

Financial Statement Review

PRESENTED BY: IMDDA

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Our Cause

The Investment Management Due Diligence Association is the voice of the individual professionals of the investment management industry. Our goal is to advance the knowledge and skills of the due diligence community through continuing education and world-class information resources and the establishment of industry standards for conducting due diligence on potential and ongoing investments.

Our Promise

IMDDA provides exceptional experiences, a vibrant community, and essential tools that make you and your organization more successful.



Meet the Presenters



Meet the Presenters

Industry veterans

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Jay Levy

Partner & Financial
Services Industry Practice
Leader
CohnReznick LLP



Ryan Weir

Senior Manager
CohnReznick LLP

Meet Jay Levy

CohnReznick LLP

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Jay Levy
Partner & Financial
Services Industry Practice
Leader
CohnReznick LLP


- 30+ years of audit and business consulting experience

Background: Audit, Accounting, Tax Issues, Consulting, Operations, Transactions

Expertise: Hedge Funds, Private Equity Funds, Venture Capital Funds, Fund of Funds, Investment Management Companies and Broker-Dealers

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Meet Ryan Weir

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Ryan Weir

Senior Manager
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- 10 years of Financial Service audit experience

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Financial Statement Review

Properly interpreting an Investment Company's (e.g. Hedge Fund, Private Equity Fund, Fund of Funds, or Venture Capital Fund) Financial Statements is paramount in understanding their operations and is a necessary and important part of the due diligence process. Over the past several years, regulators have added several types of disclosures to an Investment Company's Financial Statements. These disclosures are meant to provide investors with more transparency however are often confusing and difficult to understand. Investors need to have an understanding of how an Investment Company is investing their money in order to make informed decisions – reading the financial statements is a critical part of this process.

Agenda

- Financial Schedules
 - Balance Sheet
 - Schedule of Investments
 - Income Statement
 - Statement of Changes in Partners Capital/Net Assets
 - Statement of Cash Flows
- Footnotes
 - Nature of Operations & Accounting Policies
 - Fair Value Measurement
 - Fair Value Hierarchy (ASC 820)
 - Level 3 Roll-forward
 - Valuation Techniques (ASU 2011-04)
 - Derivative Disclosures
 - Offsetting assets and liabilities for netting arrangements
 - Capital structure
 - Financial highlights
 - Subsequent events

Balance Sheet

- Generally referred to as the Statement of Financial Condition (Onshore entities) or Statement of Assets and Liabilities (Offshore entities)
- Snapshot of the entity's financial position at a given point in time (generally year end)
- Pertinent accounts:
 - Investments (Long and Short)
 - Cash & Due to/from broker
 - Equity/Partners' Capital
- Most other accounts are receivable/payables based on timing differences:
 - Dividends & interest receivable/payable
 - Accrued expenses
 - Redemptions payable
- A reader should pay attention to any unusual or unexpected liabilities that would raise concern such as litigation payable. Generally a footnote will be included to provide further detail on these types of accounts.

Schedule of Investments

- Generally an entity's investments are allowed to be reported in a condensed format by financial instrument, country and industry
 - Any exposure to an underlying investment greater than 5% of the entity's net asset value would require the underlier's name and share/principal amount to be disclosed along with the fair value and percentage of net assets broken out.
- Investments are broken out by financial statement category and should tie back in total to the balance sheet
- The Schedule of Investments gives the reader a better understanding of the entity's portfolio exposure
- Schedule of Investments for a Fund of Funds
 - Same rules apply however the instrument is the investment in another Fund
 - Further disclosure regarding look through 5% test
 - If an entity's exposure in a single investment through its ownership of the underlying Fund is over 5% of its net asset value

Income Statement

- Generally referred to as Statement of Operations
- Depiction of the entity's profit and loss for a given time period (generally a calendar year)
- Pertinent accounts:
 - Net realized gain/loss on investments
 - Net change in unrealized gain/loss on investments
 - Interest & dividend income/expense
 - Management fee
 - Professional fees
- Most other accounts are miscellaneous expenses resulting from normal operations of the entity
 - Other income/expenses
 - Administrative fee
- A reader should pay attention to any unusual or unexpected expenses that would raise concerns such as litigation expense. Generally a footnote will be included to provide further detail on these types of accounts.

