PRIVATE EQUITY ACCOUNTING

The global guide for private equity firms and fund accountants

Mariya Stefanova
PE Accounting Insights
To my wonderful children, Alex and Lilly, who inspired me to write this book, my partner Dimitar who has supported me at all times, and my mom who has always been there to provide a helpful hand.

For all the fund accountants across the world who work so hard with very little to guide them. A special thanks to Anthony O’Connor, my editor, who made it all happen. And my sincere gratitude to the expert contributors who have added great value to the book.

Thank you all.

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About the author

Mariya Stefanova is a founder partner of PE Accounting Insights, a private equity accounting training and consultancy firm, providing specialist training and technical advice for private equity houses, fund administrators and individual fund accountants. She has more than seven years of experience in private equity accounting and more than three years of experience in training fund accountants during which period she has trained over 130 fund accountants.

Previously Mariya was working in the technical department of Augentius Fund Administration LLP, a premium provider of fund administration services specialised in private equity and real estate funds. She was in charge of the technical training of the client services accountants and keeping them up-to-date with the industry and accounting developments. Mariya also provide advice to clients and client-services accountants in resolving complex technical issues, as well as performing technical reviews of accounts, quarterly investors’ reports and complex calculations.

Before joining Augentius in 2008, Mariya worked for fund administrator Mourant International Finance Administration (now State Street) looking after a portfolio of private equity clients. Before joining Mourant in 2006, Mariya worked for Calyon, a French investment bank and before Calyon she was working for Patron Capital Partners, a leading European opportunistic real estate manager.

Mariya started her career with a large chemical company in Bulgaria where she was chief accountant and was subsequently a financial controller for an industrial catering company. Mariya holds a Masters in Finance and Accounting from the University of National and World Economy (UNWE).

E-mail: info@peaccountinginsights.com
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Why is private equity accounting different?

By Mariya Stefanova

This chapter discusses:
- The ways private equity accounting is different from accounting for other investment types
- Factors contributing to the uniqueness of private equity accounting, including:
  - The preferred legal form (limited partnership and equivalents) and its specific allocations and allocation rules
  - Limited partnership agreement (LPA)
  - Fund purpose, activities and structure
  - Investors’ needs for financial reporting information
  - Accounting frameworks and the ‘investor-defined accounting framework’ (LPA GAAP)

Introduction

Accounting for a private equity fund (and the other entities within the fund structure described in Chapter 2) is quite unique – not that accounting rules do not apply, they certainly do, but due to the fact that when accounting frameworks are defined, the standards-setters usually do not write them with private equity in mind (of course there are exceptions, such as US GAAP\(^1\)), and therefore some modifications to these rules and accounts formats are required in order for those accounts to be useful to their user – mostly the investors.

So, what is so unique about private equity accounting that sets it apart from accounting for entities of other types of investment vehicles and other industries? If you are new to private equity you will be able to answer that question by the end of this chapter.

In a nutshell, there are five major differentiators that separate private equity accounting from accounting for entities of other industries and other types of investment vehicles:

1. The legal form – a limited partnership with its different investor classes (LPs, GP and FP) – and the way that this legal form is used to cater for the specific needs of the asset class.
2. The fund terms laid down in the limited partnership agreement (LPA).
3. The purpose and nature of the activities of the private equity fund.
4. The needs of the main users of the financial statements – the investors and their reporting requirements.
5. A unique accounting framework used only in this asset class – the ‘investor-defined accounting framework’.

\(^1\) In US GAAP a separate set of rules applies – the AICPA Audit and Accounting Guide for Investment Companies, where accounting rules are put in the context of investment companies.
accounting framework’, also called LPA GAAP (Generally Accepted Accounting Principles) which is still used in certain jurisdictions (for example, the UK).

The combination of these five factors, which are explained below one by one, makes private equity accounting unique and difficult to understand, at least at first, by accountants from outside of the asset class. This guide sets out to give the reader, in a systematic and comprehensive way, an insight into the mechanics of private equity accounting.

