background: As discussed in section 4.3, some registered funds may issue more than one class of shares and charge different classes of shares for specific or incremental expenses, such as different sales charges to each class of shares.

Interpretive response: Class-specific expenses are reported for each class in the statement of operations or disclosed in the notes to the financial statements. [946-220-45-9]

Example 8.2.20 Presentation of expenses – registered funds

At December 31, ABC Mutual Fund presents the following categories of expenses in the statement of operations.

Expenses	
Management fees[1,2]	3,950,000
Dividends on securities sold short[3]	1,070,000
Research expenses[4]	260,000
12b-1 distribution fees – Class B[5,8]	395,000
Shareholder servicing fees – Class A[6,8]	235,000
Shareholder servicing fees – Class B[6,8]	95,000
Professional fees[3]	375,000
Other expenses	170,000
Less: fees paid indirectly[7]	(65,000)
Total expenses	6,485,000

Notes:

1. Management fees are required to be disclosed separately.
2. The notes to the financial statements also include information on the computation of management fees, including the fee rate and base.
3. Category is presented separately because it exceeds 5% of total expenses of $6,485,000 ($324,250).
4. Expenses in connection with research of investments are presented separately.
5. Amounts paid in accordance with a 12b-1 distribution plan are presented separately.

6. Class-specific shareholder servicing fees are combined for purposes of determining whether such expenses exceed 5% of total expenses and therefore should be presented separately.
7. Represents amounts of expenses reduced under an expense offset arrangement.
8. See Question 8.2.90 for additional requirements for class-specific expenses.

Question 8.2.100 Do nonregistered funds gross up the presentation of expenses paid indirectly under brokerage services and expense offset arrangements?

Background: When a registered fund pays expenses indirectly under such arrangements, Reg S-X Rule 6-07 requires the registered fund to gross up the amount that it would have incurred had it directly paid expenses in an arm's-length transaction (see Question 8.2.80).

Interpretive response: Yes. Topic 946 provides similar presentation guidance for expenses paid indirectly under brokerage services and expense offset arrangements. Therefore, a nonregistered fund is required to gross up the amount that would have been incurred had the expenses been paid directly in an arm's-length transaction, with a corresponding reduction in total expenses for the amounts paid indirectly (see Question 5.3.180). [946-20-45-3, 45-5]

Question 8.2.110 How are fee waivers presented?

Interpretive response: As discussed in Question 5.3.20, fee waivers are presented as a separate line item for the reduction of total expenses in the statement of operations. [946-20-50-7]

Question 8.2.120 Do nonregistered funds organized as limited partnerships present performance allocations in the statement of operations?

Interpretive response: No. As discussed in Question 5.2.10, a nonregistered fund organized as a limited partnership presents a performance allocation as a reallocation of net income from the limited partners to the general partner in the statement of partners' capital rather than as an expense in the statement of operations. [946-20-45-4]

8.2.40 Gains or losses from investments

Excerpt from ASC 946-220

> Statement of Operations

• > Gain or Loss from Investments and Foreign Currency Transactions

45-6 The following amounts related to gain or loss from investments and foreign currency transactions shall be presented as follows:

a. Net realized gain or loss from investments and foreign currency transactions.
   1. Investments. Net realized gains or losses resulting from sales or other disposals of investments shall be reported net of brokerage commissions. The net realized gains or losses from investments and net realized gains or losses from foreign currency transactions may be reported separately or may be combined.
   2. Foreign currency transactions. Net gains or losses from assets or liabilities denominated in foreign currencies during the period shall be reported separately. If separate reporting of foreign currency effects on realized gains or losses from investments is elected, those effects shall be included in this caption.

b. Net increase (decrease) in unrealized appreciation or depreciation on investments and translation of assets and liabilities in foreign currencies, which comprises both of the following:
   1. Investments. Changes in net unrealized appreciation or depreciation during the period shall be presented in the statement of operations. The major components of unrealized appreciation or depreciation shall be presented in a manner that is consistent with the guidance provided in (a). Either combining the net unrealized gains or losses from investments with net unrealized gains or losses from foreign currency transactions or reporting them separately is permissible. Any provision for deferred taxes shall be reported separately.
   2. Translation of assets and liabilities in foreign currencies. The net change during the period from translating assets and liabilities denominated in foreign currencies shall be reported under the caption "Net Increase (Decrease) in Unrealized Appreciation or Depreciation on Translation of Assets and Liabilities in Foreign Currencies."

c. Net realized and unrealized gain or loss from investments and foreign currency. The sum of the net realized gain or loss and change in unrealized gain or loss on investments and foreign-currency-denominated assets and liabilities shall be presented in the statement of operations as a net gain or loss on investments and foreign currency.

> Net Realized Gain or Loss from Investments

50-2 The statement of operations shall disclose net realized gains or losses. Gains or losses arising from in-kind redemptions shall be disclosed. Notes to financial statements shall state an entity's practice of either including or excluding that portion of realized and unrealized gains and losses from investments that result from foreign currency changes with or from other foreign currency gains and losses.

Excerpt from Reg S-X Rule 6-07

Statements of operations.

Statements of operations, or statements of comprehensive income, where applicable, filed by registered investment companies, other than issuers of face-amount certificates, subject to the special provisions of § 210.6-08, and business development companies, shall comply with the following provisions:…

7. *Realized and unrealized gain (loss) on investments-net.* (a) State separately the net realized gain or loss from: (1) Transactions in investment securities of unaffiliated issuers, (2) transactions in investment securities of affiliated issuers, (3) expiration or closing of option contracts written, (4) closed short positions in securities, (5) expiration or closing of futures contracts, (6) settlement of forward foreign currency contracts, (7) expiration or closing of swap contracts, and (8) transactions in other investments held during the period.
   - (b) Distributions of realized gains by other investment companies shall be shown separately under this caption.
   - (c) State separately the amount of the net increase or decrease during the period in the unrealized appreciation or depreciation in the value of: (1) Investment securities of unaffiliated issuers, (2) investment securities of affiliated issuers, (3) option contracts written, (4) short positions in securities, (5) futures contracts, (6) forward foreign currency contracts, (7) swap contracts, and (8) other investments held at the end of the period.
   - (d) State separately any: (1) Federal income taxes and (2) other income taxes applicable to realized and unrealized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes.

[81 FR 82012, Nov. 18, 2016; 83 FR 50202, Oct. 4, 2018]

Question 8.2.130 How are realized gains or losses from investments presented?

Interpretive response: An investment company discloses net realized gains or losses from investments in the statement of operations. Gains or losses from in-kind redemptions are disclosed separately. [946-220-45-6(a), 50-2]

If an investment company elects combined reporting of the effect of foreign currency gains or losses from investments in foreign securities (see sections 3.9.10 and 8.2.50), the presentation of realized gains or losses on investments also includes the related effects of changes in foreign currency rates on those investments. [946-220-45-6(a)(1), 946-830-45-36]

Registered funds

Registered funds are required to present separately realized gains or losses on investments from the following transactions.

Caption	Reference
Investment securities of unaffiliated issuers[1]	S-X Rule 6-07.7(a)
Investment securities of affiliated issuers[1]	
Expiration or closing of option contracts written	
Closed short positions	
Expiration or closing of futures contracts	
Settlement of forward foreign currency contracts	
Expiration or closing of swap contracts	
Other investments held during the period	

Notes:

1. Distributions of realized gains by other investment companies should be shown separately. [S-X Rule 6-07.7(b)]

In addition, any income tax provision charged against realized gains should be disclosed separately (see Question 8.2.190).

Nonregistered funds

Topic 946 does not prescribe separate captions for presenting realized gains or losses from investments. We believe it is acceptable for nonregistered funds to categorize realized gains or losses in a level of detail consistent with the captions used to present investments on the statement of assets and liabilities. However, we believe it is common practice for nonregistered funds to combine realized gains or losses from investments in securities and securities sold short in the same caption. [946-220-45-6(a)]

Question 8.2.140 How are unrealized gains or losses on investments presented?

Interpretive response: An investment company discloses net changes in unrealized appreciation or depreciation on investments in the statement of operations. [946-220-45-6(b)]

If an investment company elects combined reporting of the effect of unrealized foreign currency gains or losses on investments in foreign securities (see sections 3.9.10 and 8.2.50), the presentation of net unrealized appreciation or depreciation on investments also includes the related effects of changes in foreign currency rates on those investments. [946-220-45-6(b)(1), 946-830-45-36]

Registered funds

Registered funds are required to separately present net increase or decrease during the period in the unrealized appreciation or depreciation in the value of the following investment categories.

Caption	Reference
Investment securities of unaffiliated issuers	S-X Rule 6-07.7(c)
Investment securities of affiliated issuers	
Option contracts written	
Short positions	
Futures contracts	
Forward foreign currency contracts	
Swap contracts	
Other investments held at the end of the period	

In addition, any provision for deferred taxes should be presented separately (see Question 8.2.190).

Nonregistered funds

Topic 946 does not prescribe separate captions for presenting changes in net unrealized appreciation or depreciation on investments. We believe it is acceptable for nonregistered funds to categorize unrealized gains or losses in a level of detail consistent with the captions used to present investments on the statement of assets and liabilities. However, we believe it is common practice for nonregistered funds to combine unrealized gains or losses from investments in securities and securities sold short in the same caption. [946-220-45-6(b)]

Question 8.2.150 How are settlement payments on swap contracts classified?

Background: A swap contract represents an agreement between two parties to exchange cash flows determined by reference to a financial instrument (or other underlying) agreed upon by each of the respective parties. Following the initial swap transaction, periodic payments are exchanged between the counterparties at recurring payment dates until the swap contract expires or is terminated. These periodic payments represent streams of cash flows exchanged between the counterparties, which are determined by variables associated with the underlying to the swap contract, such as fixed or floating interest rates, foreign exchange rates, commodity prices or equity prices.

Depending on the legal terms of agreements entered into between parties or executed under the conditions of an exchange or clearinghouse, the periodic payments can represent legal settlements of cash flows between counterparties to the swap contract, or payments of collateral (either in favor of the investment company or the swap counterparty).

Interpretive response: Although Topic 815 does not prescribe the specific presentation of derivative gains or losses in the statement of operations, the SEC staff believes investment companies should present payments received or paid as periodic settlements of a swap contract as realized gains or losses in the statement of operations. [AICPA IC EP 3/2004, 6/2004]

The SEC staff also stated that all fair value adjustments to the swap contract should be reflected in the net change in unrealized appreciation or depreciation. [AICPA IC EP 3/2004]

We do not believe it would be appropriate to classify any portion of receipts or payments as an adjustment to investment income because it may result in 'synthetic hedge accounting' for arrangements that do not qualify for hedge accounting. See Question 14.3.20 in KPMG Handbook, Derivatives and hedging.

8.2.50 Foreign currency transactions

Excerpt from ASC 946-830

> Expenses

45-35 The accounting for expenses payable in a foreign currency is identical to that for investment income receivable in a foreign currency. An expense shall be accrued as incurred and translated into the functional currency at the spot rate each day. The use of an average weekly or monthly foreign currency rate would be acceptable if the foreign currency rate does not fluctuate significantly. The related accrued expense balance shall be accumulated in the foreign currency and translated into the functional currency daily, using the spot rate for that date. The difference between the expense accrued in the functional currency and the related foreign currency accrued expense balance translated into the functional currency at the valuation date spot rate shall be recognized as an unrealized foreign currency gain or loss. When the expense is paid, the unrealized foreign currency gain or loss shall be reclassified as realized foreign currency gain or loss.

> Financial Statement Presentation

45-36 An investment company is not required to separately disclose that portion of unrealized and realized gains and losses on investments that results from foreign currency changes. All other foreign currency gains or losses shall be reported under the realized and unrealized gain or loss on investments and foreign currency section in the statement of operations.

45-37 For example, realized foreign currency gain or loss on interest and dividends shall be included in the realized foreign currency gain or loss component of net realized gain or loss. All unrealized foreign currency gain or loss, other than those on investments, shall be reported as unrealized appreciation or depreciation on translation of assets and liabilities in foreign currencies. The statement of changes in net assets and the statement of assets and liabilities shall reflect the same realized and unrealized gain and loss components. However, it is permissible to report each of the following items as single components in those statements:

a. The combination of the net realized gains or losses from investments with net realized gains or losses from foreign currency transactions
b. The combination of the net unrealized appreciation (depreciation) on investments with the net unrealized appreciation (depreciation) on translation of assets and liabilities in foreign currencies.

45-38 If separate reporting of the unrealized and realized foreign currency gains or losses on investments is chosen, such gains and losses shall be aggregated with all other foreign currency gains and losses and reported as described in the preceding paragraph.

Excerpt from ASC 946-220

> Statement of Operations

• > Gain or Loss from Investments and Foreign Currency Transactions

45-6 The following amounts related to gain or loss from investments and foreign currency transactions shall be presented as follows:

a. Net realized gain or loss from investments and foreign currency transactions.
   1. Investments. Net realized gains or losses resulting from sales or other disposals of investments shall be reported net of brokerage commissions. The net realized gains or losses from investments and net realized gains or losses from foreign currency transactions may be reported separately or may be combined.
   2. Foreign currency transactions. Net gains or losses from assets or liabilities denominated in foreign currencies during the period shall be reported separately. If separate reporting of foreign currency effects on realized gains or losses from investments is elected, those effects shall be included in this caption.
b. Net increase (decrease) in unrealized appreciation or depreciation on investments and translation of assets and liabilities in foreign currencies, which comprises both of the following:
   1. Investments. Changes in net unrealized appreciation or depreciation during the period shall be presented in the statement of operations. The major components of unrealized appreciation or depreciation shall be presented in a manner that is consistent with the guidance provided in (a). Either combining the net unrealized gains or losses from investments with net unrealized gains or losses from foreign currency transactions or reporting them separately is permissible. Any provision for deferred taxes shall be reported separately.
   2. Translation of assets and liabilities in foreign currencies. The net change during the period from translating assets and liabilities denominated in foreign currencies shall be reported under the caption "Net Increase (Decrease) in Unrealized Appreciation or Depreciation on Translation of Assets and Liabilities in Foreign Currencies."
c. Net realized and unrealized gain or loss from investments and foreign currency. The sum of the net realized gain or loss and change in unrealized gain or loss on investments and foreign-currency-denominated assets and

liabilities shall be presented in the statement of operations as a net gain or loss on investments and foreign currency.

> Net Realized Gain or Loss from Investments

50-2 The statement of operations shall disclose net realized gains or losses. Gains or losses arising from in-kind redemptions shall be disclosed. Notes to financial statements shall state an entity's practice of either including or excluding that portion of realized and unrealized gains and losses from investments that result from foreign currency changes with or from other foreign currency gains and losses.

Question 8.2.160 How are accrued expenses denominated in foreign currency accounted for?

Interpretive response: Similar to the accounting for investment income receivable in foreign currency (see Question 3.9.60), an investment company accrues the expense as incurred and translates the accrued expense into its functional currency at the daily spot rate. However, it may be acceptable to use a weekly or monthly average exchange rate if the exchange rate does not fluctuate significantly.

The related accrued expense balance is accumulated in the foreign currency and translated into the functional currency daily at the applicable spot rate. An unrealized foreign currency gain or loss is recorded for the difference between:

- the expense accrued in the functional currency; and
- the foreign currency accrued expense balance translated into the functional currency at the spot rate as of the measurement date.

When the expense is paid, the cumulative unrealized foreign currency gain or loss is reclassified as a realized foreign currency gain or loss. [946-830-45-35]

Question 8.2.170 How are realized gains or losses from foreign currency transactions presented?

Interpretive response: An investment company presents gains or losses from assets or liabilities denominated in foreign currencies during the period in the statement of operations as realized gains or losses from foreign currency transactions, separate from realized gains or losses from investments. [946-220-45-6(a)(2)]

Realized gains or losses from foreign currency transactions occur from the following:

- disbursement of foreign currency cash balances (see Question 7.2.270);
- settlement of receivables and payables denominated in foreign currency (see Question 7.2.280);
- interest sold (see Question 3.9.90);
- translation effects of amortization of premiums and discounts on debt instruments, upon maturity (see Question 3.9.70);

- receipt of interest and dividends (see Questions 3.9.60 and 3.9.100); and
- payment of expenses (see Question 8.2.160).

If separate reporting of foreign currency effects on realized gains or losses from investments is elected (see Question 3.9.30), those effects are included in this caption. [946-220-45-6(a)(1), 946-830-45-36]

An investment company's election for reporting the effect of foreign currency gains or losses from investments in foreign securities is disclosed in the notes to the financial statements. [946-220-50-2, 946-830-50-1]

Question 8.2.180 How are unrealized gains or losses on translation of assets and liabilities presented?

