Current and emerging issues facing business development companies

by Eyal Seinfeld

The business development company (BDC) industry continues to experience tremendous growth, and with that growth, new questions and issues are arising on a regular basis. The US Securities and Exchange Commission’s (SEC) Division of Investment Management (IM Division) has focused its attention on the industry and the unique issues that it presents being subject to both the Investment Company Act of 1940 and the Securities and Exchange Act of 1934.

In this article, we identify recurring issues that our clients are encountering. This is not intended to provide authoritative guidance; rather, our aim is to highlight issues that many BDCs may be facing and should consider addressing with the help of their external auditors, legal counsel and potentially the SEC.

The most common topics that we discuss with our BDC clients are:

- Consolidation of wholly-owned or majority-owned subsidiaries
- Accounting for joint ventures
- Application of S-X Rules 3-09 and 4-08(g)
- Disclosure of one-time fees
- Disclosure of related-party transactions
- SOX 404 requirements (timing of adoption)
- Treatment of original issue discounts
- Asset transfers and transactions among lenders
Consolidation of wholly-owned or majority-owned subsidiaries

Under current accounting guidance, investment companies generally only consolidate other wholly-owned or substantially wholly-owned investment companies. However, in October 2014, the IM Division issued Guidance Update 2014-11 that shares the SEC’s observation that an evaluation of subsidiary holding companies and other structures that could reasonably be considered extensions of the BDC is required and that those entities may need to be consolidated. The factors to consider include whether the holding company has substantive operations or employees that would indicate the subsidiary is in fact an operating company.

Accounting for joint ventures

The guidance on joint venture accounting focuses on whether a party has control over the joint venture. Some BDCs have formed joint ventures and have not been required to consolidate the joint venture even when the BDC receives more than 50% of the economics of that joint venture. The decision on whether to consolidate a joint venture involves the careful consideration of the economics as well as the rights held by each of the parties to the joint venture. In certain circumstances, a joint venture will not be consolidated if, after careful consideration of the substance of the joint power arrangements, decisions significant to the operation of the joint venture are evenly split between the BDC and its joint venture partner.

Application of S-X Rules 3-09 and 4-08(g)

In September 2013, the IM Division issued Guidance Update 2013-07, Business Development Companies – Separate Financial Statements or Summarized Financial Information of Certain Subsidiaries, which reminds issuers that S-X Rules 3-09 and 4-08(g) are applicable to BDCs. S-X Rule 3-09, Separate Financial Statements of Subsidiaries not Consolidated and 50 Percent or Less Owned Persons, requires that annual financial statements included in Form 10-K and Form N-2 contain separate financial statements, prepared in accordance with Regulation S-X (including financial schedules), for subsidiaries not consolidated or investees accounted for by the equity method when such entities are individually significant.

The significance of a subsidiary or investee is based on the “significant subsidiary” tests specified in Rule 1-02(w) of Regulation S-X. Separate financial statements of each unconsolidated subsidiary, including investments carried at fair value, are required if any of the three significance tests (investment, asset and income tests) are met at the 20% level. Separate financial statements of each investee are required if either the investment test or the income test is met at the 20% level. (The asset test is not applicable for equity method investees under S-X Rule 3-09 but is applicable for the Rule 4-08(g) requirements discussed below.)

S-X Rule 4-08(g), Summarized Financial Information of Subsidiaries not Consolidated and 50 Percent or Less Owned Persons, requires annual consolidated financial statements included in Form 10-K and Form N-2 to contain disclosure in the notes to the financial statements of summarized financial information about subsidiaries not consolidated and investees accounted for by the equity method if, individually or in the aggregate, they exceed 10% significance under any one of the three significant subsidiary tests. Registrants must present summarized financial information under Rule 4-08(g) for the same periods as the consolidated financial statements, which generally includes summarized balance sheet information for the most recent two fiscal years and the summarized income statement information for the most recent three years. To the extent that separate financial statements of unconsolidated subsidiaries or equity method investees are required under Rule 3-09 and included in the registrant’s Form 10-K, the summarized financial information doesn’t need to include those entities.

BDCs should also remember that if the summarized financial information is included as a footnote to the financial statements, that footnote cannot be labelled “unaudited.” Additionally, the preparation of the financial information must be subjected to internal controls over financial reporting and, if applicable, will be subjected to internal control testing by the external auditor.

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Disclosure of one-time fees

Many BDC investors focus on the yields that BDCs generate and, as a result, are interested in understanding the nature of the investment income generated in each period. Often the interest income line item on the statement of operations includes both recurring coupon payments and amortization of original issue discount, as well as nonrecurring payments such as prepayment penalties, acceleration of amortization and other fees. We understand that the SEC has been asking registrants to expand disclosures in BDC financial statements to ensure that the reader of the financial statements can clearly distinguish between recurring and nonrecurring payments.

Disclosure of related-party transactions

ASC 850, Related Party Disclosures, requires the disclosure of transactions between a registrant and related parties. We understand that the SEC has reminded registrants that the disclosures required by ASC 850 are applicable to controlled unconsolidated investees of BDCs.

SOX 404 requirements (timing of adoption)

The JOBS Act was signed into law on 5 April 2012 and included a key provision that provides an exemption from auditor attestation of internal controls over financial reporting (for a period of up to five years) for new registrants. Newly registered BDCs that meet the definition of an “emerging growth company” can take advantage of this provision. Many of the more recent BDCs coming to market have been in the form of a non-traded and continuously offered BDC. Non-traded BDCs are classified as non-accelerated filers and are therefore exempt from auditor attestation of internal controls over financial reporting. Non-accelerated filers are permanently exempt from the auditor attestation requirements until such time as the registrant becomes an accelerated filer or large accelerated filer. Therefore, a non-traded BDC could potentially continue to receive the deferral of the auditor attestation requirements for a period longer than five years.

Treatment of original issue discount

In connection with a call of a debt investment held by the BDC prior to maturity, the unamortized premium and discount is removed from the statement of assets and liabilities and recorded to the statement of operations. We have observed diversity in practice regarding the treatment of the unamortized premium or discount and related prepayment penalties as either a component of the realized gain (or loss) on the sale of the investment or included in interest income. BDCs should evaluate their accounting policies and the related accounting guidance to ensure the consistency of the application of its accounting policy and its conformity to US GAAP.

Asset transfers and transactions among lenders

BDCs whose asset acquisition strategies include loan originations need to be mindful of the requirements of ASC 860, Transfers and Servicing. Transactions where a BDC originates a loan and subsequently sells off portions of the loan need to be carefully evaluated as to whether all the criteria for a sale are met. Additionally, if the origination of a loan involves a consortium of buyers that subsequent to or even concurrent with the loan origination enter into a transaction to transfer certain rights and payments among lenders, multiple potential accounting issues can arise. The evaluation is driven by facts and circumstances and both the form and substance of the transaction(s) matter. BDCs will potentially need to consider the accounting for sales and transfers as well as derivative accounting in evaluating the proper treatment for these agreements.

Final thoughts

The financial statement preparation for BDCs has continued to increase in complexity. The transactions and various structures create new challenges that have not previously been addressed within the construct of a BDC. Continuous monitoring of developments and interaction with external auditors and others will be critical to address and avoid potential issues.

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