FAQ2020-08 FREQUENTLY ASK QUESTIONS

(as adopted by IRE Council on 16 January 2020)

AUDITING CARRIED INTEREST IN THE ACCOUNTS OF ALTERNATIVE INVESTMENTS STRUCTURES

Index

1. Purpose

Carried interest is an important element in Alternative Investment Structures[1] as it is a significant part of the management's remuneration.

The purpose of this FAQ is to provide:

a) Definition of carried interest,
b) Overview and guidance on the general audit procedures to be performed,
c) Understanding of the accounting and disclosure requirements of carried interest.

The following International Standards on Auditing ("*ISAs*") are also particularly relevant to audits of carried interest:

a) ISA 315 and ISA 330 deal with identifying and assessing risks of material misstatement and responding to those risks,
b) ISA 500 explains what constitutes audit evidence and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion, and
c) ISA 540 deals with the auditor's responsibilities relating to auditing accounting estimates, including accounting estimates related to financial instruments measured at fair value and related disclosures.

2. Limitations

The clarifications and interpretations presented in this document summarise conclusions drawn from questions put to the *Institut des réviseurs d'entreprises* ("IRE") and are of a purely informative nature. They are not normative in nature and in no way bind the IRE. The reader should always refer to national legislation and ISAs as adopted for Luxembourg by the "*Commission de Surveillance du Secteur Financier*" ("*CSSF*"). The IRE, its Board and/or its Secretariat accept no responsibility for the content of this document and any damage resulting from its use and suffered by a party who has relied on this document in its decisions, actions or inactions.

3. Questions & Answers

3.1 What is carried interest?

Carried interest is a share of the profit for the carried interest Partner ("*CIP*"; usually the Investment Manager, the General Partner or a specific carry vehicle in an investment structure) on the gain realized on the exit of the investments held by the entity[2]. It is a key incentive for managers to turn the investments into more profitable business to realize the best exit possible, as rapidly as possible. It aligns the interest of the management with those of the investors.

[1] Alternative Investment Structures comprise vehicles such as AIF, SIF, SICAR, UCI part II, and unregulated vehicles such as RAIF and Soparfis

[2] For AIFs, Carried interest is defined in Art 1. (52) as follows: "'carried interest': a share in the profits of the AIF accrued to the AIFM as compensation for the management of the AIF and excluding any share in the profits of the AIF accrued to the AIFM as a return on any investment by the AIFM into the AIF".

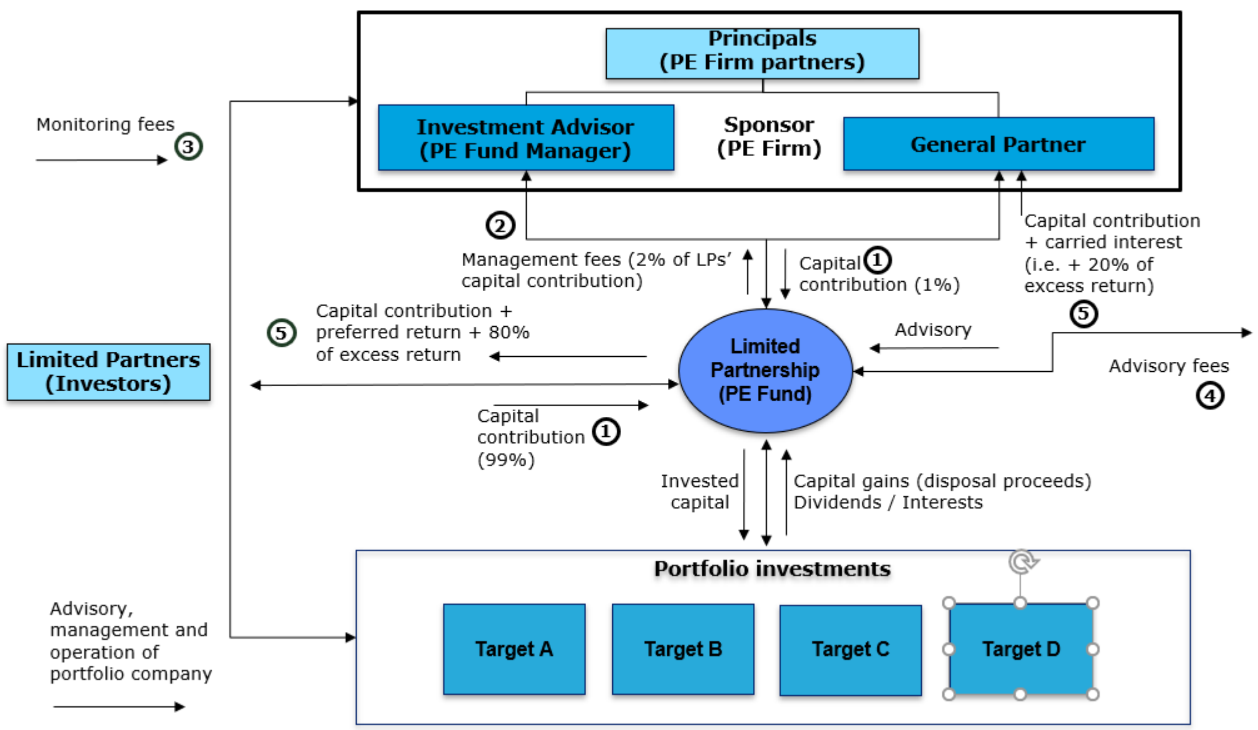
The calculation of carried interest is set out in the entity offering documents (the prospectus or the Private Placement Memorandum, "*the offering document*"), the bylaws/the management regulation (for common funds/FCP) and/or the contractual arrangement (e.g. Limited Partnership Agreement). Carried interest is typically a fixed percentage of the entity net realised gains (above preferred return, see below). The entity's offering documents usually describe a "*waterfall*" of entity distributions between the CIP and the Limited Partners ("*LPs*")/shareholders, setting out the methodology of carried interest allocation and payment.