As explained in Chapters 1 and 2, a limited partnership (fund for joint account or other similar forms) is the preferred legal form for private equity funds. The ways in which that legal form is used to cater for the needs of the asset class, particularly the arrangement of the different classes of partners (limited partners (LP), general partner(s) (GP), founder partner (FP)), with different rights and responsibilities, are the framework for the accounting and reporting that dictates the layout of the accounts, how the information is recorded and what level of analysis is used.

The first thing to bear in mind is that, in a limited partnership, investors (LPs) have an interest in the partnership. The same logic applies to a corporate form, but instead of interest in a partnership, investors have shares. There are other types of partner. A GP acts in its capacity as a GP with its responsibility to manage the fund, but it can also be an LP/investor. In a UK partnership there may be an FP, which is basically a carried interest partner (CIP) that can act in its capacity as such, but also, similar to the GP, may act in its capacity as an LP/investor; these different entities in the fund can be referred to as ‘classes of partners’ (but sometimes I may refer to them as ‘classes of investors’). A basic premise for the preparation and presentation of the partnership’s financial statements is to reflect the interest of each class of partner (or shareholders in a corporate form) in the net assets of the partnership at each reporting date, or in other words the share of each class of partners in all the partnership’s assets, liabilities, income and expenses (net income) and gains or losses.

The aim is also to present the return (understand the total profit & loss) by partner class, as well as by individual non-managing partner/investor. Therefore a fund’s accountant needs to be able to track transactions and identify balances at the partner level, which is achieved by recording the transactions at that level. All the partners - LPs, GP and FP - have certain functions, rights and responsibilities within the structure, as explained in more detail in Chapter 2. Following that logic, when recording transactions that stem from those functions, rights and responsibilities, these transactions should be allocated to each partner; this then allows for individual reporting on each partner in terms of its share in the assets, liabilities, income, expenses and gains or losses which is ultimately their share in the net assets or net asset value (NAV).

From the drawdown to the distribution, from the simplest fund expense or the income from interest on loan notes to the capital gain or loss on realisation of investments, the total amount of each of these transactions must be allocated to each individual partner.
The limited partnership agreement explained

By Mariya Stefanova

This chapter discusses:
- The limited partnership agreement (LPA)
- The LPA structure, including its important clauses
- Where to look in the LPA
- Implications for accounting and reporting

As explained in Chapter 2, the second crucial document for any fund accountant to understand, after familiarising himself or herself with the fund structure, is the limited partnership agreement (LPA).

The LPA is the key legal document for a fund set up as a limited partnership. It sets out the relationships, rights and responsibilities of each class of partners – limited partners (LPs), general partner (GP) and, where applicable, the founder partner (FP). The LPA essentially sets out all the rules of the fund. Anything and everything that a fund accountant needs to know should be in the LPA, although this is not necessarily always the case and that poses some challenges for fund accountants. Therefore, a fund accountant needs to have a thorough knowledge of the LPA of any fund he or she looks after.

The partners can agree whatever commercial terms they want, as long as the LPs do not take part in the management of the fund so as to preserve their limited liability status as explained in Chapter 2 (with the slightly modified terms of and the extra limited liability shield for LLLPs, explained in the same chapter). The problem with some LPAs is that they are often not detailed enough, whereas some of them lack detail about important aspects, such as allocations and even the waterfall calculation. In some cases certain parts of an LPA might even contain errors or omissions (with no offence to the lawyers intended, because they usually do a great job, but certain commercial, accounting and reporting aspects are sometime not fully addressed).

A universal wisdom that I learned from a seasoned fund accountant – a partner in one of the Big Four⁠¹ – is that you should never let a lawyer put a formula in your LPA. This is precisely why fund sponsors, lawyers and accountants need to work together from the outset when the LPA is being drafted to avoid making changes to the LPA later in the life of the fund when, for important changes, there needs to be consent from the LPs. In my

¹ The Big Four refers to the four largest global firms offering accountancy and professional services. This group currently includes Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers.
experience sponsors more frequently refer to their accountants or fund administrators from an early stage of the fund’s establishment to ask for advice on certain practical aspects of the LPA.

The following section provides an outline of some of the key clauses in an LPA and should serve as an overview for new fund accountants; it contains the most important clauses for accountants to be aware of in order to do their job properly.

