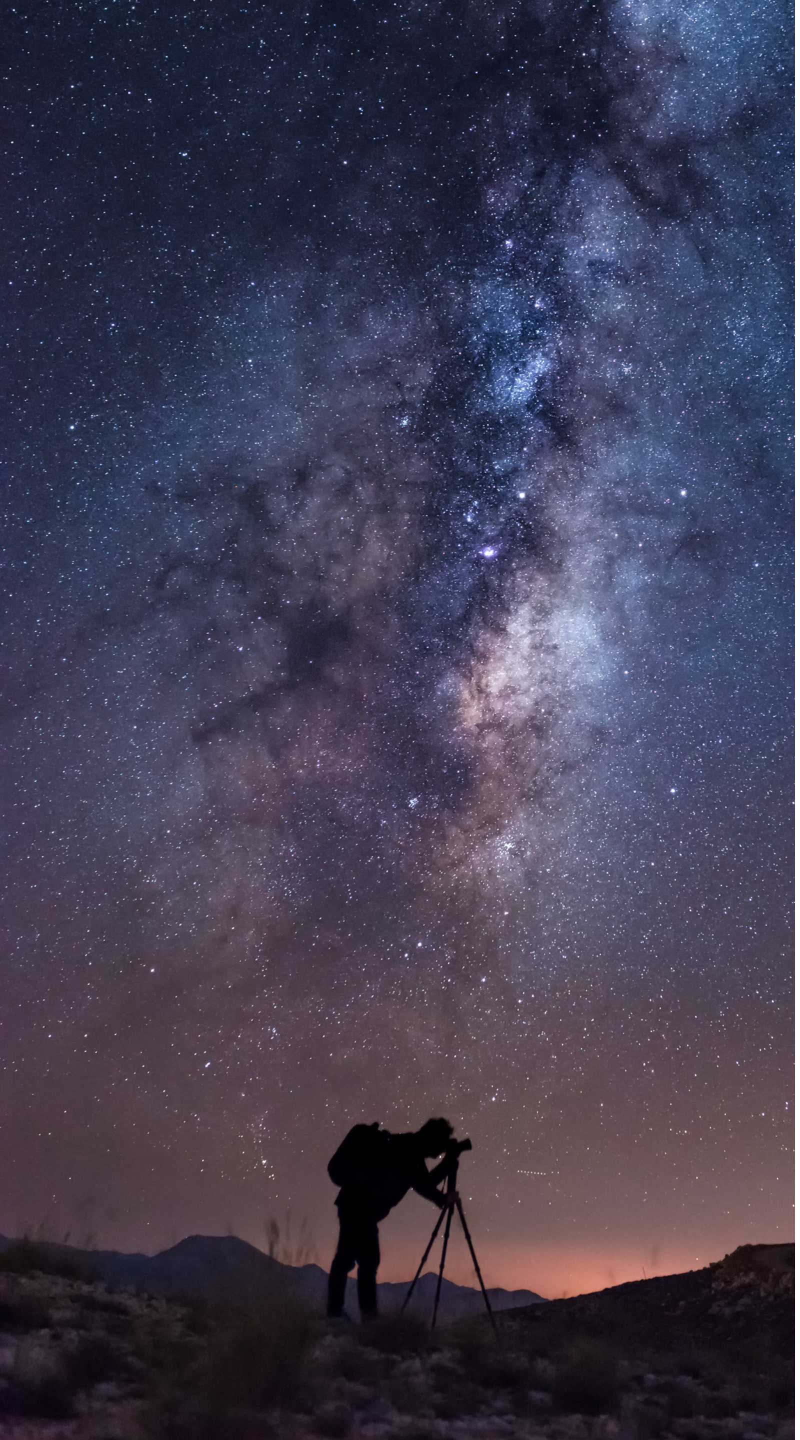
Special purpose financial statements:
Key considerations for financial services entities

Deloitte.

Contents



Financial services entities such as asset managers, management companies, and family offices often have a requirement, or a desire, to produce financial statements for a specific purpose or specific users. There can be situations where the traditional reporting frameworks of US generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS), or another similar framework does not satisfy the user's needs. Similarly, if there are topics under GAAP or IFRS that may be complex or not meaningful to the users of the financial statements for their purposes, entities may consider utilizing another basis to report the information in a way that is most meaningful and useful to its intended audience.

This alternative reporting results in utilizing an other comprehensive basis of accounting and issuing what are commonly referred to as special purpose financial statements. Most special purpose financial statements are on either a cash, modified cash, tax, or regulatory basis, or on a framework required or agreed upon in a contract—often referred to as a contractual basis.

When having discussions with finance professionals, recurring questions often surface about special purpose financial statements, and we regularly visit the topic of what kind of adjustments are typically made and what the potential challenges of preparing special purpose financial statements are.
Let us break it down.