Generally, carried interest is payable to the CIP after LPs/shareholders have been repaid their capital contributions plus a "*preferred return*" (so called *hurdle rate* representing a defined minimum Rate of Return, "*RR*").

The offering document defines the set-up of carried interest through the set-up of a specific class of shares/participating interest giving right to the allocation of carried interest.

Example of set-up: The CIP is entitled to receive a carried interest of 20% of the excess of a performance above 8% (hurdle rate).

In this example, the profit of the entity will be first allocated to the investors until these profits reach a cumulative RR of 8% calculated on the capital amount that have been contributed by the LPs/shareholders, including in some cases the General Partner and/or the CIP who usually holds a small portion interest in the entity. Realised gains above 8% will be split using a ratio of 20% for the CIP and the remaining 80% for the LPs / shareholders.



3.2 How can carried interest be settled?

Generally, carried interest can be settled either in *cash* or in *equity*. Equity settled carried interest is not commonly used and therefore will not be further described.

Carried interest is usually settled on a *whole entity basis*, when all investments have been disposed of (at liquidation/term of the entity) or, less commonly, on a *deal-by-deal* basis, meaning after each exit, RR met.

3.3 What is a Clawback clause?

Clawback is the LPs/ shareholders' right to reclaim part of the carried interest received by the CIP in case ultimately, the conditions for the carried interest are not met.

The *clawbacks* arrangements are usually foreseen and requested by LPs/shareholders to ensure that initial over payments of carried interest can be paid back to the entity (if carried interest is treated as an expense) respectively to the LPs/shareholders (if carried interest is treated as NAV allocation) in case the conditions of carried interest are ultimately not fulfilled.

Clawbacks represent a receivable for the entity from the CIP (if carried interest is treated as an expense) or receivables for LPs/shareholders from the CIP (if carried interest is treated as NAV allocation).

3.4 What are the key audit considerations for the auditor in relation to carried interest?

3.4.1 How can the auditor obtain understanding about the applicable accounting policy for the investment structure?

As part of the risk assessment process, the auditor should verify whether a carried interest mechanism is in place for the entity by reading the entity's offering documents and contractual arrangements in place. If such a mechanism is foreseen, the auditor needs to understand its calculation methodology and disclosure requirements in light of the applicable accounting and financial reporting framework.

The auditor should gain an understanding (revised ISA 540.13) of the accounting policy for carried interest used by the investment vehicle and check whether this/these method(s) is/are acceptable under the applicable GAAP and laws and regulations (for non-regulated or regulated funds such as SIF, SICAR, etc.) and contractual arrangements (e.g. the fund documentation).