Statement of Changes in Partners' Capital/Net Assets

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- Depiction of the entity's overall capital activity (contributions and withdrawals) and income/loss
 - Statement shows beginning equity, capital activity, total net income/loss and finally ending equity
 - For onshore entities, typically broken out by general partner and limited partner totals
 - For offshore entities, can be broken out by each Class of shares (not necessary as long as disclosed in the footnotes)
- For onshore entities, typically will show any reallocation of incentive to/from the General Partner
 - For offshore entities, incentive fee is typically portrayed as an expense on the statement of operations



Statement of Cash Flows

- Depiction of the entity's cash movements for a given time period (generally a calendar year) broken out by each applicable account
- Cash flows for an investment company are typically broken out into 2 sections: Operating activity and Financing activity
- The Operating activity section displays the cash activity movement of all balance sheet accounts
 - Net income is generally the starting point and then realized & unrealized gain/loss is backed out as these accounts do not represent true cash movement
 - Purchases/proceeds of investments portrays investment activity during the period
 - Changes in operating assets/liabilities portrays the change of balance sheet accounts (excluding investment and capital related accounts) between the current and prior fiscal periods
- The Financing activity section displays the cash activity movements from capital activity
- Other disclosures may include amounts paid for interest (if any) and other non-cash financing activities such as stock distributions

FOOTNOTES



Nature of Operations

- Description of the entities structure
 - Name the applicable Investment Manager/General Partner whom are in charge of the operations of the entity
 - Disclose where the entity is domiciled
 - Master/Feeder structure (if applicable)
- ASC 946 requires a disclosure be made if an entity is an Investment Company as defined under the guidance
- Basis of accounting disclosure (GAAP, IFRS, etc.)
- Income recognition (FIFO, LIFO, adjusted cost basis)
- Use of estimates
- Recognition of dividend/interest income and expense

Fair Value Measurement

- Fair Value Definition
 - Descriptions of each investment type the entity has owned during the period
 - Fair value approach for each investment type
 - Description of fair value hierarchy
- Fair Value Measurements
 - Fair Value hierarchy table (ASC 820)
 - Level 3 Roll-forward
 - Valuation techniques and unobservable inputs for Level 3 investments (ASU 2011-04)



Fair Value Hierarchy Table

- Fair Value hierarchy table (ASC 820)
 - Investments are categorized as Level 1, 2 or 3
- Level 1 investments are exchange-traded in active markets
 - Examples: Common stock, most exchange traded securities as long as the market is “active”
 - An active market is defined as a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis
- Level 2 investments include not actively traded exchange-traded investments and investments for which quoted prices for similar assets or market inputs are used
 - Examples: Most OTC derivatives, Level 1 investments that are not actively traded, Corporate & Government bonds
- Level 3 investments are generally hard to value and/or illiquid securities
 - Examples: Private Investments, OTC derivatives that are illiquid, investments valued using models with certain unobservable inputs

Fair Value Hierarchy Table

	Level 1	Level 2	Level 3	Total
Assets (at fair value)				
Investments in securities				
Common stocks	\$ -	\$ -	\$ -	\$ -
Preferred stocks	-	-	-	-
Exchange traded funds	-	-	-	-
Private preferred stocks	-	-	-	-
Corporate bonds	-	-	-	-
Government bonds	-	-	-	-
Municipal bonds	-	-	-	-
Asset-backed securities	-	-	-	-
Total investments in securities	-	-	-	-
Investments in private investment companies	-	-	-	-
Derivative contracts				
Interest rate swaps	-	-	-	-
Warrants purchased	-	-	-	-
Total return swaps	-	-	-	-
Call options	-	-	-	-
Put options	-	-	-	-
Total derivative contracts	-	-	-	-
	\$ -	\$ -	\$ -	\$ -

Level 3 Roll-forward

- The Level 3 roll-forward discloses the activity of all Level 3 investments throughout the period categorized by investment type
 - Beginning balance
 - Realized & unrealized gain/loss
 - Purchases/sales/settlements
 - Transfer into/out of Level 3
 - Ending balance
 - Change in unrealized of investments still held at the end of the period
- The Level 3 roll-forward provides further transparency into the movements and liquidity of these typically illiquid investments