Interpretive response: An investment company presents the net change during the period from translating assets and liabilities denominated in foreign currencies in the statement of operations as net increase (decrease) in unrealized appreciation or depreciation on translation of assets and liabilities in foreign currencies, separate from unrealized appreciation or depreciation on investments. [946-220-45-6(b)(2)]

Unrealized appreciation or depreciation on translation of assets and liabilities in foreign currencies occurs from the following:

- translation of foreign currency cash balances (see Question 7.2.270);
- translation of receivables and payables denominated in foreign currency (see Question 7.2.280);
- translation effects of amortization of premiums and discounts on debt instruments, prior to maturity (see Question 3.9.70);
- translation of interest and dividends receivable (see Questions 3.9.60 and 3.9.100); and
- translation of accrued expenses balance (see Question 8.2.160).

If separate reporting of foreign currency effects on unrealized gains or losses from investments is elected (see Question 3.9.20), those effects are included in this caption. [946-220-45-6(b)(1), 946-830-45-36]

An investment company's election for reporting the effect of foreign currency gains or losses from investments in foreign securities is disclosed in the notes to the financial statements. [946-220-50-2, 946-830-50-1]

8.2.60 Taxes

Excerpt from ASC 946-220

> Statement of Operations

• > Taxes

45-4 Income tax expense shall be presented by investment companies under the separate income categories (such as investment income or realized and unrealized gains) to which it applies. Taxes in certain foreign jurisdictions may be based on the net investment income and realized gains of the fund within that jurisdiction; the guidance in Topic 740 is applicable to such taxes.

> Net Investment Income

50-1 Any income tax provision relating to net investment income shall be disclosed separately.

Excerpt from ASC 946-740

35-1 If a provision for deferred income taxes on unrealized appreciation exists, it shall be charged against the unrealized gains account.

50-1 A provision for deferred income taxes on unrealized appreciation charged against the unrealized gains account pursuant to paragraph 946-740-35-1 shall be disclosed as such in the statement of operations.

Excerpt from ASC 946-830

> Withholding Tax

05-3 This Subtopic includes guidance on effects of withholding tax. Dividends and interest received from foreign investments may result in withholding taxes and other taxes imposed by foreign countries, usually at rates from 10 percent to 35 percent. Tax treaties between certain countries and the United States may reduce or eliminate such taxes.

• > Withholding Tax

45-33 Many foreign countries do not tax capital gains on investments by foreign investors; however, if such gains are taxable, an accrual for capital gains taxes payable on both realized and unrealized gains shall be included in the **net asset value per share** calculation.

45-34 Whenever tax is withheld from investment income at the source, the amounts withheld that are not reclaimable shall be accrued along with the related income on each income recognition date if the tax rate is fixed and known. If the tax withheld is reclaimable from the local tax authorities, it shall be recorded as a receivable and not as an expense. When the investment income is received net of the tax withheld, a separate realized foreign currency gain or loss shall be computed on the gross income receivable and the accrued tax expense. If the tax rate is not known or estimable, such expense or receivable shall be recorded on the date the net amount is received; accordingly, there would be no foreign currency gain or loss. However, if a receivable is recorded, there may be a foreign currency gain or loss through the date such receivable is collected.

> Financial Statement Presentation

45-39 Taxes withheld that are not reclaimable, if any, on foreign source income shall be deducted from the relevant income item and shall be shown either parenthetically or as a separate contra item in the income section of the statement of operations. Taxes levied on the aggregate income or capital gains of the investment company itself shall be presented in a manner that is similar to that used for income taxes. The normal withholding taxes shall be presented as follows.

Interest or dividend income (net of withholding taxes of $ X)	$XXX
or	
Interest or dividend income	$XXX
Less withholding tax	(XXX)

Excerpt from Reg S-X Rule 6-07

Statements of operations.

Statements of operations, or statements of comprehensive income, where applicable, filed by registered investment companies, other than issuers of face-amount certificates, subject to the special provisions of § 210.6-08, and business development companies, shall comply with the following provisions:…

4. *Investment income before income tax expense.*
5. *Income tax expense.* Include under this caption only taxes based on income.…
7. *Realized and unrealized gain (loss) on investments-net.…*
   (d) State separately any: (1) Federal income taxes and (2) other income taxes applicable to realized and unrealized gain (loss) on investments, distinguishing taxes payable currently from deferred income taxes.

[81 FR 82012, Nov. 18, 2016; 83 FR 50202, Oct. 4, 2018]

Question 8.2.190 How are income taxes presented?

Interpretive response: An investment company presents income tax expense under the separate income categories for the activities to which the income tax is attributed. [946-220-45-4]

Net investment income

Any income tax provision related to net investment income is presented separately under that section. [946-220-50-1, S-X Rule 6-07.5]

Realized gains

An investment company presents income tax expense on realized gains separately in the statement of operations. [946-220-45-4, S-X Rule 6-07.7(d)]

Unrealized gains

Any provision for deferred income taxes on unrealized appreciation is charged against the net change in unrealized appreciation or depreciation. However, the provision for deferred income taxes is presented as a separate component of unrealized appreciation or depreciation on investments in the statement of operations. [946-740-35-1, 50-1, 946-220-45-6(b)(1), S-X Rule 6-07.7(d)]

Registered funds

In addition to the above, a registered fund presents Federal income tax separately from other income taxes, distinguishing taxes payable currently from deferred income taxes. [S-X Rule 6-07.7(d)]

Question 8.2.200 How is foreign withholding tax presented?

Background: Dividends and interest received from foreign investments may be subject to withholding taxes and other taxes imposed by foreign countries, often resulting in taxes being withheld at the source. [946-830-05-3]

Interpretive response: Foreign withholding tax expense is deducted from the relevant income item and presented either parenthetically or as a separate contra item to the corresponding income item. [946-220-45-3(h)]

However, whether foreign taxes withheld at the source are recorded as an expense depends on whether the amounts are reclaimable from the local tax authorities.

Amounts not reclaimable

Foreign taxes withheld that are not reclaimable are accrued along with the related income on each income recognition date if the tax rate is fixed and known. [946-830-45-34]

Amounts that are reclaimable

If taxes withheld are reclaimable from the local tax authorities, the amounts are recorded as a receivable, not as an expense. [946-830-45-34]

However, an investment company should consider the Topic 740 guidance on uncertain tax positions and evaluate whether it is more likely than not that it will be able to reclaim foreign taxes withheld from the local tax authorities. See KPMG Handbook, Accounting for income taxes, for additional guidance on accounting for uncertain tax positions.

Foreign currency gain or loss

When investment income is expected to be received net of the tax withheld, a separate realized foreign currency gain or loss is computed on both the gross income receivable and the accrued tax expense.

If the tax rate is not known or estimable, the expense or receivable is recorded on the date the net amount is received; accordingly, there would be no foreign currency gain or loss. However, if a receivable is recorded, there may be a foreign currency gain or loss through the date such receivable is collected. [946-830-45-34]

Question 8.2.210 How are reclaims of foreign withholding taxes accounted for?

Background: An investment company may be subject to foreign withholding taxes that are recorded as an expense due to uncertainty about whether such amounts are reclaimable from the local tax authorities.

However, it may subsequently apply for reclaims on the previous withholding taxes with the local tax authorities and incur significant professional fees in attempting to recover the withholding taxes paid. Some professional fee arrangements may be contingent upon successful reclaim of foreign withholding taxes.

Interpretive response: When evaluating reclaims of foreign withholding taxes, an investment company applies the uncertain tax positions guidance in Topic 740. Under that guidance, it evaluates whether the tax position that amounts are reclaimable from the local tax authorities is more likely than not to be sustained. See KPMG Handbook, Accounting for income taxes, for additional guidance on accounting for uncertain tax positions.

The SEC staff generally expects registered funds to present amounts recognized for foreign tax reclaims separately from dividend income in the statement of operations if the amounts exceed 5% of total investment income.

The SEC staff has also indicated it would object to a registered fund offsetting professional fees against the related income when the professional fees are contingent upon the ultimate collection of the reclaimed income. Instead, it has asserted that such professional fees should be presented as an expense in the statement of operations. [AICPA IC EP 7/2021]

8.2.70 Master-feeder funds

Excerpt from ASC 946-220

> Complex Capital Structures

• > Master-Feeder Funds

• • > Master Funds

45-10 For master funds, the standard reporting format for investment companies with simple capital structures shall be used.

• • > Feeder Funds

45-11 The statement of operations shall report details of the feeder fund's allocated share of net investment income from the master fund (that is, present allocated interest, dividends, and expenses separately).

45-12 The statement also shall report separately the feeder's allocated share of the master fund's realized and unrealized gains and losses. The total of all feeders' income, expense, and realized and unrealized gain or loss components shall agree to the corresponding totals of the master fund. Feeder funds shall present their fund-specific expenses, such as transfer agent, distribution, legal and audit expenses, and registration and directors' fees. Additionally, any fee waivers or reimbursements at the feeder-fund level shall be reported.

Question 8.2.220 How do investment companies that are part of a master-feeder structure present a statement of operations?

Interpretive response: Investment companies that are part of a master-feeder structure present statements of operations as follows.

Master fund

The master fund uses the standard reporting format for investment companies with simple capital structures. [946-220-45-10]

Feeder funds

A feeder fund's statement of operations presents the fund's allocated share of investment income, investment expenses, realized and unrealized gains and losses allocated from the master fund. [946-220-45-11 – 45-12]

When the interests of the master fund are held solely by its feeder funds, the total of all feeder funds' income, expense, and realized and unrealized gain or loss components must agree to the corresponding totals of the master fund.

A feeder fund also reports any fund-specific expenses in the statement of operations, including any expense waivers or reimbursements at the feeder-fund level. [946-220-45-12]

Question 8.2.230 How does a feeder fund report a performance allocation levied at the master-fund level?

Background: In some master-feeder structures organized as partnerships, a performance allocation is levied at the master-fund level, where a portion of the net income allocated to the feeder funds is reallocated to the general partner of the master fund.

Interpretive response: The statement of operations of a feeder fund reports the fund's allocated share of income, expenses, gains and losses from the master fund. A performance allocation levied at the master-fund level is considered part of the feeder fund's allocated share of the income and expenses from the master fund, the effect of which should be reported in the statement of operations. [946-205-50-17]

Although Topic 946 does not prescribe a location in the statement of operations to report a performance allocation levied at the master-fund level, we believe a performance allocation includes elements of compensation to an investment adviser, and therefore represents, in substance, an operating expense of the feeder fund when presented in the statement of operations.

8.2.80 Fund of funds

Excerpt from ASC 946-220

> Complex Capital Structures

• > Fund of Funds

45-13 Income reflected on the statement of operations shall represent the net earnings received from investee funds. For example, if the investee funds are all registered investment companies the income would represent the dividends received from such investee funds.

45-14 The investor fund shall not reflect any operating expenses if the investee funds have agreed to assume certain of the investor fund expenses. To the extent the investor fund has such agreements, they shall be disclosed in the notes to financial statements. (See paragraph 946-220-50-4.)

45-15 When investing in registered investment companies, distributions received from long-term capital gains shall be reported as realized gains together with gains realized on disposition of shares of investee entities.

45-16 Expenses are those incurred only at the reporting fund level. Expenses of the investee funds are embedded in the net earnings from such funds.

A fund of funds is a type of investment company whose strategy is to invest in other investment companies ('investee funds').

Question 8.2.240 How are income, expenses, and gains or losses from other investment companies presented?

Interpretive response: Income from investments in other investment companies represent the net earnings received from those investee funds. [946-220-45-13]

The investor fund recognizes only its expenses in its statement of operations. Expenses incurred by the investee funds are included in the net earnings received and recognized by the investor fund. This includes any investment advisory fees incurred by the investee funds; the investor fund does not separately recognize an expense for those fees since they are embedded in the net earnings amount. [946-220-45-16]

Nonregistered funds

Generally, the changes in fair value of the investee funds that are nonregistered funds are recorded as changes in net unrealized appreciation or depreciation on investments.

Upon the sale or disposition of such an investee fund, a realized gain or loss is recognized based on the difference between the proceeds and the cost basis of the investment (see Questions 3.8.50 and 3.8.130).

Registered funds

Typically, the income received from investee funds that are registered funds will be in the form of dividends received from such investees to the extent such amounts are paid from economic earnings of the investee fund. [946-220-45-13]

However, distributions that represent long-term capital gains are recorded as realized gains, along with gains realized on the disposition of shares in those investee funds. [946-220-45-15]

Presentation similar to a master-feeder fund

When a substantial portion of a fund of funds' net assets is in a single underlying fund, the fund of funds should consider whether the investment is so significant that it would be more appropriate to present the financial statements in a manner similar to a master-feeder fund (see section 9.6). This means presenting the financial statements of the investee fund as an attachment to the financial statements of the investor fund, but we believe a fund of funds also should consider whether other elements of a master-feeder presentation would be meaningful. [946-210-45-7]

8.2.90 Other classification issues

Question 8.2.250 How are changes in fair value of debt accounted for under the fair value option presented?

Background: Some investment companies elect to measure their debt at fair value using the fair value option in Topic 825. The total change in the fair value of a financial liability (such as debt) accounted for under the fair value option is presented as follows. [825-10-45-4, 45-5A]

- Changes in fair value resulting from changes in the instrument-specific credit risk are presented separately in OCI.
- All other changes in the liability's fair value are recognized in net income.

Interpretive response: Topic 946 is silent on the classification of the portion of the change in fair value of an investment company's debt reported in net income – i.e. changes in fair value not attributable to changes in the instrument-specific credit risk.

However, because these changes in fair value are related to an investment company's debt and not to the investment portfolio, we believe it is acceptable for an investment company to present the change in fair value of its debt under the fair value option as a separate category from net investment income and net gains or losses from investments and foreign currency transactions in the statement of operations.

Question 8.2.260 How does a registered fund classify changes in the carrying amounts of redeemable preferred shares?

Background: As discussed in Question 4.2.80, redeemable preferred shares issued by registered closed-end funds are subject to the SEC's temporary equity guidance and are classified outside of permanent equity (i.e. below liabilities and above net assets on the statement of assets and liabilities).

Interpretive response: Changes in the carrying amounts of redeemable preferred shares (including distributions paid to preferred shareholders and accretion of the carrying amount) are presented below net investment income in the statement of operations (see Question 4.2.80).

Because such classification in the statement of operations also applies to financial highlights, changes in the carrying amounts of redeemable preferred shares are not included in the expense and net investment income ratios (see section 8.3.30).

However, we believe the changes in the carrying amounts of redeemable preferred shares should be included in the per-share information as a separate category within investment operations (see section 8.3.20).

8.3 Financial highlights

8.3.10 Overview

Excerpt from ASC 946-205

45-2 For investment companies not using **unitized** net asset value, financial highlights shall be presented and consist of net investment income and expense ratios and total return, or the internal rate of return since inception if applicable.

> Financial Highlights

50-1 Financial highlights shall be presented either as a separate schedule or within the notes to financial statements for each class of common shares outstanding.

50-2 Investment companies with multiple classes of shares may present financial highlights only for those classes of shares that are included in reports to such shareholders. In such cases, the investment company shall include appropriate disclosures related to all classes so as to ensure that the financial statements are complete (for example, detail of capital share activity in the statement of changes in net assets or notes to financial statements).

50-3 Nonregistered investment partnerships shall disclose per-share data for all common classes in general-purpose financial statements. However, it is permissible for **financial highlights** to be presented only for those classes of shares that are included in reports to those classes.

50-4 Only the classes related to the **nonmanaging investors** (that is, classes of investors that do not consist exclusively of managing investor interests) are considered to be the common interests requiring financial highlight disclosure.

50-5 If a fund is not **unitized**, only investment returns (either total return or internal rate of return) and net investment income and expense ratios shall be disclosed as indicated in paragraphs 946-205-50-10 through 50-25.

50-6 The remainder of this guidance is organized according to the nature the item included in the financial highlights as follows:

a. Per-share information
b. Ratios
c. Total return
d. Capital commitments.

20 Glossary

Nonregistered Investment Partnerships—Financial Highlights

Nonregistered investment partnerships, when disclosing financial highlights, shall interpret the terms classes, units, and theoretical investments as follows:

a. Classes. Nonregistered investment funds typically have one of the following two classes of ownership interest, with one class being the management interest in the fund and the other being the investment interest:
   1. For unitized funds (that is, funds with units specifically called for in the governing underlying legal or offering documents), the management interest usually is a voting class and the investment interest is a nonvoting class. Temporary series of shares (that is, shares that are intended at the time of issuance to be consolidated at a later date with another specified series of shares that remains outstanding indefinitely) are not considered separate classes. Permanent series of a class of share shall be the basis for which that share's financial highlights are determined and presented.
   2. For nonunitized funds, the management interest usually is the general partner class and the investment interest usually is the limited partner class. Generally, a class has certain rights as governed by underlying legal documents or offering documents and local law. Rights to certain investments that do not otherwise affect the rights available under the underlying legal documents and local law do not ordinarily represent a separate share class. For example, rights to income and gains from a specific investment attributed solely to investors at the date the investment is made (side-pocket investments) are not considered to give rise to a share class. Similarly, a temporary series of shares is not considered a share class.
b. Units. Only funds with units specifically called for in the governing underlying legal or offering documents shall be considered unitized. Some funds may employ units for convenience in making allocations to investors for internal accounting or bookkeeping purposes, but the units are not required or specified by legal or offering documents, and for all other purposes operate like nonunitized investment partnerships. For per-share operating performance, those funds are not considered unitized.

c. Theoretical investment. The term theoretical investment in paragraph 946-205-50-20 shall be considered as the actual aggregate amount of capital invested by each reporting class of investor as of the beginning of the fiscal reporting period, adjusted for cash flows related to capital contributions or withdrawals during the period.