**Parties**

This section identifies the different parties involved with, and therefore bound by, the LPA. They are usually the GP, the FP (where applicable) and the LPs. Occasionally some LPAs include other specific parties with some special rights, for example, a government body or organisation participating in an infrastructure fund.

**Introduction (or recitals)**

The ‘recitals’ set out, by way of a general introduction, the reasons why the LPA is being entered into by the parties. In the recitals, there is some historical information that serves as a short overview of what has happened between the date the partnership was originally established and the date of the relevant version of the LPA, for instance, when the partnership was formed, who originally formed it, which partner retired and who was appointed instead. You will also find information on all the amended versions and the relevant dates on which the LPA has been amended, provided that you are reading a subsequent or final version. Information on initial contributions can also be found here, for example, the FP’s initial capital contribution as a carried interest partner and LP. If the final closing date has been extended, this information will be included here as well.

**Definitions and interpretations**

The definitions are extremely important because they contain some subtle details that can make a significant difference when applied in practice under the terms of the LPA. The following are some of the most common and important definitions, which have the largest impact on the accounting and reporting aspects of the fund, but this is by no means an exhaustive list. Furthermore, fund-specific definitions are sometimes encountered that need to be taken into consideration; obviously it is not possible to cover all of these here, but they are some that will serve you well in dealing with certain specific practical accounting aspects.

**Accounting date and accounting period**

If you are uncertain about the accounting date of the fund, typically the LPA will hold the answer for you in an unambiguous way, but what might be trickier sometimes is that in most LPAs the accounting period is defined as a calendar year and, although it may seem obvious, as fund accountants we often think of the accounting period more as a quarterly period, due to the industry best practice of preparing accounts and reports on a quarterly basis. However, in some cases, such as the calculation of the management fee/priority profit share (PPS) with the offsetting of transaction and other fees (which, for the management fees/PPS reduction purposes, are typically calculated based on the amounts for the previous accounting period; for more details on the management fee/PPS calculation, refer to Chapter 12), we need to consider that the management
fee is applied in terms of accounting period which is again usually a year, not a quarter (and then pro-rated accordingly in calculating the quarterly/semi-annual GP drawings entitlement). Therefore, though this may seem like a basic term - an axiom that does not need defining - my advice would be that you always check your LPA definitions first rather than making assumptions about what certain terms mean.

These dates are extremely important and often, although not always, they are mentioned in the final version of the LPA. Most of the events in the life of the fund begin from the initial closing date (also called first closing date), for example, the management fee/PPS will start being calculated from that date. This is also typically the date from which the investment period will start. The initial closing date is the closing date at which time the first investors are admitted to the partnership. There is usually a 12-month window between the initial and final closing dates to allow the sponsor to raise the targeted commitment. For more details on the closing process, please refer to Chapter 6.

This is another milestone in the life of the fund. It starts on the first closing date (or sometimes the first drawdown date, if this is different) and ends on whichever of the following occurs earliest:

1. The date falling five years (or any other number of years as stipulated by the LPA) after the first closing date (or sometimes the first drawdown date or the final closing date).
2. The date on which the total commitment has been fully drawn down.
3. The date on which at least a certain percentage of the commitment has been drawn down (for example, 75 percent or 80 percent, depending what is stated in the LPA) or a successor fund has been launched.
4. Another date nominated for early termination by the GP, for example, key-man termination or when applicable law or regulation or some unexpected significant event makes it necessary.

Following the investment-period end date, the basis of calculation for the management fee/PPS will change (for more details, see Chapter 12).

Partners are usually defined as the GP and the LPs and would typically exclude the FP; however, fund accountants should still check the definitions contained in the LPA. It is important to be clear about this definition when reading the LPA; for example, when reading the clauses on contributions and determining whether or not contributions (capital and loan contributions) need to be drawn down from different classes of partners - GP, FP and LPs - as different funds may have different arrangements.

ERISA partners are benefit-plan investors – pension plans that are subject to the US Employee Retirement Income and Security Act (ERISA). These partners are subject to specific rules that the fund will need to comply with. To establish whether any of your

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2 Often after the final closing date, an amended and restated version of the LPA is issued.