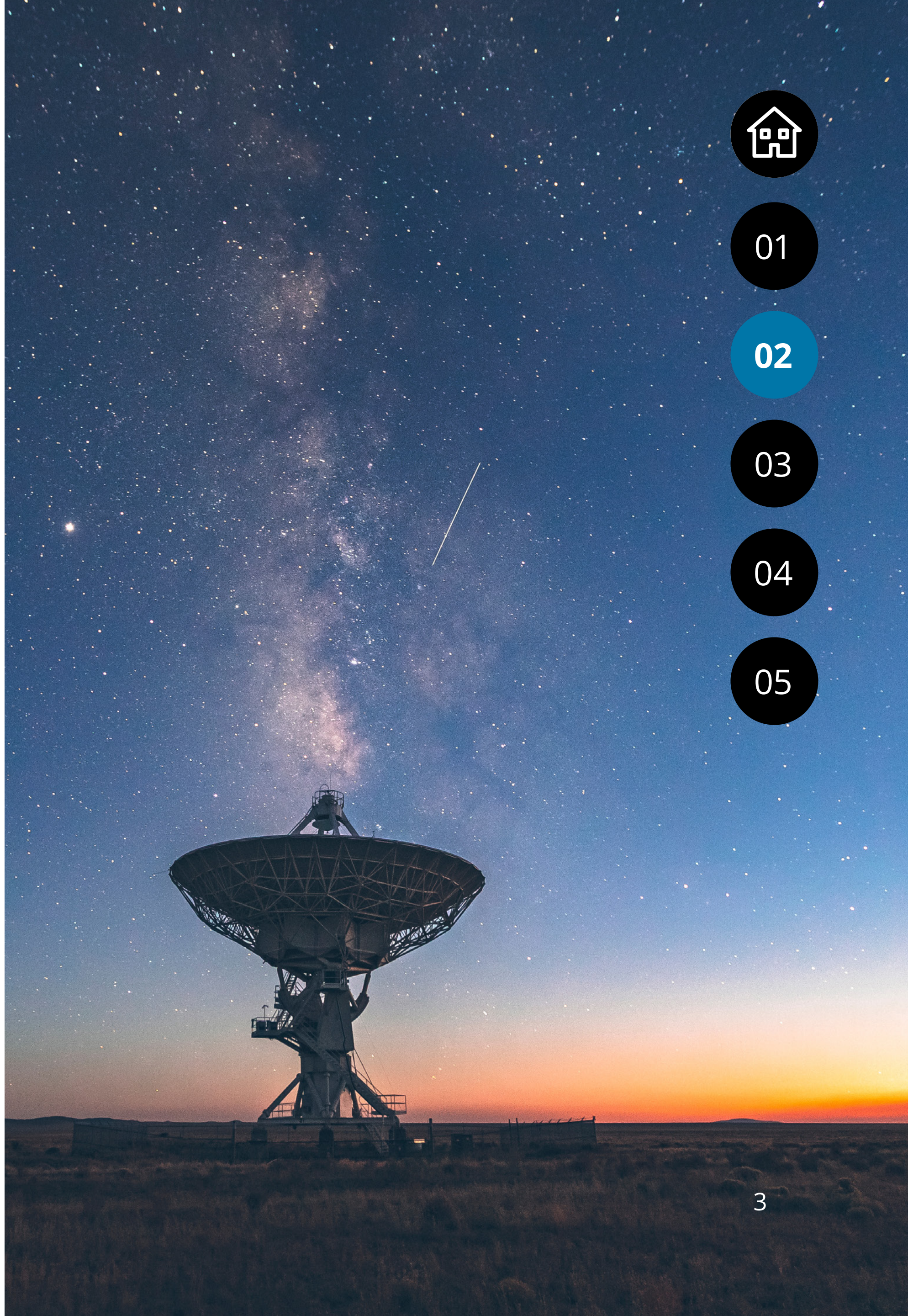
When to consider special purpose financial statements

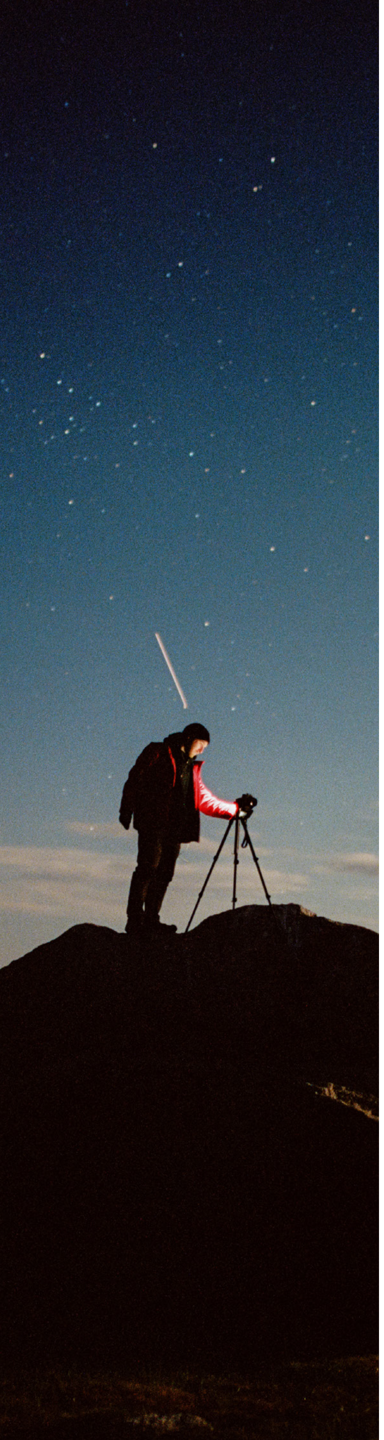
Your entity may prepare financial statements for a specific group of users, such as regulators, banks, real estate landlords, family member owners, or investors/ customers. Special purpose financial statements can often be more relevant and less costly to prepare than financial statements that are fully GAAP or IFRS compliant, depending on the intended use of the financial statements.