Financial highlights provide additional condensed financial information of an investment company's results of operations during the reporting period. The primary information included when presenting financial highlights comprises:

- per-share information;
- ratios to average net assets;
- investment returns.

Such information may be presented as a separate schedule or in the notes to the financial statements.

Subtopic 946-205 addresses the presentation of financial highlights for investment companies, including guidance specific to nonregistered investment partnerships (see Question 7.6.10).

Additionally, registered funds are subject to incremental disclosure requirements and instructions to calculate certain aspects of financial highlights per the SEC registration forms for open-end funds (Form N-1/A) and closed-end funds and BDCs (Form N-2).

Question 8.3.10 What information is required when disclosing financial highlights?

Interpretive response: An investment company's required disclosures of financial highlights depend on whether the investment company is a registered fund and whether it issues its equity interests in the form of units. The following table summarizes the required disclosures for registered and nonregistered funds.

Disclosure	Registered fund	Nonregistered fund	
		Unitized fund	Nonunitized fund
Per-share information (see section 8.3.20)	Yes	Yes[1]	No
Ratios (see section 8.3.30)	Yes	Yes	Yes
Investment return (see sections 8.3.40 and 8.3.50)	Yes[2]	Yes[2]	Yes[2]
Capital commitments (see section 8.3.50)	No	Yes[3]	Yes[3]

Notes:

1. Presented for each reporting share class related to nonmanaging investors. Information should be disclosed for each major category affecting NAV per share (as reflected in the statements of operations and changes in net assets). NAV per

share represents the amount at which a participant can transact with the fund. [946-205-50-8]

2. Total return is generally used to present the investment return for an investment company. However, for certain limited-life funds (see section 8.3.50), internal rate of return since inception is presented instead of total return. [946-205-50-23, SOP 03-4.14.d.]
3. Required for certain limited-life funds (see section 8.3.50).

Question 8.3.20 Where are financial highlights presented?

Interpretive response: Financial highlights may be presented in a separate schedule of the financial statements or in the notes to the financial statements. [946-205-50-1]

Question 8.3.30 What is the difference between a unitized fund and a nonunitized fund?

Interpretive response: The financial highlights presentation requirements for a nonregistered investment partnership depend on whether it is a 'unitized fund' or a 'nonunitized fund'.

For a nonunitized fund, financial highlights comprise only the expense and net investment income ratios and total return (or internal rate of return since inception, if applicable). [946-205-45-2]

Unitized funds

A unitized fund is a type of nonregistered investment partnership with units specifically called for in the governing legal or offering documents, commonly in the form of shares issued by a corporate entity. These units represent a proportionate share of the fund's holdings.

Nonunitized funds

A nonunitized fund is a type of nonregistered investment partnership that does not issue equity interests in the form of units specifically called for in its governing legal or offering documents. Although some funds may use units for internal accounting or bookkeeping purposes, these are still considered nonunitized if equity interests in the form of units are not required by legal or offering documents. [946-205 Glossary]

Question 8.3.40 Is disclosure of financial highlights required for all investor interests?

Interpretive response: No. Financial highlights are not required to be disclosed for share classes consisting exclusively of managing investor interests. Financial highlights are required only for classes related to the nonmanaging investors. [946-205-50-4]

Unitized funds

For unitized funds, the management interest is usually a voting class of shares or units.

Nonunitized funds

For nonunitized funds, the management interest is usually the general partner (or equivalent) class. [946-205 Glossary]

Question 8.3.50 How does an investment company with multiple common share classes present financial highlights?

Interpretive response: An investment company with multiple classes of common shares presents financial highlights for each class of common shares outstanding. [946-205-50-1]

In addition, a nonregistered investment partnership that is a unitized fund discloses per-share data for all common classes. [946-205-50-3]

Because financial highlights are considered to be a financial statement disclosure, and not a separate financial statement, an investment company may present financial highlights only for those classes of shares for financial statements included in reports distributed to such shareholders. However, in that instance, they are required to include the disclosures related to the fund as a whole, such as detail of capital share activity in the statement of changes in net assets or notes to the financial statements, for completeness in financial statement presentation (see Question 4.3.10). [946-205-50-2, AAG-INV 5.39]

Question 8.3.60 Are financial highlights presented for a temporary series of shares?

Background: In some instances, a unitized fund may issue a temporary series of shares within a share class for each interim subscription of shares during the reporting period. A temporary series of shares is intended at the time of issuance to be consolidated at a later date with another specified series of shares that remains outstanding indefinitely (permanent series of shares). [946-205 Glossary]

Interpretive response: No. A temporary series of shares is not considered a separate share class. A temporary series of shares is used for interim calculations of performance fees, but does not otherwise affect the rights of a share class available under the underlying legal documents.

Instead, the permanent series of shares is the basis for which financial highlights are presented for a unitized nonregistered investment partnership. [946-205 Glossary, SOP 03-4.A15]

Question 8.3.70 Are income and gains from side-pocket investments presented as a separate class when disclosing financial highlights for nonregistered investment partnerships?

Background: Nonregistered investment partnerships typically have two classes of ownership interests: the management interest (general partner class) and the investment interest (limited partner class).

Some investment companies provide certain investors with rights to income and gains from a specific investment (typically illiquid or hard-to-value assets). Such income and gains are attributed solely to those investors that elected to participate in the investment on the date the investment company purchased the investment. These arrangements are commonly referred to as 'side-pocket investments' and are segregated from the general classes of investor capital accounts.

Interpretive response: No. Rights to income and gains from side-pocket investments that do not otherwise affect the rights available under the underlying legal documents are not considered a separate share class. [946-205 Glossary, SOP 03-4.A-15]

We believe that side-pocket investments should be included within the reporting class related to nonmanaging investors for which financial highlights are presented. For nonunitized funds, side-pocket investments are generally included in the financial highlights for the limited partner class as a whole. Because the participation in side-pocket investments may vary from investor to investor, an investment company should disclose that an individual investor's return and ratios may vary from the limited partner class taken as a whole. [946-205-50-4, 50-15]

In cases where income and gains from side-pocket investments are significant, but the participation is held by disproportionately few limited partners, the financial highlights for the limited partners as a whole may not be representative of a typical limited partner. In such instances, we believe financial highlights should still be presented for the limited partner class as a whole, but supplemental financial highlights may be appropriate to provide additional context.

Question 8.3.80 Are financial highlights for nonregistered investment partnerships presented separately for investor classes that have different participating rights in new issues?

Background: Some investment companies may purchase or sell investments in an initial public offering of an equity security (new issues). However, certain investors that are considered restricted persons under Rule 5130 of the Financial Industry Regulatory Authority (FINRA) are restricted from participating in new issues.

As a result, investment companies frequently establish separate classes for investors that are eligible to participate in new issues (unrestricted class) and for investors that are restricted from participating in new issues (restricted class). Unrestricted classes and restricted classes of a nonregistered investment partnership are in essence sub-classes that have the same rights under the governing documents for a given class and participate equally in the investments in the fund other than such new issues.

Interpretive response: It depends.

For purposes of presenting classes when disclosing financial highlights for nonregistered investment partnerships, rights to certain investments that do not otherwise affect the rights available under the underlying legal documents and local law do not represent a separate share class. Therefore, classes that have different participation rights in new issues, but otherwise share the same rights under the fund's governing documents and participate equally in the other investments in the fund, are not considered to be a separate class for purposes of disclosing financial highlights. [946-205 Glossary]

For nonunitized funds, both restricted classes and unrestricted classes are included in the presentation of financial highlights for the limited partner class taken as a whole. Because the participation in new issues may vary from investor to investor, the nonregistered investment partnership should disclose that an individual investor's return and ratios may vary from the limited partner class taken as a whole. [946-205-50-4]

However, if the effect of new issues has a material impact to investment performance, we believe a nonregistered investment partnership should consider disclosing in the financial statements the total gains or losses recognized from new issues investments, and their effect on total return, for the period. Such disclosure may help financial statement users better understand the impact of nonrecurring gains or losses from new issues to the entity’s performance during the period. [SOP 03-4.A-16]

8.3.20 Per-share information

Excerpt from ASC 946-205

> Financial Highlights

• > Per-Share Information

50-7 Per-share amounts presented are based on a share outstanding throughout each period presented. The caption descriptions in the per-share data shall be the same captions used in the statement of operations and statement of changes in net assets to allow the reader to determine which components of operations are included in or excluded from various per-share data. All of the following per-share information shall be presented for registered investment companies and for investment companies that compute unitized net asset value:

a. Net asset value at the beginning of the period.
b. Per-share net investment income or loss. Other methods, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, are acceptable.
c. Realized and unrealized gains and losses per share, which are balancing amounts necessary to reconcile the change in **net asset value per share** with the other per-share information presented. The amount shown in this caption might not agree with the change in aggregate gains and losses for the period. If such is the case, the reasons shall be disclosed.
d. Total from investment operations, which represents the sum of net investment income or loss and realized and unrealized gain or loss.
e. Distributions to shareholders shall be disclosed as a single line item except that tax **return of capital** distributions shall be disclosed separately. Details of distributions shall conform to those shown in the statement of changes in net assets.
f. Purchase premiums, redemption fees, or other capital items.
g. Payments by affiliates (see paragraphs 946-20-05-2 through 05-3).
h. Net asset value at the end of the period.

The information required in (b) through (g) is not required for separate accounts that represent an ownership interest in the underlying separate account portfolios or mutual funds.

50-8 Nonregistered investment partnerships that compute unitized net asset value shall disclose information for each reporting share class related to nonmanaging investors. The information shall be disclosed for each major category affecting net asset value per share (as shown in the statement of operations and statement of changes in net assets of the fund).

Question 8.3.90 How is per-share net investment income or loss calculated?

Interpretive response: An investment company calculates per-share net investment income or loss as follows.

Registered funds

A registered fund calculates per share net investment income or loss as the sum of the following per the instructions to Forms N-1/A or N-2:

- the *increase (decrease) per share in undistributed net investment income* for the period; and
- dividends from net investment income per share for the period.

Although undistributed net investment income is recorded continuously throughout the reporting period, it is not necessary to calculate the per share amount at each date changes to net investment income are recorded. The *increase (decrease) per share in undistributed net investment income* may be derived by calculating the difference between the per share amounts of undistributed net investment income at the beginning and end of the period divided by the number of shares outstanding on those respective dates. [Form N-1/A Item 13(a) (Instruction 2(a), Form N-2 Item 4.1 (Instruction 9)]

If another method is used, such as dividing net investment income by the average or weighted average number of shares outstanding during the period, it is disclosed in a note to the table. [946-205-50-7(b), AAG-INV 7.179, Form N-1/A Item 13(a) (Instruction 2(a)), Form N-2 Item 4.1 (Instruction 9)]

Nonregistered funds

A nonregistered fund generally calculates per share net investment income or loss using the net investment income or loss in the statement of operations rather than calculating separate per share components as required for registered funds. A nonregistered fund may calculate the per share amounts continuously throughout the reporting period as changes to net investment income are recorded. Other methods are acceptable, such as dividing net investment income by the average or weighted average number of shares outstanding during the period. [946-205-50-7(b)]

Question 8.3.100 How are realized and unrealized gains and losses per share calculated?

Interpretive response: Realized and unrealized gains and losses per share are the balancing amounts necessary to reconcile the change in NAV per share with the other per-share amounts presented.

Because the timing of capital share transactions may vary in relation to changes in market values of a registered fund's investment portfolio, the per share amount may not agree with the change in aggregate gains and losses for the period presented; therefore these reasons should be disclosed. [946-205-50-7(c), Form N-1/A Item 13(a) (Instruction 2(b)), Form N-2 Item 4.1 (Instruction 10)]

Question 8.3.110 How is per-share total from investment operations calculated?

Interpretive response: Total from investment operations per share is calculated by adding the per share amounts for net investment income (or loss) and realized and unrealized gains and losses. [946-205-50-7(d)]

Generally, this will include the same amounts presented in the statement of operations as net increase (decrease) in net assets from operations. However, in some circumstances, the statement of operations may include other amounts that are excluded from net investment income (or loss) and realized and unrealized gains and losses. We believe an investment company can elect to include or exclude the per-share amount of those other items from per-share total from investment operations provided the amounts are clearly presented in the per-share information.

Question 8.3.120 How are per-share distributions disclosed?

Interpretive response: It depends. Disclosure of per-share distributions of capital are different for registered and nonregistered funds.

Registered funds

A registered fund presents per-share distributions separately for dividends (from net investment income) and distributions (from capital gains).

For any distributions made from sources other than net investment income and capital gains, a registered fund states the per share amounts separately when presenting the per-share information for returns of capital and notes the nature of the distributions. [Form N-1/A Item 13(a) (Instruction 2(c)), Form N-2 Item 4.1 (Instruction 11)]

Nonregistered funds

Except for disclosing the tax return of capital distributions separately, a nonregistered fund discloses distributions to shareholders as a single line item in conformity with the distribution details presented in the statement of changes in net assets. [946-205-50-7(e)]

Question 8.3.130 How are changes in fair value of debt reported in net income and in other comprehensive income classified when presenting per-share information?

Background: Some investment companies elect to measure their debt at fair value using the fair value option in Topic 825. If an entity has elected the fair value option for an eligible financial liability, such as its debt, it is required to present the portion of the total change in the fair value of the liability resulting from a change in the instrument-specific credit risk separately in OCI. All other changes in the fair value of the liability are recognized in net income. [825-10-45-4, 45-5A]

Neither Topic 946 nor SEC Forms N-1/A or N-2 address the classification of the changes in fair value of an entity's debt reported in net income and OCI.

Interpretive response: The classification of per-share information should be consistent with the classification in the presentation of the statement of operations and statement of changes in net assets. Such consistency in presentation is useful for financial statement users to determine which components of operations are included in or excluded from various per-share data. [946-205-50-7]

As such, we believe an investment company should classify the per-share amount of the portion of the change in fair value of an entity's debt included in net income consistent with how it classifies such changes in the statement of operations (see Question 8.2.250).

We believe the portion of the change in fair value of an entity's debt reported in OCI should be presented as a separate caption after total from investment operations when presenting per-share operating performance. We believe this presentation is consistent with how the components of comprehensive income are presented in the statement of changes in net assets.

8.3.30 Ratios

Excerpt from ASC 946-205

> Financial Highlights

• > Ratios

50-10 Ratios of expenses and net investment income to average net assets are generally annualized for periods less than a year.

50-11 The ratio of expenses to average net assets should be increased by brokerage service and expense offset arrangements (see paragraphs 946-20-45-3 and 946-20-45-5).

50-12 When determining expense and net investment income ratios, nonregistered investment partnerships shall calculate average net assets by using the fund's (or class's) weighted-average net assets as measured at each accounting period or periodic valuation (for example, daily, weekly, monthly, quarterly), adjusting for capital contributions or withdrawals from the fund occurring between accounting periods or valuations. (This paragraph is not intended to require any additional interim accounting period or periodic valuation date beyond that which may be provided in offering or organizational documents of the partnership.)

50-13 The expense and net investment income ratios shall be calculated by nonregistered investment partnerships based on the expenses allocated to each common or investor class (for example, the limited partner class) before the effects of any incentive allocation. Adequate disclosure shall be made to indicate that the net investment income ratio does not reflect the effects of any incentive allocation. Expenses directly related to the total return of the fund, such as incentive fees, and nonrecurring expenses, such as organizational costs, shall not be annualized when determining the expense ratio. Disclosure shall be made of the expenses that have not been annualized.

50-14 Generally, the determination of expenses for computing those ratios shall follow the presentation of expenses in the fund's statement of operations. Accordingly, if the manager's or general partner's incentive is structured as a fee rather than an allocation of profits, the incentive fee would be factored into the computation of an expense ratio. Because an incentive allocation of profits is not presented as an expense, it shall not be considered part of the expense ratio. However, to avoid potentially significant inconsistencies in ratio presentations based solely on the structuring of incentives as fees or allocations, all incentives shall be reflected in the disclosure of financial highlights.