When auditing financial statements of an investment structure that foresees carried interest, the following aspects should therefore be considered by the auditor:

a) Applied accounting framework
b) Accounting policy of the entity (treatment of carried interest as expense or NAV allocation)
c) Key features of the carried interest arrangement
d) Waterfall calculation to determine the amount of carried interest or Clawback
e) Probability of distribution of carried interest
f) Disclosure requirements
g) Consider carried interest on all level of the entity structure (Master/Feeder)

Disclosure requirements and accounting treatments may be different under Luxembourg legal and regulatory requirements ("*LuxGAAP*") and IFRS and the extent of disclosures might vary depending on the nature of the reporting entity. The auditor should check that the accounting policy and the disclosures requirement are sufficiently detailed in the context of the reporting entity, the accounting framework and the applicable measurement method.

3.4.2 What are the possible accounting policies of Carried interest for the financial statements of the investment structure?

In general, there are two possibilities with respect to the accounting of carried interest of the investment vehicle:

a) as a *NAV Allocation*: the carried interest amount is deducted from the NAV attributable to the LPs/Shareholders and allocated to the NAV attributable to the CIP; or
b) as an *Expense*: similarly to performance fees, the carried interest amount is charged to the entity's profit and loss and consequently, total NAV.

The accounting policy will depend on the description in the offering document, the legal structure and the accounting framework and should be analysed on a case-by-case basis.

3.4.3 How is carried interest treated in accordance to LuxGAAP?

3.4.3.1 What are the accounting requirements when treated as NAV allocation?

There is no specific guidance provided by LuxGAAP or the industry specific laws with respect to the accounting of carried interest. Nevertheless, for some fund vehicles, the NAV per share needs to be disclosed in the primary statements or the notes of the financial statements[3].

By analogy to the specific guidance on the disclosure of the NAV allocation that can be found at industry guidelines as published by the International Private Equity and Venture Capital Valuation ("*IPEV*"), taking the view from the entity's investor's point of view *"NAV should be adjusted such that it is equivalent to the amount of cash that would be received by the holder of the interest in the Fund if all underlying Investee Companies were realised as at the Measurement Date."*

Chapter 4.2 of the IPEV Guidelines (version December 2018) recommends the following adjustment when calculating the NAV: *"One of the adjustments mentioned is "[…] the appropriate recognition of potential performance fees or carried interest in the Fund NAV."*

Consequently, the *NAV attributable to the LPs/shareholders* should be net of any allocation of carried interest to the CIP.

The allocation of carried interest to the CIP is dependent on the following factors:

- the conditions as per the offering document are met (e.g.: hurdle rate is exceeded);
- whether the investments are measured at cost or at fair value.

[3] The requirement of disclosure of the NAV per shareholder / share class could be based on contractual basis (e.g. mandatory in accordance to the LPA) or on legal requirements (e.g. mandatory disclosure of the NAV per unit in accordance to the SIF or RAIF law)

3.4.3.1.1 What are the consequences when assets are valued at fair value?

When, in accordance with the entity's financial reporting framework, investments are measured at fair value, unrealised gains or losses on the investments are recognized in the financial statements, a carried interest amount needs to be calculated if conditions as per the offering document are reached.

Carried interest will not have any impact on the total NAV of the entity but will have an impact on the NAV attributable to the Partners/the NAV per share class, as the carried interest amount will be deducted from the value of the shares of the LPs and allocated to the value of the shares held by the CIP.

In case there is no separate disclosure of the NAV per shareholder / share class in the primary statements, the information regarding carried interest would be disclosed in the notes to the financial statements.

3.4.3.1.2 What are the consequences when assets are measured at cost?

In case of cost measurement, the NAV per shareholder / share class will not reflect the amount of cash that would be received by the investors of the entity as the unrealised profit and carried interest are not accounted for. Consequently, the carried interest would not be considered in the NAV per shareholder / share class, but only recorded when carried interest is due as a result of a distribution waterfall (i.e. when investments have been sold and amounts are distributed to the LPs/GP/CIP).

In any event, a disclosure of the fact that a carried interest mechanism exists should be made in the notes to the financial statements. Refer to the section 3.4.3.3 below.

3.4.3.2 What are the accounting requirements when carried interest is treated as an expense?

Similarly to performance fees, the recognition of the carried interest depends on the probability it becomes due. Therefore, it is essential to assess at each reporting date if the performance conditions as defined in the entity's offering document are met (e.g.: hurdle rate is exceeded).