We see this most frequently considered when certain financial services entities are privately held and have no Securities and Exchange Commission (SEC) or other regulatory reporting requirements. For these entities, there is no need (nor, for the most part, any expectation of a future need) to file reports with the SEC that would require SEC and GAAP or IFRS-compliant financial statements. Additionally, special purpose financial statements can still be subject to review or audit procedures by an independent auditor with the applicable basis of accounting applied.

While cash and tax basis are among the most used, we have observed the contractual basis also being used within financial services firms. We see financial services entities utilize special purpose financial statements prepared under a contractual basis when the following are present:

- Complex or unique compensation and share-based equity arrangements
- Contract provisions requiring unique financial reporting calculations, such as partnership agreements, line of credit agreements, or service agreements
- Users who prefer unconsolidated financial statements so they can understand the reporting entity's operational and economic results better (particularly observed with asset managers when consolidation of the funds they manage would be required)
- Users who prefer the ability to separately disclose accounts that would be presented together (such as partner accounts, income on certain investments, or liabilities to certain parties)
- Complex tax arrangements





Typical special purpose exceptions

There is no established standards or guidance on how to report transactions and what modifications are appropriate; however, we have observed certain modifications utilized more regularly depending on the industry. For financial service entities who utilize special purpose financial statements, specifically those prepared under a contractual basis, the following table highlights some of the more frequently observed modifications.

Impacted area	Description
Investments and loans	• Elect to report investments in other entities at cost, fair value, or equity method, rather than on a consolidated basis; accounting for certain investments at cost or using the equity method, instead of applying full consolidation guidance, can result in special purpose financial statements being more useful to financial services entities that have small equity stakes but direct the significant activities of the funds they manage primarily on behalf of fund investors • Elect to report investments at historical cost instead of fair value or another appropriate amount
Compensation and benefits	• Reflect partner distributions and/or withdrawals as equity distributions or withdrawals instead of compensation expense • Treat bonuses and other compensation plans as cash bonuses (i.e., expensed when paid) as opposed to a defined benefit or post-retirement benefit • Treat share-based compensation as cash bonuses, valued on the vesting date rather than grant date, as opposed to amortizing over the service period • Record pension liabilities at the amount determined to be deductible for tax purposes
Other areas	• Decide against presenting expenses paid on behalf of the funds, and the subsequent reimbursement received from the funds, on a gross basis • Include only deferred revenue and other journal entries that impact cash (for financials reported on a modified cash basis) • Decide against adopting ASC 842 or IFRS 16—the accounting standards that bring most operating leases onto the balance sheet • Recognize transactions when they would be recognized in the company's tax return, and measure them based on the amounts that would be reported in the tax return • Account for certain items such as leases, contingent liabilities, depreciation, interest expense, and other fees or expenses under Internal Revenue Code rules

Common stumbling blocks

Special purpose financial statements do have some potential challenges. There is no single approach to preparing them, which could lead to confusion for both preparers and users of the financial statements. For entities accounting on a cash basis, it is also possible to manipulate the timing of receipts and distributions so that the financial statements fail to provide a complete picture of the entity's economic condition. And there is always a chance they do not meet the requirements of certain users—or regulators, should the entity decide to go public or later have investors or lenders who require GAAP or IFRS-compliant financial statements.

Let us expand on that last point. Suppose a financial services entity finds itself having to unwind its special purpose financial statements. This could happen if the entity goes public or sells itself to another entity. It could also happen if a regulator—or a new counterparty such as a lender or investor—requires financial statements that are GAAP or IFRS-compliant.

To convert from special purpose financial statements to financial statements prepared under GAAP or IFRS, or vice versa, you need to know the differences between current presentation and GAAP or IFRS presentation and how many periods to present. You may also need to determine whether:

- Certain specialists (think valuation or tax experts) need to be involved.
- An audit is required and for how many periods.

Applying the excluded or modified topics of a generally accepted accounting framework can get complicated in a hurry. It often gets into complex areas of accounting that may require considerable judgment and when it comes to applying special purpose accounting frameworks, there is not much in the way of authoritative guidance. Accounting advisers can help determine whether an applied framework is acceptable and appropriate for the users of the financial statements and help a company understand the necessary adjustments needed to its financial statements.

Contacts

If you have questions about special purpose financial statements or need assistance with preparation or unwinding this type of reporting, please contact any of the following Deloitte professionals.

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