3 That window does not necessarily need to be 12 months; it is entirely up to the GP to determine the length, taking into account the fundraising conditions alongside some other factors. It is therefore important to check the LPA rather than just assuming it is 12 months.
For now, the dominant practice is that these fees are accrued by the manager and 50 percent (or 80 percent when mimicking carried interest) is offset (sometimes is also called a rebate) against the management fee. The following example illustrates how this usually works in a management fee calculation.

Based on an excerpt from an LPA and some additional information shown below, the following example calculates the management fee/GPS from inception to December 31, 2010.

The following excerpt is a typical example of LPA clauses with regards to the PPS/GPS:

8.1. Allocation of the General Partner’s Share

The General Partner shall be entitled to receive and, as a first charge on Net Income and Capital Gains, there shall be allocated to the General Partner in respect of each Accounting Period an amount equal to the General Partner’s share for that Accounting Period and pro rata in respect of Accounting Periods of more or less than one year.

8.2 Calculation of the General Partner’s Share

The General Partner’s Share of each Accounting Period shall be an amount equal to:

a. until the earlier of (i) the end of the Investment Period and (ii) the date on which the Manager, General Partner or any Associate closes, acts as investment adviser or manages a Successor Fund, the sum of 2% per annum of the Total Commitment; and

b. thereafter, 2% per annum of the Acquisition Cost of Investments which have not been either:
   i. distributed in specie; or
   ii. realised and the proceeds distributed to investors.

For this purpose the winding up of any company in which an investment is held or the permanent write off or write down below Acquisition Cost of an Investment shall be treated as a realisation of the whole or part thereof and provided that where an Investment has only been partially realised the appropriate portion of the Acquisition Cost to be taken into account for this clause shall be the portion of the Acquisition Cost of the Investment equal to the proportion of the Investment that has been realised.

REDUCED by such part of any Transaction Fees, Underwriting Fees, Abort Fees and Other Fees that have been earned and retained by the General Partner, the Manager and any Associate of either of them during the previous Accounting Period pursuant to clause 4.9.2 up to a maximum amount that shall be no greater than an amount equal to the Abort Costs during the previous Accounting Period plus 50% of the excess (if any) of the Transaction Fees, Underwriting Fees and Other Fees for
8.3. Provisions relating to General Partner’s Share

The following provisions shall apply in relation to the allocation of the General Partner’s Share:

a. The General Partner’s Share shall rank as a first charge on Net Income in any Accounting Period;

b. If Net Income in any Accounting Period shall exceed the share thereof to be allocated to the General Partner hereunder, the General Partner shall be entitled to elect, so far as practicable, which items of Net Income shall form the whole or a part of the share of Net Income allocated to the General Partner; and

c. If Net Income in any Accounting Period shall be less than the General Partner’s Share, there shall be allocated to the General Partner as a first charge on all or against any surplus of Capital Gains over Capital Losses in such Accounting Period an amount not exceeding the amount of the General Partner’s Share which remains unsatisfied out of Net Income, provided that, instead of the order of priority set out in paragraph (a), (b) and (c) above, the General Partner shall be entitled to allocate the General Partner’s Share against such items of Income or Capital Gains as it may select.

8.4 Deficiency in General Partner’s Share

If Net Income and Capital Gains less Capital Losses in any Accounting Period shall be less than the General Partner’s Share, any deficiency to the extent not already drawn by the General Partner under clause 10.8 shall be paid to the General Partner as an interest free loan but such payment shall not extinguish the amount of the General Partner’s Share outstanding which shall be carried forward to subsequent accounting periods: in the event that any part of the General Partner’s Share then unpaid can subsequently be satisfied by an allocation of Net Income or Capital Gains to the General Partner such allocation shall be applied in the discharge of an equivalent amount of such loan; in no circumstances shall such loan be recoverable from the General Partner other than by an allocation of Net Income or Capital Gains in accordance with this paragraph.

10.8 Drawings by the General Partner

10.8.1. The General Partner shall be entitled to make drawings out of the Partnership’s cash funds, on the First Closing Date in respect of the period from such First Closing Date up to the first quarter date thereafter and thereafter on, or on the first Business Day following, 31 March, 30 June, 30 September and 31 December in each year, on account of the General Partner’s Share for the quarter commencing on that date. If at any time during or after a relevant Accounting Period it should be discovered that drawings made in respect of that relevant accounting
Management fee versus priority profit share

Period are less or more than the amount that the General Partner is entitled to receive (whether by profit share pursuant to clause 8.1 or by interest-free loan pursuant to clause 8.4) pursuant to this Agreement then additional drawings shall be made to make good the shortfall or the excess shall promptly be repaid to the Partnership, as the case may be.