50-15 Additionally, for the expense ratio, disclosure shall be made of the effect of any agreement to waive or reimburse fees and expenses to each reporting class as a whole, as described in paragraph 946-20-50-7, and of expense offsets, as described in paragraphs 946-20-45-3 and 946-20-45-5. Agreements to waive a portion or all of certain fees to a specific investor, which do not relate to the share class as a whole, do not require disclosure in the financial highlights. However, as ratios are calculated for each common class taken as a whole, the financial statements shall disclose that an individual investor's ratio may vary from those ratios.

Question 8.3.140 What ratios are disclosed when presenting financial highlights?

Interpretive response: An investment company is required to disclose ratios of expenses (expense ratio) and net investment income (net investment income ratio) to average net assets. [946-205-50-10]

Question 8.3.150 How are average net assets calculated?

Interpretive response: An investment company calculates average net assets as follows.

Registered funds

A registered fund is required to calculate average net assets no less frequently than the end of each month included in the reporting period. [Form N-1/A Item 13(a) (Instruction 4(a)), Form N-2 Item 4.1 (Instruction 15)]

Nonregistered funds

A nonregistered investment partnership calculates average net assets using the fund's (or share class's) weighted-average net assets measured at each accounting period or interim valuation, adjusting for capital contributions and/or withdrawals occurring between period or valuation date. This accounting period may be daily, weekly, monthly or quarterly. [946-205-50-12]

Question 8.3.160 How are expense and net investment income ratios calculated?

Interpretive response: An investment company calculates the expense and net investment income ratios using the corresponding amounts of investment income and expenses included in the statement of operations. [946-205-50-14]

The expense ratio includes amounts for brokerage service and expense offset arrangements (see Question 5.3.180).

The expense ratio also includes the effects of fee waivers (see Question 8.3.170) and 12b-1 expense reimbursements (see Question 8.2.80). [946-205-50-11, 50-15, Form N-1/A Item 13(a) (Instruction 4(b)), Form N-2 Item 4.1 (Instruction 16)]

Nonregistered funds

A nonregistered investment partnership calculates the expense ratio based on the expenses allocated to each investor class, before the effects of a performance fee or allocation (see Question 8.3.180).

Periods less than a year

For reporting periods less than a year, the expense and net investment income ratios are generally annualized (see Question 8.3.190). However, expenses related to total return (i.e. performance fees) and nonrecurring expenses are not annualized. Disclosure of the expenses that have not been annualized is required. [946-205-50-10, 50-13]

Question 8.3.170 How is the effect of fee waivers presented in the expense ratio?

Interpretive response: Unless the fee waiver agreement(s) pertain to a specific investor and not an entire share class, the effects of fee waivers on the expense ratio are disclosed (see Question 5.3.20).

An investment company is also required to disclose that an individual investor's ratio may vary from the ratios of its share class as a whole. [946-205-50-15]

Question 8.3.180 How is the effect of a performance fee or allocation presented in the expense ratio?

Interpretive response: Because a performance (incentive) fee is included in the expense ratio but a performance allocation is not, disclosing the gross and net effect of a performance fee or allocation on the expense ratio in the financial highlights is necessary to avoid potentially significant inconsistencies in the presentation of overall fund expenses (see Question 5.2.70 and Example 8.3.10). [946-205-50-14]

Example 8.3.10 Presentation for performance fees and allocation

The following table illustrates the presentation of the gross and net effect of a performance fee on the expense ratio.

Operating expenses	3.25%
Performance fee	7.50%
Total expenses	10.75%

The following table illustrates the presentation of the gross and net effect of a performance allocation on the expense ratio.

Operating expenses	3.25%
Performance allocation	7.50%
Total expenses and performance allocation	10.75%

Question 8.3.190 Is it permissible to not annualize ratios for periods less than a year?

Interpretive response: It depends.

Topic 946 states that the expense and net investment income ratios are *generally* annualized for periods less than a year. We do not believe the use of the term *generally* was intended to provide an optional accounting election to not annualize the expense and net investment income ratios for periods less than a year. Rather, we interpret the term as a presumptive requirement for an investment company to annualize ratios, except in limited circumstances where applying the guidance yields a result that is not consistent with its intended objectives. [946-205-50-10]

A limited exception may be justified when an initial reporting period is very short (e.g. one month or less) and annualizing the financial highlights ratios would distort the presentation of financial highlights to such an extent that the results are not reasonably comparable to future reporting periods or are not meaningful to financial statement users.

In such cases, we believe an investment company should disclose the fact that the financial highlights ratios have not been annualized and its basis for such determination.

8.3.40 Total return

Excerpt from ASC 946-205

> Financial Highlights

• > Total Return

50-18 Total return shall be presented for all investment companies (for interim periods, the disclosure shall include whether or not total return is annualized).

• • > Nonregistered Investment Companies Using Unitized Net Asset Value

50-19 For nonregistered investment companies organized in a manner using unitized net asset value, total return shall be computed based on the change in the net asset value per share during the period, and assuming that all dividends are reinvested.

• • > Investment Companies Not Using Unitized Net Asset Value

50-20 For investment companies not using unitized net asset value, including investment partnerships, total return shall be computed based on the change in value during the period of a **theoretical investment** made at the beginning of the period. The change in value of a theoretical investment is measured by comparing the aggregate ending value of each class of investor with the aggregate beginning value of each such class, adjusted for cash flows related to capital contributions or withdrawals during the period.

50-21 If capital cash flows occur during the reporting period, returns are geometrically linked based on capital cash flow dates. In general, geometrically linking requires the computation of performance for each discrete period within a year in which invested capital is constant (that is, for each period between investor cash flow dates), then multiplying those performance computations together to obtain the total return for a constant investment outstanding for the entire year.

50-22 Because incentive allocations or fees may vary among investors within a class, total return for reporting classes subject to an incentive allocation or fee should report total return before and after the incentive allocation or fee for each reporting class taken as a whole. The effect of incentive allocations on total return is computed on a weighted-average aggregate capital basis. That results in an incentive computation less than the maximum if, for example, certain partners had loss carryovers at the beginning of the period.

Question 8.3.200 How does a registered fund compute total return?

Interpretive response: It depends. The calculation of total return for open-end funds differs from closed-end funds and BDCs as described in the following table.

Type of fund	Instructions
Open-end funds (Form N-1/A)	• Total return is based on the change in NAV per share during the period[1,2] • Does not reflect sales loads or account fees in the initial investment[3] • Sales loads assessed on reinvestment of dividends or distributions are reflected [Form N-1/A Item 13(a) (Instruction 3)]
Closed-end funds and BDCs (Form N-2)	• Total return is based on the change in market price during the period[4,5,6.] • Does not reflect sales loads • Assumes reinvestment of dividends and distributions at prices obtained by the registrant's dividend reinvestment plan[7] [Form N-2 Item 4.1 (Instruction 13)]

Notes:

1. Assumes an initial investment made at the NAV per share calculated on the last business day before the first day of the period and a redemption at the price calculated on the last business day of each period.
2. For periods less than a fiscal year, state the total return for the period and disclose that total return is not annualized.
3. If sales loads or account fees are imposed, note that they are not included in total return.
4. Assumes a purchase of common stock at market price on the first day of the period and a sale at market price on the last day of the period.
5. A closed-end fund may separately present total return based on the change in NAV per share provided a note explaining the differences in the calculations is included. [Form N-2 Item 4.1 (Instruction 14)]
6. For a non-traded BDC, total return is based on the change in NAV per share in the absence of a market price for its shares.
7. If there is no dividend reinvestment plan, reinvestments of dividends and distributions are assumed based on the lower of the per share NAV or the closing market price of the registrant's shares on the dividend/distribution date.

In addition, for interim periods, Subtopic 946-205 requires disclosure of whether total return is annualized. [946-205-50-18]

Question 8.3.210 How does a unitized fund compute total return?

Interpretive response: A nonregistered investment partnership that is a unitized fund computes total return based on the change in the NAV per share during the period, assuming all dividends are reinvested. [946-205-50-19]

As discussed in Question 5.2.70, total return is presented gross and net of performance fees. [946-205-50-22]

Question 8.3.220 How does a nonunitized fund compute total return?

Interpretive response: A nonregistered investment partnership that is a nonunitized fund computes total return based on the change in value during the period of a theoretical investment made at the beginning of the period.

When capital cash flows occur during the period, the returns for the period are geometrically linked based on capital cash flow dates (see Question 8.3.240). This requires calculating the performance for each discrete period between capital cash flows, then multiplying those performance calculations together to obtain total return.

As discussed in Question 5.2.70, total return is presented gross and net of performance fees or allocations for each reporting class as a whole. [946-205-50-20 – 50-22]

Question 8.3.230 Is it appropriate to annualize total return?

Interpretive response: It depends.

For interim periods, Subtopic 946-205 requires disclosing in the notes to the financial statements whether total return has been annualized. [946-205-50-18]

However, we believe an investment company should evaluate whether annualizing total return would be potentially misleading to financial statement users, particularly if expected returns do not reasonably correlate with the progression of time as a result of market volatility, changing economic conditions or other factors that cannot be reliably predicted.

Question 8.3.240 How frequently does a nonunitized fund determine capital cash flow dates used to calculate total return?

Interpretive response: Capital cash flows represent cash flows from capital contributions or withdrawals during the reporting period. Generally, the frequency with which a nonunitized fund determines capital cash flow dates is based on the frequency with which interim capital contributions and withdrawals (interim capital dates) are permitted under the governing documents for a nonunitized fund (e.g. monthly or quarterly).

Because geometric linking of interim returns is based on periods for which invested capital is constant, a nonunitized fund is only required to compute returns for periods between the occurrence of capital cash flows. However, we believe a best practice is to compute interim returns at each interim capital date, even when no capital cash flows occur, as a recurring procedure to ensure completeness in recording all capital cash flows during a year. [SOP 03-4.A-28]

8.3.50 Certain limited-life funds

Excerpt from ASC 946-205

> Financial Highlights

• > Total Return

• • > Certain Limited-Life Investment Companies

50-23 An investment company shall disclose the internal rate of return since inception of the investment company's cash flows and ending net assets at the end of the period (residual values) as presented in the financial statements, net of all incentive allocations or fees, to each investor class, as of the beginning and end of the period, if, by the terms of their offering documents, they meet all of the following criteria:

a. Have limited lives
b. Do not continuously raise capital and are not required to redeem their interests upon investor request (obtaining initial capital commitments from investors at time of organization and subsequently drawing on those commitments to make investments is not considered continuous for this purpose)
c. Have as a predominant operating strategy the return of the proceeds from disposition of investments to investors
d. Have limited opportunities, if any, for investors to withdraw before termination of the entity
e. Do not routinely acquire (directly or indirectly) as part of their investment strategy market-traded securities and derivative instruments.

50-24 A footnote to the financial highlights shall disclose that the internal rate of return since inception of the investment is net of all incentives. The internal rate of return since inception shall be based on a consistent assumption, no less frequently than quarterly, as to the timing of cash inflows and outflows (for example, on actual cash flow dates or cash inflows at the beginning of each month or quarter and cash outflows at the end of each month or quarter). All significant assumptions with respect to the internal rate of return since inception shall be disclosed in the footnotes to the financial highlights.

• > Capital Commitments

50-25 Investment companies that obtain capital commitments from investors and periodically call capital under those commitments to make investments (principally limited-life, nonregistered investment partnerships) shall disclose in the financial highlights or in a note to financial statements the total committed capital of the partnership (including general partner), the year of formation of the entity, and the ratio of total contributed capital to total committed capital.

A limited-life fund is subject to unique financial highlights disclosures.

Question 8.3.250 What is a limited-life fund?

Interpretive response: A fund is a limited-life fund if, by the terms of its offering documents, it meets all of the following criteria: [946-205-50-23]

- has a limited life;
- does not continuously raise capital and is not required to redeem its interests upon investor request (obtaining initial capital commitments from investors and subsequently drawing on those commitments is not considered continuous);
- has a predominant operating strategy of returning the proceeds from disposition of investments to investors;
- has limited opportunities, if any, for investors to withdraw before termination of the investment company; and
- does not routinely acquire (directly or indirectly) as part of its investment strategy market-traded securities and derivative instruments.

Question 8.3.260 What financial highlights disclosures are required for a limited-life fund?

Interpretive response: A limited-life fund discloses the internal rate of return since inception (IRR), as of the beginning and end of the period, as opposed to total return. [946-205-50-23]

A limited-life fund is also required to disclose: [946-205-50-25]

- the year of formation;
- the total committed capital of the fund (including the general partner); and
- the ratio of total contributed capital to date to total committed capital.

Question 8.3.270 How should a limited-life fund calculate IRR since inception?

Interpretive response: A limited-life fund should calculate its IRR using consistent assumptions for the timing of cash inflows and outflows. For purposes of these assumptions it can use all cash flow activities based on the actual date, assumed as of a specific date of the month, or cash inflows at the beginning of the month and cash outflows at the end of the month. Further, the timing of cash flows must be calculated no less frequently than quarterly.

A limited-life fund is also required to state in a footnote to its financial highlights that the IRR since inception of the investment is net of all performance fees or allocations. This footnote also must identify all significant assumptions with respect to the IRR since inception. [946-205-50-24]

Question 8.3.280 Is a limited-life fund required to present the separate effects of a performance fee or allocation?

Interpretive response: No. Typically, performance fees are charged at a uniform rate for all investors in a class of shares in a limited-life fund, leading to less variances in performance-based rates and loss carryforward periods than in other fund structures. Given the inherent difficulties in calculating IRR before and after the effects of such performance-based arrangements, a limited-life fund does not present the separate effects of such arrangements, but instead presents IRR net of performance fees or allocations. [946-205-50-24, SOP 03-4.A-35]

Question 8.3.290 How does a limited-life fund that obtains financing from a subscription credit facility account for the timing of cash flows when calculating IRR?

Background: Some limited-life funds use subscription credit facilities to obtain liquidity to purchase portfolio investments more quickly than calling capital from their limited partners. These credit facilities provide short-term bridge financing, which is repaid when the capital is called from the limited partners.

If the date capital is called to settle the credit facility is used as the date of the cash inflows when calculating the IRR, the effect of leverage on the timing of cash inflows used results in a shortening of the period between the cash inflows (i.e. the date of contributed capital) and cash outflows (i.e. when capital is returned to the limited partners upon realizing the investment). This potentially increases the IRR calculation.

Interpretive response: Topic 946 is not prescriptive on the assumptions used to determine the timing of cash flows when calculating IRR. We believe it is acceptable to use the actual dates of capital contributions as the cash inflows when calculating IRR, because such approach reflects the rate of return on the limited partners' equity contributions.

However, we believe this is a signification assumption to the calculation of IRR that should be disclosed to avoid any misrepresentation of the levered nature of the IRR calculation.

We also believe it may be appropriate to present IRR on both a levered and unlevered basis if such information would be meaningful to investors and such assumptions are appropriately disclosed. [946-205-50-24, AICPA IC EP 9/2016]

8.3.60 Master-feeder funds

Excerpt from ASC 946-205

> Financial Highlights

• > Ratios

• • > Funds-of-Funds

50-17 In a master-feeder structure, the feeder shall include its proportionate share of the income and expenses of the master when computing the ratios at the feeder level. If, in a master-feeder structure, an incentive is levied as an allocation at the master level, the feeder shall present its share of the incentive allocation as a separate line item in the statement of operations.

> Complex Capital Structures

• > Master-Feeder Funds

• • > Feeder Funds

50-28 The feeder fund's ratios of expenses and net investment income to average net assets shall include the expenses of both the feeder and the master fund. Balance credits earned by the master fund shall be reflected in the feeder fund ratios as if they had been earned by the feeder fund directly. Feeder funds need not disclose a portfolio turnover rate because feeders invest all their assets in the master fund.

• • > Master Funds

50-29 The financial highlights section of the master fund organized as a partnership is substantially modified, because per share information is not applicable. The master fund financial highlights section shall include the total return, ratios of expenses and net investment income to average net assets, and portfolio turnover rate. The financial highlights section of master funds not organized as a partnership shall report the normal per-share data.

Question 8.3.300 Does a feeder fund include investment income and expenses allocated from the master fund when calculating financial highlights ratios?

Interpretive response: Yes. A feeder fund generally includes its proportionate share of the income and expenses of the master fund when computing the ratios at the feeder level. [946-205-50-17]

Question 8.3.310 Is a feeder fund's share of a performance allocation that is levied at the master-fund level included in the feeder fund's expense and net investment income ratios?

Background: Performance-based arrangements paid to an investment manager can vary among master-feeder fund structures. Some performance-based arrangements are levied as an allocation at the master-fund level when the master fund is structured as a partnership where the proportionate share of the performance allocation is passed through to the respective feeder funds.

Interpretive response: Yes. Typically a performance-based arrangement charged as an allocation of income is not presented as an expense in the statement of operations. However, for master-feeder structures, a feeder fund's share of a performance allocation levied at the master-fund level is considered to be part of the proportionate share of income and expenses recognized by the feeder fund and therefore is classified as a separate line item in the statement of operations.