In accordance with Art. 51 (1) d) of the law of 19 December 2002 on the register of commerce and companies and the accounting and annual accounts of undertakings ("*the accounting law*") "*The […] account must be taken of income and charges relating to the financial year in respect of which the accounts are drawn up irrespective of the date of receipt of payment of such income or charges*".

In accordance to Art. 64 of the accounting law, a provision should be booked with corresponding effect on the P&L when there is evidence that certain triggering events occurred in that period, such as reaching cumulative RR targets or profit.

Depending on the probability of the occurrence of the triggering event, the carried interest would be treated either as a contingent liability, a provision or a liability.

In any event, a disclosure of the fact that a carried interest mechanism is in place should be made in the notes to the financial statements. See the section 3.4.3.3 below.

3.4.3.3 What are the disclosure requirements when financial statements are prepared in accordance with LuxGAAP?

The description of the carried interest mechanism in place, including sufficient information about the mechanism of the calculation and payment, as well as the accounting policy retained by the entity must be disclosed in the notes to the financial statements, regardless of the occurrence or non-occurrence of the triggering event (e.g. Hurdle rate exceeded), in accordance with Art. 65 (1) 1° of the accounting law. A sole reference to the offering document is not sufficient.

The notes to the financial statements should include a comprehensive accounting policy in accordance with Art. 65 (1) 1° of the accounting law including an indication of economic rights attached to specific classes of shares in accordance with Art. 65 (1) 5°.

For directly or indirectly regulated alternative investment vehicles, the specific additional disclosure requirements must be applied:

Alternative Investment Funds (AIF)	Art. 20 (3) (Law of 12 July 2013)
Specialised Investment Funds (SIF):	Art. 52 (4) (Law of 13 February 2007)
Investment Company in Risk Capital (SICAR):	Art. 24 (2) (Law of 15 June 2004)
Reserved Alternative Investment Fund (RAIF):	Art. 38 (4) (Law of 23 July 2016)
UCI Part II Funds	Art. 152 (3) (law of 17 December 2010)

For entities where carried interest is treated as an expense Art. 38 of the accounting law below could be applicable.

> *"Art. 38 – The total amount of any financial commitments, guarantees or contingencies that are not included in the balance sheet, and an indication of the nature and form of any in rem security which have been provided must be set out in the notes to the accounts. Any commitments concerning pensions and affiliated or associated undertakings shall be disclosed separately."*

3.4.4 How is carried interest accounted for in accordance with IFRS?

An analysis of contractual legal information is to be performed to assess whether the carried interest represents a remuneration for services provided by the general partner acting in its capacity as owner ("*ownership model*") or as a service provider ("*service model*").

3.4.4.1 What are the accounting requirements under the ownership model?

In case carried interest is treated under the ownership model in the IFRS accounts, carried interest will form part of the net asset attributable to the partners and therefore will be accounted only as a re-allocation of profits of the partnership between its partners with the disclosure requirements as described below in the section 3.4.4.3.

3.4.4.2 What are the accounting requirements under the service model?

In case of treatment under the service model, carried interest may be analysed either in accordance with IAS 32/IFRS 9 as a financial liability, or in accordance with IAS 37 as a provision or contingent liability. IAS 37 cannot be applied in case the contract is considered as executory.

Depending on the outcome, carried interest would be accounted for as a financial liability, provision or contingent liability.

3.4.4.3 What are the disclosure requirements under IFRS?

Financial statements under IFRS must provide useful information and give a true and fair view (IAS 1.15 and 1.112). In case of treatment under the ownership model, the carried interest partner is a related party – e.g. the GP in a Partnership – and relevant IAS 24 "*Related Party Disclosures*" requirements would apply. The carried interest should be presented separately in the statement of changes in the net assets attributable to the partners in line with IAS 1.6 and IAS 1.106(d)(iii) as it represents a transaction with the owners of the partnership interests.

If the accounting of carried interest is treated under the service model, IAS 1 "*Presentation of Financial Statements*", IFRS 7 "*Financial instruments Disclosures*", and IAS 32 "*Financial instruments: Presentation*", would apply. If the carried interest partner is a related party, relevant IAS 24 "*Related Party Disclosures*" requirements would be also applicable.

Alternatively, if treated under IAS 37 "*Provisions, Contingent Liabilities and Contingent Assets*", relevant disclosures required under this IAS need to be followed.

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