10.8.2. In no circumstances (except to the extent of any excess drawings as stated in clause 10.8.1 above) shall any drawings made pursuant to this clause 10.8 be repayable by the General Partner other than by a set-off against allocations of Net Income and Capital Gains.

Additional information for the following three-stage example:

| Year-end date: | December 31 |
| First-closing date: | January 1, 2008 |
| End of investment period: | December 31, 2009 |
| (probably not very likely to end in just two years from the first closing, but used for the sake of this example) |
| Total commitment: | £100,000,000 |
| Transaction fees in 2010: | £300,000 |
| Other fees in 2010: | £200,000 |
| Abort costs in 2010: | £100,000 |
| Investment details as of January 1, 2010 with no changes by December 31, 2010: |

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<td>25,000,000</td>
</tr>
</tbody>
</table>

*Investment LMN went into administration on January 1, 2012.

Let's split the calculation in three stages, based on the different bases of calculation and adjustments used in the calculation.

### Stage 1

**Period from inception to December 31, 2010**

- Management fee/GPS for the first period is calculated on a commitment-only basis with no adjustments/rebate due to the fact that the rebate is calculated based on the fees earned and abort costs incurred in the previous accounting period (that is, a year).
- Percentage management fee/GPS: 2 percent (as per clause 8.2.a of the LPA).
- Starting date: January 1, 2008 (first closing date as per clause 10.8.1 of the LPA).
- Ending Date: December 31, 2008.
Chapter 12

- Basis of calculation: £100,000,000 (total commitment as per clause 8.2.a of the LPA).
- Number of days: 365.
- Management fee/GPS for the period*: (£100,000,000 x 2 percent x 365 days/365 days) = £2,000,000.

*Note that the management fee/GPS is calculated in respect of accounting periods (usually defined in the definitions as a year), but the GP's entitlement to make management fee/GPS drawings is quarterly in advance on the first business day following the previous quarter-end (see clause 10.8.1 of the LPA), therefore the calculation in practice is done on a quarterly basis.

Stage 2

**Period from January 1, 2009 to December 31, 2009**

- Management fee/GPS is still calculated on the same basis - total commitment, but reduced by some transaction and other fees earned by the GP/manger in 2010 (most of the LPAs would provide for the adjustment to take place in the period, usually a year, following the period when they were incurred, but there would be LPA where that may not be the case, see the example in Chapter 20).
- Percentage GPS: 2 percent (as per clause 8.2.a of the LPA)
- Starting date: January 1, 2009.
- Ending date: December 31, 2009 (after that date the basis for calculation will change due to the end of the investment period).
- Basis of calculation: £100,000,000 (total commitment as per clause 8.2.a of the LPA).
- Number of days: 365.
- Management fee/GPS for the period before reduction for rebate/offset: (£100,000,000 x 2 percent x 365 days/365 days) = £2,000,000.
- Management fee/GPS reduction/rebate/offset (calculated as per the last paragraph in clause 8.2 of the LPA). The calculation of the reduction/rebate/offset is split below in two elements just for simplicity and better understanding:
  a. The first element to reduce the GPS by is 100 percent of the transaction fees, underwriting fees, abort fees and other fees (as defined in the LPA) up to the maximum amount of the abort costs (if any). Note that, in reference to the LPA in this example, the fees must have been earned and retained by the general partner, the manager or any of their associates. Therefore, if any of the above-mentioned fees have been earned by the partnership, no reduction of the GPS is applicable. In the example, the transaction fees amount to £300,000 and there are other fees amounting to £200,000 or a total of £500,000; however the calculation of this first element is limited to the amount of the abort costs incurred during the previous accounting period (as per most definitions again, this is the previous year, not quarter) which in this case is £100,000 or, that is, the maximum amount that should be reduced under that provision. If there were no abort costs, then proceed to step b) below.
  b. The second element to reduce the GPS by is 50 percent of the excess (if any) of the transaction fees, underwriting fees and other fees over the abort costs. The same period of calculation - previous accounting period - is applicable. In the example, the excess of the transaction and other fees over the abort costs is £400,000, so there is a need to calculate 50 percent of £400,000, which is £200,000. The reason
Carried interest or carry in private equity jargon is, in substance, a performance fee - a reward for good performance. In layman’s terms it is similar to a bonus payable to the carried interest partner (CIP) for doing a good job, which means that carried interest is conditional on performance. If the general partner’s/manager’s performance, that is, the returns it generates for limited partners in the fund it manages hits certain targets (the hurdle), the CIP is entitled to receive (often subject to some limitations called clawback provisions) a bonus or performance fee called carried interest, which is in simplified terms usually a certain share (usually 20 percent) of the profits. Since it is performance-related, carried interest is designed to incentivise the carried interest holders; therefore it could be regarded as an incentive mechanism.