We believe that performance-based arrangements represent compensation for investment advisory services provided by the investment manager of the master fund. Therefore, we believe that a feeder fund's proportionate share of compensatory arrangements levied at the master-fund level should be classified as an operating expense of the feeder fund, not as a miscellaneous item classified outside of net investment income.

Since determining ratios to average net assets follows the classification of income and expenses presented in the statement of operations, we believe that both the expense and net investment income ratios should include a feeder fund's share of a performance allocation levied at the master-fund level.

8.3.70 Fund of funds

Excerpt from ASC 946-205

> Financial Highlights

• > Ratios

• • > Fund of Funds

50-16 Funds-of-funds shall compute the expense and net investment income ratios using the expenses presented in the fund's statement of operations. Therefore, funds-of-funds typically shall compute these ratios based on the net investment income and expense items at the fund-of-funds level only. Adequate disclosure shall be made so that it is clear to users that the ratios do not reflect the funds-of-funds' proportionate share of income and expenses of the underlying investee funds.

> Complex Capital Structures

• > Fund of Funds

50-30 The financial highlights for the reporting fund in a fund-of-funds structure are usually similar to a standalone feeder fund in a master-feeder structure. Net investment income and expense ratios shall be computed based on the amounts reported in the statement of operations, and portfolio turnover shall be measured based on the turnover of investments made by the reporting fund in the investee funds, not looking through the investee funds to their portfolio activity.

Question 8.3.320 Does a fund of funds include investment income and expenses allocated from its investee funds when calculating financial highlights ratios?

Interpretive response: No. A fund-of-funds uses the amounts presented in its statement of operations and does not include its proportionate share of the income and expenses of any of its investees. Further, it discloses that the ratios do not include the fund of fund’s proportionate share of income and expenses of the underlying investees. [946-205-50-16]

9. Financial statements: Other presentation matters

Detailed contents

9.5 Notes to the financial statements

Questions

Question 9.5.60 Is a registered fund permitted to present schedule of investments information in the notes to the financial statements?

Question 9.5.70 Is a registered fund required to provide tax basis disclosures for each class of investments?

Question 9.5.80 What is a registered fund required to disclose about the issuance and repurchase of its own securities?

9.6 Master-feeder funds

Questions

Question 9.6.10 What are the unique presentation requirements for master-feeder structures?

Question 9.6.20 Are there other circumstances where master-feeder presentation may be appropriate?

9.7 Consolidated financial statements

Questions

Question 9.7.10 Does Topic 946 provide guidance about when an investment company has a controlling financial interest in an investee?

Question 9.7.20 Does Topic 946 provide guidance about whether an investment company should consolidate another investment company in which it holds a controlling financial interest?

9.8 Combined financial statements

Question

Question 9.8.10 Is it appropriate to present combined financial statements for investment companies that are under common management?

Example

Example 9.8.10 Combined financial statements

9.1 How the standard works

This chapter discusses other financial statement presentation matters applicable to investment companies, including presentation issues related to:

- master-feeder funds
- consolidated financial statements
- combined financial statements.

Cash flow statements

The objective of a statement of cash flows is to describe the sources and uses of cash during a period because this information generally is not readily available when reviewing the financial position or results of operations of an investment company.

However, Topic 230 exempts certain investment companies from presenting a statement of cash flows if they meet the following conditions:

- substantially all of the investment company's investments are measured at fair value and meet certain other conditions;
- the investment company has minimal debt; and
- the investment company provides a statement of changes in net assets.

When an investment company provides a statement of cash flows, it applies Topic 230. A few issues arise when applying Topic 230 due to some unique attributes of an investment company's operations.

Statement of changes in net assets

A statement of changes in net assets summarizes an investment company's changes in net assets during the reporting period resulting from:

- investment operations;
- net equalization debits or credits;
- distributions to shareholders;
- capital share transactions;
- other contributions of capital (other than from capital share transactions); and
- other equity transactions.

Registered investment companies follow very detailed requirements when presenting a statement of changes in net assets, as summarized in the following table.

Category	Description
Results from operations	The following are presented separately to arrive at the net change in net assets resulting from operations: • net investment income or loss; • net realized gains or losses from investments and foreign currency transactions; and

Category	Description
	• changes in unrealized appreciation or depreciation on investments and the translation of assets and liabilities in foreign currencies.
Net equalization debits or credits	If equalization accounting is used, the net amount of undistributed investment income included in the price of capital shares issued or reacquired is shown as a separate line item.
Distributions to shareholders	Distributions from net investment income, net realized gain from investment transactions, and other sources are disclosed as a single line item. However, tax return of capital distributions are presented separately.
Capital share transactions	The increase or decrease in net assets derived from the net change in the number of outstanding shares or units must be disclosed. The number and value of shares issued in reinvestment of dividends as well as the number and dollar amounts received for shares sold and paid for shares redeemed are disclosed for each share class.
Other contributions of capital	Other contributions of capital resulting from equity transactions that do not involve a change in outstanding units or shares are distinguished by disclosure or separate presentation from capital share transactions presented in a statement of changes in net assets.
Other elements of capital	Changes in net assets resulting from any other elements of capital or residual interests appropriate to the capital structure of the entity are presented separately or disclosed.

For investment companies organized as investment partnerships, a statement of changes in partners’ capital is typically presented in lieu of a statement of changes in net assets to provide information about changes in net assets (partners’ capital) separately for each ownership class (i.e. the general partner class and the limited partner class).

Notes to the financial statements

There are three broad sources of disclosure requirements for investment companies:

- general disclosure requirements in a broad range of Codification Topics that include investment companies in their scope;
- disclosure requirements specific to investment companies in Topic 946 and related Subtopics; and
- incremental disclosure requirements specific to registered funds in Reg S-X and other SEC requirements.

Disclosure items required by Topic 946	Disclosure items required by SEC
• Investment company status • Change in status • Payments by affiliates • Certain distribution costs • General partner advisory services • Expense limitation agreements • Fee waivers • Dividends • Distributable earnings • Financial support to investees • Financial highlights ratios • Total return • Internal rate of return • Capital commitments • Credit enhancements • Net investment income tax provision • Foreign currency gains or losses from foreign investments • Multiple class funds • Master-feeder funds • Fund of funds • NAV per share • Capital share transactions • Difference between net investment income and net realized gain and actual distributions • Foreign currency risk	• Aggregate purchases and sales of investment securities • Remuneration paid • Restricted securities • Tax status • Tax basis disclosures • Issuance and repurchase of a registered fund's own securities • Swing pricing • Restrictions on cash and compensating balances • Unused financing arrangements • Management and service fees • Brokerage commissions • Brokerage service and expense offset arrangements • Interest and amortization of debt discount and expense • Capital share transactions

9.2 Statement of cash flows – scope

9.2.10 Overview

Excerpt from ASC 946-230

45-1 Paragraph 230-10-15-4 specifies conditions under which an investment company is exempt from the requirements to provide a statement of cash flows.

Excerpt from ASC 230-10

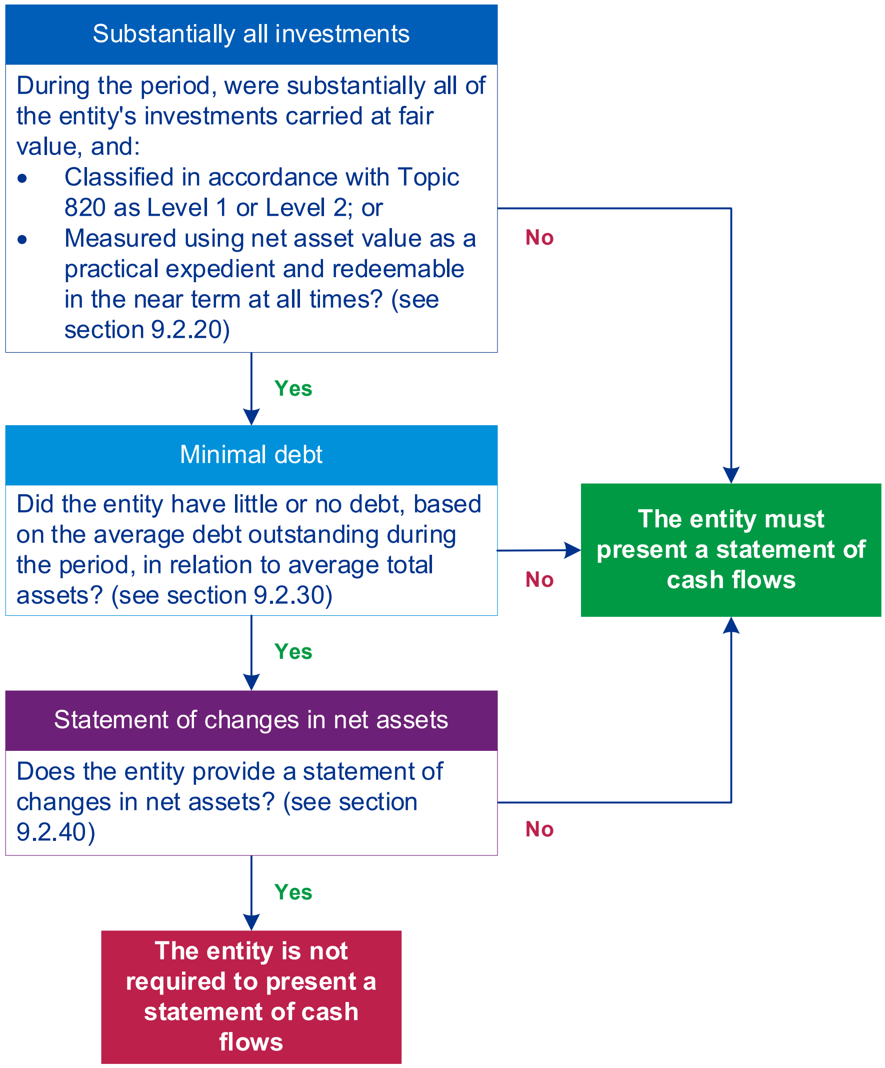
> Entities

15-4 The guidance in this Topic does not apply to the following entities:…

b. Provided that the conditions in (c) are met, a statement of cash flows is not required to be provided by the following entities:
   1. An investment company within the scope of Topic 946 on investment companies.…
c. For an investment company specified in (b) to be exempt from the requirement to provide a statement of cash flows, all of the following conditions must be met:…
   2. 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.
   3. 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.
   4. The entity provides a statement of changes in net assets.

For highly liquid investment companies that do not finance investments with debt, the FASB concluded that the other financial statements presented by an investment company generally would provide sufficient information for a user to assess the enterprises' liquidity, financial flexibility, profitability, and risk. [FAS 102.20]

The following summarizes all the conditions that must be met for an investment company to be exempt from the requirements to provide a statement of cash flows, as discussed in Question 2.3.40 in KPMG Handbook, Statement of cash flows: [230-10-15-4]



9.2.20 Substantially all investments

To meet the 'substantially all investments' criterion, during the period, substantially all of an investment company's investments are required to be carried at fair value, and must be: [230-10-15-4(c)(2)]

- classified as Level 1 or Level 2 in the fair value hierarchy; or
- measured using the NAV per share practical expedient (NAV practical expedient) and be redeemable in the near term at all times.

Question 9.2.10 What does 'substantially all' mean?

Interpretive response: 'Substantially all' is used elsewhere in US GAAP and is usually interpreted to mean 90%. As a result, we believe an entity should generally use 90% as a benchmark in evaluating the portion of its investments that are classified as Level 1 or Level 2 in the fair value hierarchy or are measured using the NAV practical expedient and redeemable in the near term at all times.

Question 9.2.20 Is an investment company able to meet the 'substantially all investments' criterion if it has significant Level 3 investments?

Interpretive response: No.

We believe Level 3 investments representing greater than 10% of the fair value of an investment company's portfolio generally would be significant and therefore the 'substantially all investments' criterion generally would not be met. However, we believe when evaluating whether Level 3 investments are significant to an investment company's portfolio consideration also should be given to factors such as the composition of the portfolio throughout the reporting period and the significance of purchases and sales of such investments during the period.

Question 9.2.30 How are investments in other investment companies evaluated under the 'substantially all investments' criterion?

Interpretive response: This evaluation depends on whether such investments are measured using the NAV practical expedient.

Investees measured using the NAV practical expedient

To meet the conditions in the 'substantially all investments' criterion, investments in other investment companies that are measured using the NAV practical expedient must be redeemable in the near term at all times. If not redeemable in the near term at all times such investments could preclude the investment company from meeting this criterion. Question 9.2.40 explains what 'near term' means in this context.

Investees not measured using the NAV practical expedient

If an investment company has investments in other investment companies that are not elected or eligible to be measured using the NAV practical expedient, the fair value measurements for those investments are subject to classification in the fair value hierarchy. Such investments would not preclude an investment company from meeting the 'substantially all investments' criterion if the fair value measurements are classified as Level 1 or Level 2 in the fair value hierarchy. [230-10-15-4(c)(2)]

Question 9.2.40 What is considered 'near term'?

Interpretive response: Determining whether an investment that is measured using the NAV practical expedient is redeemable in the near term depends on the specific facts and circumstances. We believe a redemption period of 90 days or less generally would be considered near term because the effects of time value of money are likely to be insignificant to the fair value of the investment. However, other factors (e.g. liquidity restrictions imposed by the investee, changes in the liquidity of the investee's portfolio) may influence whether the investment is redeemable in the near term.

Question 9.2.50 How does a feeder fund evaluate whether its investment in a master fund meets the 'substantially all investments' criterion?

Interpretive response: Under Topic 946, a feeder fund measures its investment in a master fund based on its proportionate interest in the net assets of the master fund rather than fair value (see Question 3.5.50). However, we do not believe a feeder fund is necessarily precluded from meeting the 'substantially all investments' criterion because substantially all of its assets are invested in a proportionate share of a master fund that measures its investment portfolio at fair value.

Because of the proportionate nature of its investment in the master fund, we believe it is appropriate for a feeder fund to look through to the investments of the master fund when evaluating whether the 'substantially all investments' criterion is met. We believe a feeder fund should also consider whether it has the ability to redeem its investment in the master fund in the near term at all times.

Further, to the extent a feeder fund has direct investments at the feeder fund level, it should include those feeder-level investments as part of its evaluation of the 'substantially all investments' criterion.

9.2.30 Minimal debt

To meet the 'minimal debt' criterion, an investment company should have little or no debt, based on the average debt outstanding during the period, relative to average total assets.

Question 9.2.60 What is considered 'little or no debt'?

Interpretive response: US GAAP does not specify a threshold for what is considered to be 'little or no debt' based on the average debt outstanding during the period in relation to average total assets.

While there may be judgment involved, we believe that industry practice typically is to use between 5% to 10% as an upper limit for average debt outstanding during the period in relation to average total assets to be considered little or no debt.

Question 9.2.70 Are all liabilities required to be included in average debt outstanding?

Interpretive response: No.

Obligations resulting from redemptions of an investment company's shares, unsettled purchases of securities, covered written options, and certain liabilities from other investment transactions (see Question 9.2.80) are generally excluded from average debt outstanding.

However, liabilities occurring from the extension of credit or under terms that are not consistent with standard industry practices for redeeming shares or for settling purchases of investments are included in average debt outstanding. [230-10-15-4(c)(3)]

Question 9.2.80 What is considered when evaluating whether liabilities from other investment transactions are included in average debt outstanding?

Background: Under the 'minimal debt' criterion, liabilities from unsettled purchases of securities or covered written options are generally excluded from average debt outstanding (see Question 9.2.70).

However, Topic 230 does not specify whether liabilities resulting from other investment practices or transactions, such as securities sold short, uncovered written options and reverse repos are excluded from average debt outstanding.

Interpretive response: We believe whether liabilities resulting from other investment transactions should be classified as debt depends on the nature of the activities related to those transactions.

We believe certain transactions initiated for operating purposes or as part of an investment strategy are not considered debt when an investment company either retains the proceeds in cash accounts or invests the proceeds in securities that are considered as cash equivalents while the liability is outstanding. [TQA 6910.25]

However, if an investment company uses a significant portion of the cash proceeds as part of its operations or to settle other obligations, we believe the substance of the transaction involves either a significant financing element or an extension of credit, and therefore should be included in average debt outstanding.

Example 9.2.10 Securities sold short

ABC Fund enters into a short sale transaction and receives cash proceeds from the sale of securities. ABC Fund is required to maintain the cash proceeds as a deposit against the securities borrowed. Because ABC Fund enters into the short sale transaction as part of its investment strategy and does not use the cash proceeds for any other purpose, the nature of the liability for the securities sold short does not involve a significant financing element or an extension of credit and therefore is not included in average debt outstanding.