Level 3 Roll-forward

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	LEVEL 3							
	Beginning Balance January 1, 20XX	Realized & Unrealized Gains (Losses) ^(a)	Purchases	Sales	Transfers Into Level 3	Transfers (Out) of Level 3	Ending Balance December 31, 20XX	Change in Unrealized Gains (Losses) for Investments still held at December 31, 20XX ^(c)
Assets (at fair value)								
Investments in securities								
Common stocks	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Preferred stocks	-	-	-	-	-	-	-	-
Exchange traded funds	-	-	-	-	-	-	-	-
Private preferred stocks	-	-	-	-	-	-	-	-
Corporate bonds	-	-	-	-	-	-	-	-
Government bonds	-	-	-	-	-	-	-	-
Municipal bonds	-	-	-	-	-	-	-	-
Asset-backed securities	-	-	-	-	-	-	-	-
Total investments in securities	-	-	-	-	-	-	-	-
Investments in private investment companies	-	-	-	-	-	-	-	-
Derivative contracts								
Interest rate swaps	-	-	-	-	-	-	-	-
Warrants purchased	-	-	-	-	-	-	-	-
Total return swaps	-	-	-	-	-	-	-	-
Call options	-	-	-	-	-	-	-	-
Put options	-	-	-	-	-	-	-	-
Total derivative contracts	-	-	-	-	-	-	-	-
	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -

(a) Realized and unrealized gains and losses are all included in net gain (loss) on investments in the statement of operations.

(b) The change in unrealized gains (losses) for the year ended December 31, 20XX for investments still held at December 31, 20XX are reflected in net change in unrealized appreciation or depreciation on securities in the statement of operations.

Valuation Techniques & Unobservable Inputs

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- The table required by ASU 2011-04 lays out the valuation techniques and unobservable inputs for all Level 3 investments
 - Categorized by investment type and valuation technique
 - Unobservable Inputs can be disclosed as a single amount or range with weighed average
 - Valuation techniques include:
 - Discounted cash flow
 - Comparable companies
 - Historical transactions
 - Indicative quotes
 - Black Scholes model
 - Unobservable input examples include:
 - EBITDA
 - Marketability discounts
 - Prepayment rates
 - Credit spreads
 - Weighted average cost of capital
 - Historical volatility



Valuation Techniques & Unobservable Inputs

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	Fair Value at December 31, 20XX		Valuation Technique	Unobservable Inputs	Range of Inputs (Weighted Average)
Assets (at fair value)					
Investments in securities					
Private preferred stocks	\$	XXX	Market comparable companies	Adjusted valuation multiples (EBITDA) Discounts for lack of marketability Control premiums	X - XX (X) X% - XX% (X%) X% - XX% (X%)
Corporate bonds	\$	XXX	Indicative quote	Discounts for lack of marketability	X% - XX% (X%)
Asset-backed securities	\$	XXX	Discounted cash flow model	Loss severities Probabilities of default Prepayment rates	X% - XX% (X%) X% - XX% (X%) X% - XX% (X%)
Derivatives					
Call warrants	\$	XXX	Industry accepted model	Historical volatility	X% - XX% (X%)
Liabilities (at fair value)					
Derivatives					
Credit default swaps	\$	XXX	Probability model	Indicative credit spread Default rates	X% - XX% (X%) X% - XX% (X%)

- The derivative footnotes generally begin with qualitatively describing each type of derivative in which the entity invests
- The volume of derivative activities is disclosed through a notional table
 - Broken out by underlying risk, derivative type and long/short exposure
 - Notional amounts must be indicative of the overall volume throughout the year. Not necessarily the notional amounts held at the end of the period.
- Fair value of derivatives and realized & unrealized gain/loss from derivatives must be disclosed
 - Broken out by underlying risk and derivative type



Derivatives – Notional Table

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Primary underlying risk	Long exposure		Short exposure	
	Notional amounts	Number of contracts	Notional amounts	Number of contracts
Interest rate				
Interest rate swaps	\$ -	-	\$ -	-
Swaptions	-	-	-	-
	-	-	-	-
Foreign currency exchange rate				
Forward contracts	-	-	-	-
	-	-	-	-
Equity price				
Total return swaps	-	-	-	-
Futures contracts	-	-	-	-
Options (b)	-	-	-	-
Warrants (b)	-	-	-	-
	-	-	-	-
Commodity price				
Futures contracts	-	-	-	-
	-	-	-	-
Credit				
Purchased protection:				
Credit default swaps	-	-	-	-
Written protection:				
Credit default swaps	-	-	-	-
	-	-	-	-
	-	-	-	-
	\$ -	-	\$ -	-

(a) [if applicable] Notional amounts are presented net of identical offsetting derivative contracts.

