

Formation Costs

Background

The initial costs of forming a fund are divided into two classes: organizational costs and initial offering (or syndication) costs. Both are often referred to as “org costs,” but the initial offering costs are usually the larger proportion. Technically, “organization” consists only of the minimal filings that declare the entity’s existence. Most auditors agree that true “org costs” are usually small, perhaps less than \$1,000; the greater share are initial offering costs – the legal expenses involved in crafting the details of the partnership or operating agreement, plus the creation of the private placement memorandum.

Regardless of terminology, these initial legal costs often add up to a significant expense that the fund usually pays. Prior to 1998, the standard process was to capitalize the formation costs as an asset and to amortize it over a period of years (typically 3 to 5). This procedure was viewed as a fair way to spread formation costs among investors over time.

Note that the tax treatment of formation costs is somewhat complex and beyond the scope of this summary. This discussion is limited to economic allocations.

AICPA Statement of Procedure 98-5

In late 1998, the AICPA complicated things when it declared that formation costs in private funds should be immediately expensed. Despite that new “rule,” many funds continued to elect amortization; their rationale being that the effect of the amortization in relation to the capitalization of the fund would likely be deemed non-material by independent auditors and would not result in a qualified audit opinion. If it were considered a material departure from GAAP, the fund would necessarily receive an audit with a “qualified opinion” something along the lines of “in accordance with GAAP, with the exception that the manager has elected to amortize initial organizational and offering costs over a period of X years.” In most cases, this was viewed as an acceptable departure by investors and otherwise of no particular consequence.

Still, concern about not being GAAP did lead to the appearance of a new methodology for the treatment of formation costs – the so-called “non-recourse installment reimbursement.” In that method, the manager pays formation costs, either directly or as a charge to its capital account, and is then reimbursed over a period of years in equal installments. This has exactly the same economic effect as amortization, except that if the fund closes early, there is no further obligation for the fund or the investors for the outstanding balance. This non-recourse aspect is what makes each month’s reimbursement a simple current expense for that period – somewhat like an added fee to the fund manager for a period of time. This method was thought by many to be safer from an audit perspective; however, with the downside (to the manager) that the manager doesn’t recoup its money as quickly – and has some risk regarding any unpaid amount if the fund fails.

The SEC Custody Rule (Sep 2003)

The next relevant event was the publishing of the new “Custody Rule” in late 2003. Among other things, the new rule provided an exemption for managers of pooled funds from certain reporting requirements if they prepared and delivered within a certain timeframe – 120 days for hedge funds, and 180 days for funds-of-funds – “audited financial statements prepared in accordance with generally accepted accounting principles.”

The question for hedge fund managers became, “If the fund receives a qualified audit opinion, is it still GAAP-enough for purposes of the Custody Rule?” A secondary question was, “Even if the opinion is not qualified due to non-materiality, if the fund is not using a GAAP method, is it still okay?”

The ABA Subcommittee on Private Investment Entities Private Letter Ruling 12/8/2005

The GAAP issue was again addressed by a private letter ruling in December 2005. On the one hand, in the letter below from the ABA PLR where the SEC restates the ABA question, it seems to focus on the audit opinion itself. However, in the SEC's answer, it now says that financial statements must be "fully GAAP compliant" – the original rule just required "prepared in accordance with generally accepted accounting principles."

Following is the relevant excerpt from the SEC staff letter:

You state that an unregistered pooled investment vehicle typically amortizes its start-up costs so that those costs are not borne solely by the initial investors. As a consequence, the audit opinion accompanying such a vehicle's financial statements typically is qualified to reflect such treatment, in which case the financial statements are not prepared in accordance with GAAP.

...you essentially seek an interpretation that a pooled investment vehicle's financial statements comply with the requirement that they be prepared in accordance with GAAP despite the fact that the audit opinion accompanying the financial statements is qualified to reflect that the vehicle amortizes its start-up costs.

Answer: In adopting the 2003 amendments to the Custody Rule, the Commission clearly indicated that the exception to the quarterly reporting requirement is available only to advisers to pooled investment vehicles whose financial statements are fully GAAP compliant. Moreover, the interpretation that you seek is substantially similar to an approach suggested to the Commission by one of the commenters on the 2003 proposal to amend the Custody Rule. Following consideration of the commenter's proposal, however, the Commission determined to adopt the more narrow exception set forth in the rule.

The ABA has spelled out a scenario where the amortization methodology is assumed to have been material and

has resulted in a qualified audit. In the experience of ALPS Price Meadows, that has not been the norm; that is, it has seemed more prevalent that funds taking the amortization route have been getting "clean" audits due to non-materiality. Be that as it may, the SEC response contains a heretofore unused term: "fully GAAP compliant." So, a remaining question might be, "Are the financials of a fund that amortizes its formation costs, but due to non-materiality receives an unqualified audit report, considered fully GAAP compliant?" This is a question that should be discussed with fund management's legal counsel and the fund's auditor.

Mechanics

Either amortization or non-recourse installment reimbursement can be automated at APM.

One last thing to consider with either method is the choice of the period over which to spread formation costs. Shorter periods result in a heavier hit to performance for the initial investors. Longer periods can introduce problems if the fund shuts down early (with amortization, remaining investors may be left "holding the bag;" with reimbursement, the manager takes the hit). Typical timeframes seem to be 3 or 5 years.

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