Example 9.2.20 Reverse repurchase agreements

ABC Fund enters into a reverse repurchase (reverse repo) agreement and receives cash in exchange for securities pledged as collateral and is required to repay cash plus interest upon the expiration of the agreement. ABC Fund invests the proceeds from the reverse repo in common stock that is not considered cash equivalents. Because ABC Fund uses the cash proceeds from the reverse repo to finance the acquisition of additional equity investments, the nature of the reverse repo liability involves a significant financing element and therefore is included in average debt outstanding.

Example 9.2.30 Securities lending

ABC Fund enters into a securities lending transaction with Broker DEF, where ABC Fund lends certain of its portfolio securities to Broker DEF in exchange for securities lending fees and receives cash collateral during the term of the arrangement. ABC Fund invests the cash collateral in short-term commercial paper that is considered to be cash equivalents. Because ABC Fund invests the cash collateral in investments that are considered cash equivalents, the nature of the liability to return the cash collateral does not involve a significant financing element or an extension of credit and therefore is not included in average debt outstanding.

Question 9.2.90 Are margin borrowings considered debt under the 'minimal debt' criterion?

Interpretive response: Yes.

Under the 'minimal debt' criterion, obligations resulting from standard industry practices for redeeming shares or for settling purchases of investments, or from covered options written are generally excluded from average debt outstanding (see Question 9.2.60).

Margin borrowing arrangements are entered with brokers to use borrowed funds to purchase securities and use those securities as collateral under the arrangement. Because margin borrowings are used to finance purchases of investments, rather than to redeem the shares of an investment company or to settle purchases of investments, we believe that margin borrowings should be included in average debt outstanding.

Question 9.2.100 Are redeemable equity interests of an investment company considered to be debt when determining whether the 'minimal debt' criterion is met?

Interpretive response: It depends.

Some investment companies issue redeemable preferred stock that is redeemable upon events outside the control of the issuer but not mandatorily redeemable as of the reporting date (see Question 4.2.80). Such redeemable preferred shares are not classified as liabilities but rather are presented in the 'mezzanine' section below liabilities and above net assets. Consistent with the views discussed by the AICPA Investment Companies Expert Panel, we do not believe such redeemable preferred stock should be included in average debt outstanding for purposes of the 'minimal debt' criterion. [AICPA IC EP 2/2005]

However, an investment company should evaluate whether there are subsequent conditions that cause its preferred shares to become mandatorily redeemable (see section 6.4 of KPMG Handbook, Debt and equity financing) that would require those interests to be reclassified as a liability, and therefore considered to be debt.

9.2.40 Statement of changes in net assets

To meet the 'statement of changes in net assets' criterion, an investment company presents a statement of changes in net assets (see section 9.4). Because Topic 946 requires all investment companies to present a statement of changes in net assets, this criterion will typically be satisfied when an investment company presents a complete set of financial statements. [946-205-45-1]

9.3 Statement of cash flows – presentation

9.3.10 Overview

Topic 230 contains overall guidance on reporting cash flows for all entities. However, there are a few other sources that interpret how an investment company applies Topic 230's presentation guidance.

This section addresses statement of cash flows presentation matters that are specific to investment companies. See KPMG Handbook, Statement of cash flows, for other general requirements for presenting a statement of cash flows.

9.3.20 Operating activities

Question 9.3.10 Do investment companies classify purchases and sales of investments as operating or investing activities?

Background: The general guidance in Topic 230 requires cash flows from purchases, sales and maturities of securities to be classified as cash flows from operating or investing activities as follows: [230-10-45-11, 45-19, 320-10-45-11, 321-10-45-1]

- cash flows from equity securities (Topic 321) and trading debt securities (Topic 320) classified based on the nature and purpose for acquiring these securities;
- cash flows from other securities acquired specifically for resale and carried at fair value in a trading account, classified as operating activities; and
- cash flows from other securities, classified as investing activities.

Interpretive response: Investment companies are excluded from the scope of Topics 320 and 321. However, because investment companies' activities consist of generating returns from investment income, capital appreciation, or both, we believe it is acceptable for an investment company to classify cash flows from investment transactions as cash flows from operating activities. [946-10-15-6]

We believe this is consistent with widespread industry practice to classify an investment company's investing activities as cash flows from operating activities. [AAG-INV 7.163, TQA 6910.26]

Question 9.3.20 Does an investment company present purchases, sales and maturities of investments on a gross or net basis?

Interpretive response: It depends. Generally, Topic 230 requires an investment company to present purchases, sales and maturities of investments on a gross basis in the statement of cash flows. However, there are two instances in which netting may be permitted.

Securities that meet the netting criteria in Topic 230

Purchases, sales and maturities of investments qualify to be presented on a net basis if the netting criteria under Topic 230 are met. Those criteria require that investments have a quick turnover, occur in large amounts, and have short maturities. See Question 9.2.40 in KPMG Handbook, Statement of cash flows.

Securities in trading accounts

As explained in Question 9.3.10, we believe Topic 230 permits an investment company to classify cash related to investments in trading accounts as operating activities. We further believe net reporting may be appropriate when the investment company's activities are commensurate to investments held in a trading account as contemplated under Topic 230. We believe an investment company may consider the following factors when determining whether its overall activities are consistent with trading: [230-10-45-9, 45-18, 320-10 Glossary, TQA 6910.20, TQA 6910.26]

- **Trading style:** whether the trading style is to sell securities in the near term;
- **Stated investment objectives:** whether the stated investment objectives are for appreciation from short-term differences in prices;
- **Portfolio turnover:** whether the trading activity reflects active and frequent purchases and sales of securities resulting in frequent turnover in the investment portfolio.

Question 9.3.30 Are proceeds associated with short positions presented separately from payments associated with long positions?

Interpretive response: Yes. Proceeds and costs reported for transactions in short positions are reflected separately from payments and costs associated with long positions. [TQA 6910.20]

9.3.30 Financing activities

Question 9.3.40 How are changes in margin borrowings presented?

Interpretive response: Investment companies enter into margin borrowing arrangements with brokers to use borrowed funds to purchase securities and use those securities as collateral under these arrangements. We believe that margin borrowings should be classified as cash flows resulting from financing activities.

An investment company may consider the guidance in Topic 230, which permits assets or liabilities with original maturities three months or less to be presented on a net basis, when determining whether to present margin borrowings and repayments on a gross or net basis in the statement of cash flows. [230-10-45-7 – 45-9]

9.3.40 Noncash activities

Excerpt from ASC 230-10

> Noncash Investing and Financing Activities

50-3 Information about all **investing** and **financing activities** of an entity during a period that affect recognized assets or liabilities but that do not result in **cash** receipts or cash payments in the period shall be disclosed. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items.

50-4 Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining a **right-of-use asset** in exchange for a **lease liability**; obtaining a beneficial interest as consideration for transferring financial assets (excluding cash), including the transferor's trade receivables, in a securitization transaction; obtaining a building or investment asset by receiving a gift; and exchanging noncash assets or liabilities for other noncash assets or liabilities.

50-5 Some transactions are part cash and part noncash; only the cash portion shall be reported in the statement of cash flows.

50-6 If there are only a few such noncash transactions, it may be convenient to include them on the same page as the statement of cash flows. Otherwise, the transactions may be reported elsewhere in the financial statements, clearly referencing to the statement of cash flows.

Excerpt from ASC 946-230

> Implementation Guidance

55-1 Examples of noncash investing and financing activities of investment companies that paragraphs 230-10-50-3 through 50-4 require be disclosed include reinvestments of dividends and distributions.

When a statement of cash flows is presented, Topic 230 requires disclosure of information about investing and financing activities of an entity during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments. Such disclosures are summarized in a schedule or in narrative form on the face of the statement of cash flows, or in the notes to the financial statements by reference to the statement of cash flows. [230-10-50-3, 50-6]

To the extent that a transaction includes both cash and noncash components, an entity should disclose the noncash component of the transaction and present the cash component in the statement of cash flows. [230-10-50-5]

Question 9.3.50 How are reinvestments of dividends and distributions presented?

Interpretive response: An investment company discloses noncash reinvestments of dividends and distributions as noncash financing activities. [946-230-55-1]

9.4 Statement of changes in net assets

9.4.10 Overview

Excerpt from ASC 946-205

> Statement of Changes in Net Assets

45-3 The statement of changes in net assets summarizes results from operations, net equalization credits or debits, dividends and distributions to shareholders, capital share transactions, and capital contributions. The increase or decrease in net assets of a registered investment company comprises the following categories:

a. Operations. Net investment income or loss, net realized gains or losses from investments and foreign currency transactions, and changes in unrealized appreciation or depreciation on investments and translation of assets and liabilities in foreign currencies, as shown in the statement of operations, shall be presented separately to arrive at the net change in net assets resulting from operations.
b. Net equalization debits or credits. If equalization accounting is used, undistributed investment income included in the price of capital shares issued or reacquired shall be shown as a separate line item.
c. Distributions to shareholders. Distributions shall be disclosed as a single line item, except for tax **return of capital** distributions, which shall be presented separately. Distributions made by regulated investment companies often differ from aggregate undistributed net investment income (including net equalization credits or debits and undistributed net investment income) determined in accordance with generally accepted accounting principles (GAAP) and accumulated net realized gains (total net realized gains determined in accordance with GAAP). The principal cause is that required minimum fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, rather than GAAP. The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. If in a subsequent period all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference shall be reclassified to paid-in capital.

> Investment Partnerships

45-5 For investment partnerships, the statement of changes in net assets may be combined with the statement of changes in partners' capital if the information in paragraph 946-205-45-3 is presented.

Excerpt from Reg S-X Rule 6-09

Statements of changes in net assets.

Statements of changes in net assets filed for persons to whom this article is applicable shall comply with the following provisions:

Statements of Changes in Net Assets

1. *Operations*. State separately: (a) Investment income-net as shown by § 210.6-07.6; (b) realized gain (loss) on investments-net of any Federal or other income taxes applicable to such amounts; (c) increase (decrease) in unrealized appreciation or depreciation-net of any Federal or other income taxes applicable to such amounts; and (d) net increase (decrease) in net assets resulting from operations as shown by § 210.6-07.9.
2. *Net equalization charges and credits*. State the net amount of accrued undivided earnings separately identified in the price of capital shares issued and repurchased.
3. *Distributions to shareholders*. State total distributions to shareholders which generally come from: (a) Investment income-net; (b) realized gain from investment transactions-net; and (c) other sources, except tax return of capital distributions, which shall be disclosed separately.
4. *Capital share transactions*. (a) State the increase or decrease in net assets derived from the net change in the number of outstanding shares or units.
   (b) Disclose in the body of the statements or in the notes, for each class of the person's shares, the number and value of shares issued in reinvestment of dividends as well as the number and dollar amounts received for shares sold and paid for shares redeemed.
5. *Total increase (decrease).*
6. *Net assets at the beginning of the period.*
7. *Net assets at the end of the period.*

[47 FR 56838, Dec. 21, 1982, as amended at 83 FR 50202, Oct. 4, 2018]

A statement of changes in net assets summarizes an investment company's changes in net assets during the reporting period resulting from: [946-205-45-3]

- investment operations;
- net equalization debits or credits;
- distributions to shareholders;
- capital share transactions;
- other contributions of capital (other than from capital share transactions); and
- other equity transactions.

For investment companies organized as investment partnerships, a statement of changes in partners' capital is typically presented in lieu of a statement of changes in net assets to provide information about changes in net assets (partners' capital) separately for each ownership class (i.e. the general partner class and the limited partner class).

Question 9.4.10 What information does a registered fund include when presenting a statement of changes in net assets?

Interpretive response: For a registered fund, more detailed requirements for the categories of increases and decreases presented in a statement of changes in net assets are described in the following table.

Category	Description	Reference
Results from operations	Net investment income or loss, net realized gains or losses from investments and foreign currency transactions, and changes in unrealized appreciation or depreciation on investments and the translation of assets and liabilities in foreign currencies must be presented separately to arrive at the net change in net assets resulting from operations. [946-205-45-3(a), S-X Rule 6-09.1]	Section 9.4.20
Net equalization credits or debits	If equalization accounting is used, the net amount of undistributed investment income included in the price of capital shares issued or reacquired must be shown as a separate line item. [946-205-45-3(b), S-X Rule 6-09.2]	Section 9.4.30
Distributions to shareholders	Distributions from net investment income, net realized gain from investment transactions, and other sources are disclosed as a single line item. However, tax return of capital distributions are presented separately. [946-205-45-3(c), S-X Rule 6-09.3]	Section 9.4.40
Capital share transactions	The increase or decrease in net assets derived from the net change in the number of outstanding shares or units must be disclosed. The number and value of shares issued in reinvestment of dividends as well as the number and dollar amounts received for shares sold and paid for shares redeemed must be disclosed for each share class. [946-205-45-3, S-X Rule 6-09.4]	Section 9.4.50
Other contributions of capital	Other contributions of capital resulting from equity transactions that do not involve a change in outstanding units or shares should be distinguished by	Section 9.4.60

Category	Description	Reference
	disclosure or separate presentation from capital share transactions presented in a statement of changes in net assets.	
Other elements of capital	Changes in net assets resulting from any other elements of capital or residual interests appropriate to the capital structure of the entity should be presented separately or disclosed. [S-X Rule 6-04.18]	Section 9.4.70

Question 9.4.20 What information does a nonregistered investment partnership include when presenting a statement of changes in partners' capital?

Interpretive response: A nonregistered investment partnership is permitted to combine a statement of changes in net assets with a statement of changes in partners' capital (see Question 9.4.40) if the requirements for a statement of changes in net assets are included (see Question 9.4.10). [946-205-45-5]

Question 9.4.30 How does a statement of changes in partners' capital differ from a statement of changes in net assets?

Interpretive response: Similar to a statement of changes in net assets, a statement of changes in partners' capital presents information about the changes in an investment company's net assets during the period.

However, a statement of changes in partners' capital presents such changes separately by each ownership class to provide additional information about the relative participation in the net assets and the results of operations between those classes. [SAB Topic 4.F]

Question 9.4.40 What classes of ownership interests are presented in a statement of changes in partners' capital?

Interpretive response: At a minimum, investment companies organized as limited partnerships present the changes in the capital accounts for the general partner and the limited partner class. However, we believe a partnership should evaluate whether there are separate classes of limited partner interests with differences in respective rights, preferences and privileges for each class, that should be presented separately in the statement of changes in partners' capital.

An evaluation of the pertinent rights, preferences and privileges is often a matter of legal interpretation. [272-10-50-3]

Generally, a class of ownership interest has certain rights as governed by underlying legal documents or offering documents and local law. Similar to the guidance for disclosing financial highlights of nonregistered investment partnerships (see section 8.3), we believe that temporary series of shares (see Question 8.3.60) and rights to certain investments that do not otherwise affect the rights available to the limited partners (see Question 8.3.70) are not considered separate classes that require presentation in a statement of changes in partners' capital. [946-205 Glossary]

Question 9.4.50 What are the requirements for master-feeder structures when presenting a statement of changes in net assets?

Interpretive response: For investment companies that are part of a master-feeder structure, the presentation of a statement of changes in net assets applies as follows.

Master funds

The statement of changes in net assets of a master fund presents capital transactions from or to its feeder funds as contributions and withdrawals, respectively.

Feeder fund

For feeder funds, the standard reporting format for investment companies with simple capital structures is used. [946-205-45-4]

9.4.20 Changes resulting from operations

Question 9.4.60 How does a registered fund present its results of operations in the statement of changes in net assets?

Interpretive response: In a statement of changes in net assets, a registered fund separately presents the following components of results of operations: [946-205-45-3(a), S-X Rule 6-09.1]

- net investment income or loss;
- net realized gains or losses from investments and foreign currency transactions (net of any Federal or other applicable income taxes);

- changes in unrealized appreciation or depreciation on investments and translation of assets and liabilities in foreign currencies (net of any Federal or other applicable income taxes); and
- net increase or decrease in net assets resulting from operations.

Question 9.4.70 Is a nonregistered investment partnership required to present separate components of results of operations in a statement of changes in partners' capital?

Background: Nonregistered investment partnerships are permitted to combine a statement of changes in net assets with a statement of changes in partners' capital if the information required for a statement of changes in net assets is included (see Question 9.4.20).

A statement of changes in net assets for a registered fund requires the following components of results of operations to be presented separately:

- net investment income or loss;
- net realized gains or losses from investments and foreign currency transactions;
- changes in unrealized appreciation or depreciation on investments and translation of assets and liabilities in foreign currencies.

Interpretive response: It depends.

Although Topic 946 states that the separate presentation of the components of results of operations applies to registered funds, it is acceptable for nonregistered investment partnerships to include such detail in a statement of changes in partners’ capital. [946-205-45-5]

However, based on our understanding of industry practices, an alternative presentation of the net increase or decrease in net assets resulting from operations as a single caption may also be an acceptable presentation of a statement of changes in partners' capital by nonregistered investment partnerships. We believe this alternative presentation may be used when the components of results of operations are presented elsewhere in the financial statements (i.e. in the statement of operations) and the alternative presentation is considered more meaningful to users of the financial statements. [AAG-INV 7.238]

We believe a nonregistered investment partnership should consider the following factors when evaluating whether presenting the results of operations as a single caption in the statement of changes in partners' capital may be less meaningful to the users of the financial statements.