In terms of legal form, in many jurisdictions, carried interest is commonly structured as an ownership share with the relevant legal and tax implications as explained below.

Based on my experience of teaching fund accountants, many people interestingly do not know why the concept is called carried interest. With reference to its etymology, many incorrectly associate the word ‘interest’ with bank interest (I have no idea why) rather than interest in a fund or limited partnership. Asking fund accountants about the meaning and origin of the word ‘carried’ usually results in stony silence in the training room.

As a brief explanation, there is a parallel to be drawn between carried interest and a highly geared investment return for the CIP. The CIP injects a very small percentage...
of the initial capital of the fund, often referred to as ‘skin in the game’, but receives a disproportionately high return on its tiny investment - the rest of its investment/interest in the fund is carried, in a way, by the limited partners (LP).

The prevailing question is whether this tiny investment is really an investment from the CIP’s perspective and whether carried interest can be regarded as an equity return on realisation. I do not claim to have the definitive answer, but I would say that we can probably view it in this way.

Without claiming to be tax expert, I think it is worth mentioning some tax aspects because taxation of carried interest, in the UK as well as in the US, is generally derived from the premise discussed above - namely that the CIP, whether the founder partner (FP) in the UK or the general partner (GP) in the US, has an interest (mostly carried by the LPs) in the partnership and the carried interest is a return on that investment in the fund. Therefore, part of the profits the CIP is allocated will be capital gains and will be taxed on the basis of capital-gains tax (CGT) and not income tax. If the manager/CIP were raising invoices for carried interest payments, this approach would be viewed by the tax authorities as a performance fee and, accordingly, income tax would be the appropriate form of taxation.

In the UK, in addition to the benefit in the tax treatment of carried interest mentioned above, there is an added benefit of base-cost shift (BCS). BCS is an extension of the reallocation of profits from the LPs to the CIP/FP (to be explained in detail later in the chapter) that is derived from the concept that if the interest in the partnership of the CIP/FP is carried by the LPs, later when profits/gains are to be distributed to LPs, a certain proportion (usually 20 percent), corresponding to the CIP’s carried interest in the partnership, should be shifted or reallocated from the LPs to the CIP/FP. Not only are the profits and the fund’s assets shifted or reallocated, but also a similar proportion of the tax-deductible base cost associated with those assets, which further reduces the effective rate of the CGT on carried interest.

With reference to tax treatments, as I have mentioned in previous chapters, they have been agreed (including carried interest and the priority profit share (PPS)) between the British Private Equity and Venture Capital Association (BVCA) and the UK’s HM Revenue & Customs (Inland Revenue at that time) in two memorandums of understanding, dated May 1987 and July 2003, respectively. However, any potential future challenges to the present agreements are likely to be politically motivated as evidenced by the ongoing situation in the US, as of late 2011, which is described in more detail in the following paragraphs.

The US Internal Revenue Service (IRS) accepts (at least currently) that carry is a ‘profit interest’, that is, a profit share and not remuneration. This, however, may change with the American Jobs Act of 2011 (a job-creation plan featuring tax reliefs to stimulate jobs, funded by tax increases), unveiled on September 8, 2011, which includes proposals to tax carry as ordinary income. The issue about carried interest taxation has been publicly debated for a number of years in the US.