(b) Notional amounts presented for options and warrants are based on the fair value of the underlying shares as if the options and warrants were exercised at December 31, 20XX.

Derivatives – Balance Sheet & Income Statement Impact 25

<u>Primary underlying risk</u>	<u>Derivative assets</u>	<u>Derivative liabilities</u>	<u>Realized gain (loss)</u>	<u>Unrealized gain (loss)</u>
Interest rate				
Interest rate swaps	\$ -	\$ -	\$ -	\$ -
Swaptions	-	-	-	-
	-	-	-	-
Foreign currency exchange rate				
Forward contracts	-	-	-	-
	-	-	-	-
Equity price				
Total return swaps	-	-	-	-
Futures contracts	-	-	-	-
Options	-	-	-	-
Warrants	-	-	-	-
	-	-	-	-
Commodity price				
Futures contracts	-	-	-	-
	-	-	-	-
Credit				
Purchased protection:				
Credit default swaps	-	-	-	-
Written protection:				
Credit default swaps	-	-	-	-
	-	-	-	-
Total	\$ -	\$ -	\$ -	\$ -

Offsetting assets and liabilities

- Certain entities may have the right to offset certain derivative assets and liabilities on the balance sheet
 - A right of setoff exists when all of the following conditions are met:
 - Each of the two parties owes the other determinable amounts
 - The reporting party has the right to set off the amount owed with the amount owned by the other party
 - The reporting party intends to set off
 - The right of setoff is enforceable at law
 - Right of setoff will further be defined in the master netting agreement with the applicable counterparty
- Even if right of setoff is allowed, an investment company may still choose to show their investments gross on the balance sheet
 - Gross vs Net presentation on the balance sheet does not eliminate the requirement to show the affects of offsetting in a tabular format

Offsetting assets and liabilities

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Description	Gross Amounts of Recognized Assets Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		
		Financial Instruments	Cash Collateral Received	Net Amount
Interest rate swaps	\$ -	\$ -	\$ -	\$ -
OTC warrants purchased	-	-	-	-
Total return swaps	-	-	-	-
Credit default swaps	-	-	-	-
Futures contracts	-	-	-	-
Forward contracts	-	-	-	-
OTC option contracts purchased	-	-	-	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Description	Gross Amounts of Recognized Liabilities Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		
		Financial Instruments	Cash Collateral Paid	Net Amount
Interest rate swaps	\$ -	\$ -	\$ -	\$ -
OTC warrants written	-	-	-	-
Total return swaps	-	-	-	-
Credit default swaps	-	-	-	-
Futures contracts	-	-	-	-
Forward contracts	-	-	-	-
OTC option contracts written	-	-	-	-
Total	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

Capital structure & Other

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- Detail of specific capital terms defined in the entity's formation agreements
 - Initial investment minimums
 - Redemption rights including applicable lock up periods, when redemptions are permitted, redemption notice period as well as other redemption limitations or fees, if any
- Incentive/performance fee
- Management fee
- Related party transactions
 - Limited partners that are related parties to the General Partner/Investment Manager
 - Members of the General Partner/Investment Manager that serve as members of the Board of Directors of certain investments
 - Expense reimbursements to/from the General Partner/Investment Manager
 - Any related party transaction should be disclosed, including amounts paid
- Commitments and contingencies
 - Disclose any legal issues

Financial Highlights

- Disclose total return of the entity by applicable class
- Disclose net investment income/loss, expense and incentive allocation/fee ratio by applicable class
 - Ratio is calculated by the average of the net assets of the applicable class
- For onshore entities, typically disclose Limited Partners taken as a whole
- For offshore entities with designated classes, typically disclose each permanent series of each class of investors
- Private Equity and Venture Capital Funds typically disclose an Internal Rate of Return at the end of the current and prior periods instead of total return

Subsequent events

- Disclose all material transactions that occurred within the entity between the financial statement and audit opinion dates. Examples would be:
 - Capital activity
 - Change in service providers, for instance administrator, prime broker, etc.
 - Any legal actions taken by or against the entity
 - Any notices from any regulatory agencies
 - A decision to terminate operations of the entity
 - Material decline in asset value





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