- The entity is required to distribute its taxable income and realized gains from securities transactions to its investors during each taxable year.
- The entity has multiple investor classes, such as different classes of limited partner interests, which have substantive differences in pertinent rights and privileges between classes.

- The entity has multiple investor classes and has significant class-level income or expenses, such as distribution and servicing fees.
- The entity has multiple investor classes and charges significant class-specific sales loads to its shareholders.

We believe an entity should apply judgment and consider the facts and circumstances, including whether other relevant factors exist, when determining the presentation that is more meaningful to users of the financial statements.

9.4.30 Net equalization debits or credits

Equalization is an accounting practice unique to the investment company industry that is used to prevent dilution of the undistributed net investment income per share attributed to continuing shareholders as a result of continuous capital share transactions. This is accomplished by applying a portion of the proceeds or purchases from capital share transactions to undistributed income. [AAG-INV Glossary, AAG-INV 4.28]

The per share amount associated with undistributed income is recorded as an equalization credit when shares are issued. When shares are repurchased, the per share amount is recorded as an equalization charge (debit). [AAG-INV 4.29]

When equalization accounting is used, undistributed investment income included in the price of capital shares issued or reacquired is shown as a separate line item in the statement of changes in net assets. [946-205-45-(b), S-X Rule 6-09.2]

9.4.40 Distributions to shareholders

Question 9.4.80 How does a registered fund present separate components of distributions in a statement of changes in net assets?

Interpretive response: Distributions are presented in the statement of changes in net assets as a single line item, except for 'tax return of capital distributions' (i.e. distributions in excess of tax-basis earnings and profits), which are presented separately. The components of distributions are instead disclosed in the notes to the financial statements (see Question 4.4.20). [946-205-45-3(c), S-X Rule 6-09.3]

Question 9.4.90 Does a nonregistered fund present separate components of dividends in a statement of changes in net assets?

Interpretive response: No. As discussed in Question 4.4.50, a nonregistered fund is not required to disclose the components of its dividends in a statement of changes in net assets. [946-20-50-14]

9.4.50 Capital share transactions

Capital share transactions result from the increase or decrease in net assets of an investment company resulting from the net change in the number of its outstanding shares or units. [S-X Rule 6-09.4]

Capital share transactions include the following:

- issuance of shares;
- redemption or repurchase of shares;
- reinvestment of dividends; and
- conversion of shares from one class to another.

When presenting a statement of changes in net assets, an investment company includes information on changes in net assets resulting from capital share transactions for each class of shares or ownership interests. [946-205-45-4]

See section 4.2 for additional guidance on accounting for an investment company's capital share transactions.

Question 9.4.100 What disclosures are required for capital share transactions related to the statement of changes in net assets?

Interpretive response: The following components of the change in net assets resulting from capital share transactions are presented for each class. [946-505-50-2]

- the number and value of shares sold;
- the number and value of shares issued in the reinvestment of distributions;
- the number and cost of shares reacquired; and
- the net change.

These disclosures can be presented either in the statement of changes in net assets or in the notes to the financial statements.

9.4.60 Other contributions of capital

Question 9.4.110 What is the difference between other contributions of capital and capital share transactions presented in a statement of changes in net assets?

Interpretive response: When presenting a statement of changes in net assets, capital share transactions represent the changes in an investment company's net assets resulting from the net change in the number of its outstanding shares or units.

However, in some circumstances, an investment company may enter into a transaction that results in a contribution of capital without involving an issuance of capital shares. An example of a transaction that can result in 'other contributions of capital' is payments by affiliates that arise from a shareholder relationship (see Question 5.4.20).

We believe adequate disclosure should be made to distinguish other contributions of capital from capital share transactions presented in a statement of changes in net assets.

9.4.70 Other elements of capital

Topic 946 requires an investment company to present two components of capital when presenting its ending net assets on a statement of assets and liabilities: [946-20-50-11]

- shareholder capital; and
- distributable earnings.

However, although not explicitly stated in Topic 946 or Reg S-X, a statement of changes in net assets may also include increases and decreases in net assets that are attributable to other elements of capital (e.g. other comprehensive income) presented separately from shareholder capital and distributable earnings on the statement of assets and liabilities. [S-X Rule 6-04.18]

Question 9.4.120 How is other comprehensive income presented in the statement of changes in net assets?

Background: Both Topic 946 and Article 6 of Reg S-X require a statement of changes in net assets to present increases and decreases in net assets resulting from operations, net equalization credits or debits, distributions to shareholders and capital share transactions.

Interpretive response: Although the presentation of other comprehensive income in the statement of changes in net assets is not addressed in either Reg S-X or Topic 946, we believe investment companies should apply the guidance in Topic 220 to report changes in accumulated other comprehensive income as a component of equity that is presented separately in the statement of changes in net assets. [220-10-45-14A]

An example of other comprehensive income is the change in the fair value of the debt liability resulting from a change in the instrument-specific credit risk when the fair value option has been elected for an investment company's own debt (see Question 8.2.250).

9.5 Notes to the financial statements

9.5.10 Overview

The notes to the financial statements supplement or explain information presented in the financial statements and with a full set of financial statements help achieve the objective of general purpose financial reporting (see Question 2.3.10 in KPMG Handbook, Financial statement presentation).

There are three broad sources of disclosure requirements for investment companies:

- general disclosure requirements in a broad range of Codification Topics that include investment companies in their scope (as discussed in general in chapter 6 of KPMG Handbook, Financial statement presentation, and more specifically in numerous other KPMG Handbooks listed at the end of this Handbook);
- disclosure requirements specific to investment companies in Topic 946 and related Subtopics; and
- incremental disclosure requirements specific to registered funds in Reg S-X Article 6.

Question 9.5.10 What disclosures does Topic 946 require an investment company to include in the notes to the financial statements?

Interpretive response: The following table summarizes the disclosure requirements in Topic 946 that an investment company includes in the notes to the financial statements when applicable.

Disclosure item	Summary of disclosure	Reference
Investment company status	• The fact that an entity is an investment company following accounting and reporting guidance under Topic 946 [946-10-50-1]	Question 2.9.10
Change in status	• Occurrence of a change in investment company status • Reasons for the change [946-10-50-2 – 50-3]	Question 2.9.20

Disclosure item	Summary of disclosure	Reference
Payments by affiliates	• Payments by affiliates to reimburse the fund for losses on investment transactions • Gains and losses on investments not meeting investment guidelines [946-20-50-2]	Question 5.4.50
Certain distribution costs	• Information related to terms and certain provisions of Rule 12b-1 distribution plans [946-20-50-3 – 50-4]	Question 4.7.110
General partner advisory services	• The method of computing payments or allocations for advisory services from the general partner [946-20-50-5]	Question 5.2.30
Expense limitation agreements	• Existence of expense limitation agreements • Carryover of excess expenses potentially reimbursable to the advisor but not recorded as a liability [946-20-50-6]	Question 5.3.150
Fee waivers	• Terms of all voluntary and involuntary fee waivers [946-20-50-7]	Question 5.3.20
Dividends	• Tax basis components of dividends paid, as follows: [946-20-50-8, 946-505-50-5] — ordinary income distributions — long-term capital gain distributions — return of capital distributions • Dividends from affiliates and controlled companies[1] [946-20-50-9] • The fact that a tax return of capital is likely to occur for the fiscal year when determined during an interim reporting period [946-20-50-10]	Question 4.4.20
Distributable earnings	• Tax basis components of distributable earnings, as follows: [946-20-50-11 – 50-12, 946-505-50-4] — undistributed ordinary income — undistributed long-term capital gains — capital loss carryforwards — unrealized appreciation or depreciation • Differences between the total of these amounts and distributable earnings (accumulated losses) are disclosed. [946-20-50-13]	Question 4.5.10

Disclosure item	Summary of disclosure	Reference
Financial support to investees	• Information about financial support provided to investees and for financial support contractually required but not yet provided: [946-20-50-15 – 50-16] — type and amount of financial support — primary reasons for providing support	Question 2.9.30
Financial highlights ratios	• Statement that the net investment income ratio does not include the effects of any performance allocation • Description of the expenses that have not been annualized [946-205-50-13] • Statement that an individual investor's ratio may vary from the common class as a whole [946-205-50-15] • Statement that the ratios of a fund of funds does not include the proportionate share of income and expenses of its investees [946-205-50-16]	Section 8.3.30
Total return	• Whether or not total return is annualized for interim periods [946-205-50-18]	Question 8.3.230
Internal rate of return (IRR)	• The fact that IRR since inception is net of all incentives • Significant assumptions with respect to calculation of IRR since inception [946-205-50-24]	Question 8.3.270
Capital commitments	• For entities that obtain capital commitments from investors and periodically call capital: [946-205-50-25] — the total committed capital of the partnership (including general partner) — the year of formation of the entity — the ratio of total contributed capital to total committed capital	Question 8.3.260
Credit enhancements	• Terms, conditions and other arrangements relating to a credit enhancement [946-210-50-11 – 50-13]	Question 5.4.30
Net investment income tax provision	• Income tax provisions relating to net investment income[1] [946-220-50-1]	Question 8.2.190

Disclosure item	Summary of disclosure	Reference
Foreign currency gains or losses from foreign investments	• Policy for reporting the effect of foreign currency gains or losses from investments in foreign securities [946-220-50-2, 946-830-50-1]	Questions 8.2.170 and 8.2.180
Multiple class funds	• Class-specific expenses for each class[1] [946-220-50-3]	Question 8.2.90
	• For entities with multiple share classes: [946-235-50-2] — a description of each class of shares — the method used to allocate income and expenses to each class — fee arrangements specific to each class — capital share transactions for each class — the total sales charge paid to any affiliates for each class	Question 4.3.10
Master-feeder funds	• For master-feeder structures: [946-235-50-3] — a description of the master-feeder structure — the feeder's ownership percentage of the master fund — a statement that the feeder invests all of its investable assets in an investment company having the same objectives of the feeder — a reference to the accounting policies of the master fund	Question 9.5.20
Fund of funds	• Agreements for investee funds to assume investor fund expenses [946-220-50-4] • General description of the fund of funds structure • Valuation policy of the fund of funds [946-235-50-4 – 50-5]	Question 9.5.30
NAV per share	• NAV per share for each class of shares [946-505-50-1]	Question 4.3.10
Capital share transactions	• For capital share transactions[2]: [946-505-50-2] — the number and value of shares sold — the number and value of shares issued in reinvestment of distributions	Question 4.3.10

Disclosure item	Summary of disclosure	Reference
	— the number and cost of shares reacquired — the net change.	
Difference between net investment income and net realized gain and actual distributions	• Primary reasons for any significant difference between: [946-505-50-6] — total net investment income and net realized gains under US GAAP, and — actual distributions	Question 4.4.30
Foreign currency risk	• Foreign currency risks associated with investing in foreign securities [946-830-50-2 – 50-4]	Question 9.5.40
Notes: 1. This information may be presented on the face of the statement of operations or disclosed in the notes to the financial statements. 2. This information may be presented on the face of the statement of changes in net assets or disclosed in the notes to the financial statements.		

In addition to the above, registered funds are subject to additional disclosure requirements under SEC regulations (see Question 9.5.50).

9.5.20 Complex capital structures

Excerpt from ASC 946-235

• > Master-Feeder Funds

50-3 Notes to financial statements of each feeder fund shall include all of the following:

a. A general description of the master and feeder structure
b. The feeder's percentage ownership share of the particular master fund at the reporting date
c. A statement that the feeder invests all of its investable assets in a corresponding open-end management investment company having the same investment objectives as the feeder, and a reference to the financial statements of the master fund, including the portfolio of investments
d. Disclosure of or reference to the accounting policies of the master fund that affect the feeders (such as valuation of investments of the master fund).

Information concerning the purchases and sales of investments and gross unrealized appreciation or depreciation of investments on a tax basis is not applicable to the feeder's financial statements.

• > Fund of Funds

50-4 Fund management shall consider whether, and to what extent, disclosure of the investee funds' investment policies is appropriate.

50-5 Notes to financial statements of the reporting fund shall include both of the following:

a. A general description of the fund of funds structure
b. Disclosure of valuation policy-values generally based on information reported by investee funds.

Topic 946 addresses certain presentation and disclosure issues related to investment companies organized under 'complex capital structures' that allow for additional channels for distribution of investment company interests. The types of complex capital structures addressed in Topic 946 include:

- multiple-class funds (see section 4.3)
- master-feeder funds (see section 9.6)
- fund of funds (see section 7.6.40).

Subtopic 946-235 addresses disclosure requirements for complex capital structures.

Question 9.5.20 What is included in the notes to the financial statements of a feeder fund?

Interpretive response: Notes to the financial statements of each feeder fund include all of the following:

- a general description of the master and feeder structure;
- the feeder's percentage ownership of the particular master fund at the reporting date;
- a statement that the feeder invests all of its investable assets in a corresponding open-end management investment company having the same investment objectives as the feeder;
- a reference to the financial statements of the master fund (see Question 9.6.10), including the schedule of investments; and
- disclosure of or reference to the accounting policies of the master fund that affect the feeder (such as valuation of investments of the master fund).

Information concerning the purchases and sales of investments and gross unrealized appreciation or depreciation of investments on a tax basis is not applicable to the feeder's financial statements. [946-235-50-3]

Question 9.5.30 What disclosures are fund of funds required to present in the notes to the financial statements?

Interpretive response: Notes to the financial statements of a fund of funds include both of the following:

- a general description of the fund of funds structure; and
- disclosure of the fund's valuation policy.

For a fund of funds, the valuation of its investments in other investment companies (investee funds) are generally based on NAVs reported by the investee funds.

A fund of funds should also consider whether and to what extent disclosure of the investee funds' investment policies is appropriate. We believe some of the considerations for this disclosure include: [946-235-50-4 – 50-5]

- the significance of the investee fund relative to the investment portfolio;
- complexity of valuation of the investee fund's investments; and
- liquidity or redemption terms of the investee fund.

A fund of funds is also required to disclose any arrangements where an investee fund has agreed to assume some of the reporting fund's expenses. [946-220-45-14]

9.5.30 Foreign currency risks

Excerpt from ASC 946-830

50-1 An entity shall disclose its practice of either including or excluding that portion of realized and unrealized gains and losses on investments that results from foreign currency changes with or from other foreign currency gains and losses.

50-2 Foreign currency risk associated with investing in foreign securities shall be assessed continuously by management and considered for financial statement disclosure, including disclosures about all of the following:

a. Liquidity. Because certain foreign markets are illiquid, market prices may not necessarily represent **fair value**.
b. Size. If market capitalization is low, a fund's share in the entire market (particularly if single-country funds are involved) or in specific securities may be proportionately very large, and the fair value, consistent with Topic 820, may not be representative of the price that would be received if the fund sold its large proportion of the specific security ("block") at the measurement date.
c. Valuation. Because of liquidity problems as well as other factors, such as securities that are unlisted or securities that are traded in inactive markets, funds are required to develop procedures consistent with Topic 820 for measuring the fair values of such securities. Doing so may be difficult in a foreign environment; while others may perform the research and provide

supporting documentation for fair values, the ultimate responsibility for determining the fair values of securities rests with the management.

50-3 These disclosures are no different from those that might be required for domestic securities with the same attributes. The preceding risks shall be disclosed in the notes to financial statements if such factors exist in the markets in which the fund has material investments.

50-4 For funds that invest in countries that are highly inflationary, the separate disclosure of the foreign currency element may not be meaningful and the disclosures in this Section may not be appropriate.

Question 9.5.40 What does an investment company disclose about foreign currency risks?

Interpretive response: If an investment company has significant exposure to investments in foreign markets, it should consider whether to disclose the following risks: [946-830-50-2 – 50-3]

- **Liquidity:** When certain foreign markets are illiquid, market prices may not necessarily represent fair value.
- **Size:** The fair value of foreign securities may not be representative of the price that would be received at the measurement date due to the size of the investment company's position relative to the market capitalization for the investment.
- **Valuation:** Securities that are unlisted or thinly traded may create additional challenges in obtaining information and supporting documentation to determine their values and doing so may be difficult in a foreign environment.

In addition, we believe an investment company should consider similar disclosures of foreign currency risks if it invests in markets subject to foreign exchange controls that restrict its ability to repatriate earnings from those jurisdictions. See section 3 of KPMG Handbook, Foreign currency, for additional discussion on the exchange rate used to measure foreign currency transactions.

9.5.40 Registered funds

Question 9.5.50 What additional disclosures are required in the notes to the financial statements of registered funds?

Interpretive response: In addition to the disclosures required by Topic 946 (see Question 9.5.10), a registered fund may be subject to the following disclosure requirements under Reg S-X and the 1940 Act.

Disclosure item	Summary of disclosure
Aggregate purchases and sales of investment securities	Aggregate dollar amounts of purchases and sales of investment securities (other than US Government securities) during the period [1940 Act §30(e)(6)]
Remuneration paid	Aggregate remuneration paid to[1] [1940 Act §30(e)(5)] • directors and advisory board members for regular compensation • directors and advisory board members for special compensation • officers • affiliates of officers and directors
Restricted securities	For restricted securities: [S-X Rule 6-03(f)] • policy for acquisition of restricted securities • policy for valuation of restricted securities • description of rights to demand registration of restricted securities held at the reporting date
Tax status	A registered fund's status as a regulated investment company under subchapter M of the IRC Principal assumptions relied on in making (or not making) a provision for income taxes [S-X Rule 6-03(h)(1)]
Tax basis disclosures	Information based on cost used for Federal income tax purposes (see Question 9.5.70), as follows: [S-X Rule 6-03(h)(2)] • aggregate gross unrealized appreciation for securities where value exceeds tax cost • aggregate gross unrealized depreciation for securities where tax cost exceeds value • net amount of unrealized appreciation or depreciation • aggregate cost of securities for Federal income tax purposes
Issuance and repurchase of a registered fund's own securities	For each class of a registered fund's own securities, information on securities sold and repurchased during the period (see Question 9.5.80) [S-X Rule 6-03(i)]
Swing pricing	Disclose the following information about a registered fund's adoption of swing pricing policies: [S-X Rule 6-03(m)] • methods to determine whether the NAV will swing • whether the NAV has swung during the period • a description of the effects of swing pricing
Restrictions on cash and compensating balances	Provisions of restrictions on cash and information on compensating balance arrangements (see Question 7.2.100)
Unused financing arrangements	Information on unused lines of credit for short-term financing and unused commitments for long-term financing arrangements (see Question 7.2.200)
Management and service fees	Information on the fee rate, the fee base and method of computing management and service fees (see Question 8.2.80)

Disclosure item	Summary of disclosure
Brokerage commissions	The amount of brokerage commissions paid to affiliates in connection with the purchase and sale of investment securities (see Question 8.2.80)
Brokerage service and expense offset arrangements	Total amounts by which expenses are increased under brokerage service and expense offset arrangements with a list of each category that is increased by at least 5 % of total expenses (see Question 8.2.80)
Interest and amortization of debt discount and expense	The average dollar amount and the average interest rate of a registered fund's borrowings[2] (see Question 8.2.80)
Capital share transactions	For each class of shares[3]: [S-X Rule 6-09.4(b)] • number and value of shares issued in reinvestment of dividends • number and dollar amounts received for shares sold • number and dollar amounts paid for shares redeemed

Notes:

1. A registered fund may disclose this information in the financial statements but is not required to do so. If not included in the financial statements, the information is required to be included in the appliable SEC Form. [Form N-CSR Item 10, Form N-2 Item 24]
2. This information may be presented on the face of the statement of operations or disclosed in the notes to the financial statements.
3. This information may be presented on the face of the statement of changes in net assets or disclosed in the notes to the financial statements.

Question 9.5.60 Is a registered fund permitted to present schedule of investments information in the notes to the financial statements?

Background: Reg S-X Rule 6-10 prescribes additional schedules to be presented with the financial statements of a registered fund, which include the schedule of investments (see section 7.5).

Interpretive response: Generally no.

In its adopting release for investment company reporting modernization reforms, the SEC indicated that the information required by S-X Rule 6-10 (including the schedules prescribed under S-X Article 12) should be placed prominently in a fund's schedule of investments rather than in the notes to the financial statements. [SEC Rel 33-10231 sec II.C.6]

However, the disclosures required by S-X Rule 12-14 (Investments in and advances to affiliates) relate to investments that are already included in the schedule of investments presented under S-X Article 12. Therefore, the SEC staff indicated that it would not object if a registered fund provides the additional disclosures required by S-X Rule 12-14 in the notes to the financial statements. [ICRM FAQ S-X 7]

Question 9.5.70 Is a registered fund required to provide tax basis disclosures for each class of investments?

Interpretive response: No. Tax basis disclosures are presented for the portfolio as a whole. A registered fund may provide tax basis disclosures by investment type but is not required to do so. However, we do not believe it would be appropriate to provide tax basis disclosures for some investment types while excluding the disclosures for others because this could result in a presentation that is misleading. [SEC Rel 33-10231 sec II.C.4]

Question 9.5.80 What is a registered fund required to disclose about the issuance and repurchase of its own securities?

Background: The issuance and repurchase of a registered fund's own shares differ between open-end funds and closed-end funds.

Open-end funds typically offer their shares on a daily basis, where shares are issued and redeemed with the issuer based on NAV per share. [AAG-INV 1.23]

However, closed-end funds (except for interval funds and tender offer funds) generally do not offer to redeem their shares at NAV per share on a continuous basis. Instead, such shares of closed-end funds are listed on an exchange and traded in the open-market at a discount or premium to NAV per share. [AAG-INV 1.24]

Because transactions in closed-end fund's own shares typically result in a premium or discount to NAV per share, such incremental effects are relevant to a registered fund's disclosures of the issuance and repurchase of its own securities.

Interpretive response: A registered fund is required to disclose information on the issuance and repurchase of its own securities during the period as follows. [S-X Rule 6-03(i)]

Securities sold

For each class of securities sold during the period:

- number of shares, units, or principal amount; and
- amounts received.

In addition, closed-end funds present the following where there is a difference (i.e. a premium or discount) between:

- the amounts received for securities sold during the period; and
- the NAV or preference in involuntary liquidation (as applicable) for securities in the same class prior to sale.

Securities repurchased

For each class of securities repurchased during the period:

- number of shares, units or principal amount; and
- cost of the securities repurchased.

Closed-end funds are also required to present the following information for securities repurchased.

Bonds and preferred shares	• Aggregate difference between cost and the face amount or preference in involuntary liquidation (as applicable to the security type) • Aggregate difference between cost and NAV[1]
Common shares	• Weighted average discount per share, expressed as a percentage[2]
Notes: 1. Applicable when the NAV as of the repurchase date is less than the face amount or the preference in involuntary liquidation (as applicable to the security type) of the securities repurchased. 2. The discount represents the difference between cost of repurchase and the NAV applicable to such shares at the repurchase date.	

9.6 Master-feeder funds

Excerpt from ASC 946-205

• > Nonpublic Investment Companies Involving Master-Feeder Arrangements

45-6 Nonpublic investment companies may present a complete set of master financial statements with each feeder financial statement, in a manner that is consistent with the requirements for public investment companies.

Excerpt from ASC 946-210

• • > Feeder Funds

45-6 Each feeder fund's statement of assets and liabilities shall show an investment in the master fund, which is the sole or principal investment of the feeder fund. The total of all feeder funds' investments in the master fund shall equal the total net assets of the master fund. A schedule of portfolio investments shall not be presented at the feeder level. The net asset value per share, total shares outstanding, and the components of net assets shall be reported. Should the feeder fund have a multiple-class structure, it would report the multiple-class information specified in this Subtopic.

• > Fund of Funds

45-7 The reporting fund may list the investee (portfolio) funds directly on the statement of assets and liabilities. Additional disclosures may be required for those funds that hold a mixture of investments in other investment companies and direct investments in securities. However, there is usually no need for a separate schedule of investments. Fund management shall consider if an investment in a single **underlying** fund is so significant to the fund of funds as to make the presentation of financial statements in a manner similar to a master-feeder fund more appropriate.

As discussed in Question 3.5.50, a master-feeder structure is composed of separate investment companies that perform the following functions. [AAG-INV 5.18]

Master fund	Feeder funds
Performs investment management function	Perform distribution function

The accounting for master-feeder structures requires the master portfolio's income, expenses, and realized and unrealized gains and losses to be allocated among the feeder funds. The total of all feeder funds' investments in the master fund should equal the total net assets of the master fund. [AAG-INV 5.21, 946-210-45-6]

Question 9.6.10 What are the unique presentation requirements for master-feeder structures?

Interpretive response: Generally, the financial reporting of master-feeder funds includes presenting the financial statements of the master fund as an attachment to the financial statements of each feeder fund. [AAG-INV 5.41, 946-205-45-6, IM-DCFO 1998-03]

The following table summarizes the individual financial statement presentation requirements for both master funds and feeder funds described in this Handbook.

Financial statement	Requirement	Reference
	Reporting financial position	
Statement of assets and liabilities	**Master fund** – Presented in the same manner as an investment company with a simple capital structure. However, a master fund generally does not report the components of net assets, shares outstanding, or NAV per share. **Feeder fund** – Presented in the same manner as an investment company with a simple capital structure. A feeder fund generally presents the investment in the master fund as its sole or principal investment.	Section 7.2.50

Financial statement	Requirement	Reference
Schedule of investments	**Master fund** – Presents the portfolio of investments held by the master fund. **Feeder fund** – Not included unless investments are directly owned at the feeder fund level.	Section 7.2.50
Reporting results of operations		
Statement of operations	**Master fund** – Presented in the same manner as an investment company with a simple capital structure. **Feeder fund** – Presents the feeder fund's allocated share of investment income, investment expenses, realized and unrealized gains and losses allocated from the master fund.	Section 8.2.70
Financial highlights	**Master fund** – Presented in the same manner as an investment company with a simple capital structure. **Feeder fund** – The feeder fund's ratios to average net assets includes the expenses of both the feeder and those allocated from the master fund.	Section 8.3.60
Other reporting		
Statement of cash flows	**Master fund** – Presented in the same manner as an investment company with a simple capital structure. **Feeder fund** – Presented in the same manner as an investment company with a simple capital structure.	Section 9.3
Statement of changes in net assets	**Master fund** – Capital transactions from or to the feeder funds are reported as contributions and withdrawals. **Feeder fund** – Presented in the same manner as an investment company with a simple capital structure.	Section 9.4
Notes to the financial statements	**Master fund** – Presented in the same manner as an investment company with a simple capital structure. **Feeder fund** – Includes the following: • general description of the master-feeder structure • feeder fund's percentage ownership of the master fund • statement that substantially all assets are invested in the master fund having the same investment objectives as the feeder fund • reference to the financial statements of the master fund	Section 9.5

Financial statement	Requirement	Reference
	• accounting policies of the master fund that affect the feeder.	

Question 9.6.20 Are there other circumstances where master-feeder presentation may be appropriate?

Interpretive response: Yes. For fund of funds, an investment in another investment company may be so significant to the reporting entity that the presentation of financial statements in a manner similar to a master feeder may be more appropriate (see Question 7.2.260). [946-210-45-7]

9.7 Consolidated financial statements

Excerpt from ASC 946-810

> Application of Consolidation Guidance

45-2 Except as discussed in the following paragraph, consolidation by an investment company of an investee that is not an investment company is not appropriate. Rather, those controlling financial interests held by an investment company shall be measured in accordance with guidance in Subtopic 946-320, which requires investments in debt and equity securities to be subsequently measured at **fair value**.

45-3 An exception to the general principle in the preceding paragraph occurs if the investment company has an investment in an operating entity that provides services to the investment company, for example, an investment adviser or transfer agent (see paragraph 946-10-55-5). In those cases, the purpose of the investment is to provide services to the investment company rather than to realize a gain on the sale of the investment. If an investment company holds a controlling financial interest in such an operating entity, the investment company should consolidate that investee, rather than measuring the investment at fair value.

Generally, it is not appropriate for an investment company to consolidate an investee that is not also an investment company. This is known as the investment company scope exception in the US GAAP guidance on consolidation. This exception exists because fair value is typically the most relevant measure of the investment company's investments when reporting investment performance and changes in NAV, as opposed to presenting an investment company and its investees as a single economic entity. [946-810-45-2, AAG-INV 7.11]

The investment company scope exception does not apply when an investment company has an investment in an operating entity that provides services to the investment company (e.g. investment adviser, transfer agent). [946-810-45-3]

See Question 2.3.130 in KPMG Handbook, Consolidation, for additional discussion on the investment companies scope exception.

Question 9.7.10 Does Topic 946 provide guidance about when an investment company has a controlling financial interest in an investee?

Interpretive response: No.

Although Subtopic 946-810 provides guidance on whether consolidation *applies* to an investment company (i.e. the investment companies scope exception), it does not address *when* an investment company has a controlling financial interest in an investee.

If the investment companies scope exception does not apply, an investment company applies Topic 810 to evaluate when it has a controlling financial interest in an investee under the either the voting interest entity (VOE) or variable interest entity (VIE) consolidation models that requires the investment company to consolidate the investee.

See KPMG Handbook, Consolidation, for overall guidance on consolidation procedure.

Question 9.7.20 Does Topic 946 provide guidance about whether an investment company should consolidate another investment company in which it holds a controlling financial interest?

Interpretive response: No. Guidance on consolidation by an investment company of another investment company is not provided by Topic 946. In practice, determining whether an investment company should consolidate another investment company in which it holds a controlling financial interest depends on the specific facts and circumstances, including whether the reporting entity is a regulated investment company.

See Questions 2.3.140 and 2.3.150 in KPMG Handbook, Consolidation, for additional discussion about whether an investment company consolidates another investment company in which it has a controlling financial interest.

9.8 Combined financial statements

Question 9.8.10 Is it appropriate to present combined financial statements for investment companies that are under common management?

Background: Combined financial statements are financial statements of a combined group of commonly controlled entities or commonly managed entities presented as those of a single economic entity. [810-10 Glossary]

An investment adviser may set up multiple investment companies as part of a single offering to investors but organize each investment company as a separate legal entity for legal, tax, regulatory or other business reasons. In some circumstances these investment companies formed as part of a single offering may invest in the same investments and have similar fee structures.

Interpretive response: It depends.

For combined financial statement presentation to be acceptable, the investment companies generally should either be under common control or under common management. Many advisory arrangements customary to the investment company industry will meet the common management criterion. However, entities should consider whether a common adviser is acting as an agent, such as in a sub-advisory role, rather than a principal to the arrangement.

In some circumstances, presenting combined financial statements of entities under common control or under common management may be more meaningful than presenting separate financial statements of each entity. [810-10-55-1B]

In IM-DCFO 2020-03 of the SEC's Accounting Matters Bibliography, the SEC staff has expressed views on when a registered investment adviser may use combined financial statements to satisfy certain requirements to deliver audited financial statements under the SEC's Custody Rule (the audit exception). When complying with the audit exception, the SEC staff indicated that an investment adviser should not rely solely on common management and should consider what presentation would be more meaningful to an investor. This consideration may also include whether an individual investor could reasonably determine its proportionate share of its ownership interests and investment returns based on the information included in a combined presentation.

Although whether combined financial statements satisfy the requirements of the Custody Rule is a legal determination, we believe an investment company may consider the factors from IM-DCFO 2020-03 when determining whether combined financial statements result in a more meaningful presentation under US GAAP. The following table summarizes those factors and examples of indicators that we believe may impact the determination that combined financial statements are an acceptable presentation: [IM-DCFO 2020-03]

Factors	Indicators supporting combined presentation
Management structure	• Each entity is under common management and subject to the same management structure.
Legal ownership of investments	• The proportionate composition of individual investment interests held by each entity is substantially the same across the entities included in the combined group (e.g. each entity in the combined group owns an approximately 3% interest in Investment ABC).
Allocation of investment gains and losses	• Investment gains and losses, including income and expenses, are allocated on a pro rata basis to each entity. • Allocation of investment gains and losses for each entity are not impacted by differences in participation rights in side-pocket investments (see Question 8.3.70) in new issues (see Question 8.3.80). • There are no differences in the tax jurisdictions that would impact any income or foreign withholding taxes on the investment gains and losses allocated to each entity.
Fee structure	• Each entity has the same management fee and performance fee structure. • The fee calculations for each entity are not impacted by any disproportionate amounts of loss carryforwards between individual entities.
Investor base and investor rights	• All of the investors of each entity have substantially the same rights over the life of each entity.

See section 9.3 in KPMG Handbook, Consolidation, for additional guidance on combined financial statements.

Example 9.8.10 Combined financial statements

For legal and regulatory reasons, Investment Adviser ABC formed two separate nonregistered investment companies (Fund A and Fund B) that invest in the same investments. Although Fund A and Fund B are separate legal entities, because they are both under common management, presenting the combined financial statements of Fund A and Fund B as a single economic entity would be acceptable if it provides a more meaningful financial statement presentation to the investors of those funds.

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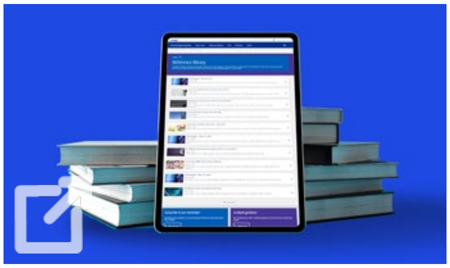

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