

## Booking of Private equities

### What is a private equity investment?

Private equity refers to an investment in unlisted companies. In most cases, these investments are not made directly, but via a private equity management company that invests in a basket of unlisted companies.

When investing in private equity, the investor undertakes to pay a certain amount (*capital commitment*) to the private equity management company on demand within a specified period of time (*capital contribution*). The investor receives repayments (*distributions*), interest and dividends, and pays expenses. The investment is made for a relatively long period, usually around 10 years. Certain private equity investments are managed by the private equity management company as investment funds and are therefore recorded "normally" in ePOCA. However, many private equity investments are not settled via shares, but are managed like an account. This account is also posted with realised and unrealised gains/losses. The investor receives a periodic (monthly or quarterly) statement from their private equity account, which may look as follows:

Estimated Capital Account Statement			
Private Equity ABC			
<u>Period: 1 October 2017 – 31 December 2017</u>			
Inception (12 August 2013) to 31 December 2017 information (in USD)			
Capital commitment			5,000,000
Capital contribution			4,300,000
Unfunded capital commitment			700,000
Capital account balance			2,453,125
Cumulative distributions			3,756,348
<b>Total value (estimated capital account plus cumulative distributions)</b>			<b>6,209,473</b>
in USD	Current period	Year-to-date	
Capital account opening balance	2,573,625	2,645,826	
Capital contributions	100,000	200,000	
Distributions	-126,437	-243,675	
Interest and dividend income	4,367	12,632	

Management fees	-10,156	-42,750
Other expenses	0	-7,431
Net operating income (loss)	-5,789	-37,549
Net realised gain on investments	13,528	29,643
Change in unrealised appreciation (depreciation) of investments	-101,802	-141,120
<b>Estimated capital account ending balance</b>	<b>2,453,125</b>	<b>2,453,125</b>

This "account statement" as at 31 December 2017 shows that of the promised investment of USD 5 million from 12 August 2013 (*capital commitment*), USD 4.3 million has already been paid in (*capital contribution*), meaning that a commitment of USD 0.7 million remains (*unfunded capital commitment*). The investor has already received payments totalling USD 3,756,348 (*cumulative distributions*) and the estimated value of his account as at 31 December 2011 is USD 2,453,125 (*capital account balance*), which amounts to a total value of USD 6,209,473. This upper part of the statement is a summary of the investment to date.

The lower part of the statement shows the changes in the current period, i.e. in the fourth quarter of 2017 (referred to as *the current period*) and in 2017 (referred to as *year-to-date*). The value of the private equity account at the beginning of the current period is USD 2,573,625 (*capital account beginning balance*). In the current period, USD 100,000 was paid in (*capital contributions*) and the investor received USD 126,437 as a payout (*distributions*). These amounts have been posted independently of this document, as they represent movements on a current account. This means that the investor has already received documents for these transactions. The other (underlying) changes are movements in the private equity account itself and are posted as at 31 December 2017.

The *net operating income* consists of the three items directly above: interest and *dividend* income posted with PED, management fees and other *expenses* posted with PESP. This is a loss that was charged to the private equity account.

The realised gain (*net realised gain on investments*) on this account statement is posted with PERG, while a realised loss would be posted with PERV. The unrealised loss (*change in unrealised appreciation (depreciation) of investments*) on this account statement is posted with PEUV, while any unrealised gain would be posted with PEUG. Please note that these two transactions are closing entries and may be treated differently depending on the accounting standard. We will analyse the case of the lower of cost or market principle later.

In our example, we have realised gains (*net realised gain on investments*) of USD 13,528 and unrealised losses (*change in unrealised appreciation (depreciation) of investments*) of USD 101,802.

The value of the private equity account at the end of the current period, i.e. as at 31 December 2017, is then USD 2,453,125, which corresponds to the value of the account at the beginning of the current period and all changes in the current period.

## Booking of private equity investments in ePOCA

### Type of accounting

Private equity investments can be managed in ePOCA either as an "account" or as a "position with number of units". Accounting as an account is the simplest method and is recommended whenever possible.

### **Accounting as an account**

The account balance of the private equity investment is taken as the quantity. This quantity is always valued at 100%, so that it also corresponds to the market value of the private equity investment in the currency of the transaction. Contributions and distributions change the quantity when they occur, i.e. when a corresponding document is received from the bank. Other changes to the quantity are recorded when the transactions are posted from the "account statement" of the private equity investment, as described above.

Although managed like an account, the private equity investment must be defined as a "normal" security. The private equity security is posted alongside the contributions and distributions in accordance with the account statements received.

First, however, we must define the private equity security in the security master data. Since the security is treated like an account, the following fields are of particular importance:

- The price currency must be the currency of the private equity investment.
- The price type must be "Account".
- The security price is always 100%, like an account.
- The security type must have the basic type "Private equity account".

These are prerequisites for the correct posting of PE transactions and the subsequent analysis of private equity investments.

### **Accounting as a position with quantity**

Accounting for private equity investments as an account is not always the best solution. When accounting according to the lower of cost or market principle, for example, we do not want to value private equity at market value. This means that we cannot take the quantity as the balance of the private equity account. If the private equity investment is made via a bank, the bank often presents the private equity investment with an "artificial" quantity. This quantity is often one, but not always. In order to present a custody account statement that is identical to the bank's custody account statement, ePOCA must also work with this "artificial" quantity. That is why ePOCA offers the option of managing private equity investments as "positions with quantity". In this situation, it is possible to work with the bank's prices, which simplifies matters, especially when the bank's prices are imported. Since there are no particular restrictions on the quantity and price, it is possible to value the position as desired, regardless of the balance of the account statement.

Certain banks treat private equity investments as funds whose shares correspond to the account balance of the private equity investment. This leads to transactions that are unnecessary thanks to PE transactions in ePOCA, such as "quantity adjustments". In this case, we recommend only posting the bank's cash-relevant transactions on an ongoing basis. The remaining transactions are posted after receiving the private equity account statement, as described in this document.

First, however, we must define the private equity security in the securities master data with the following important fields:

- The price currency must be the currency of the private equity investment.
- The price type must be "Unit".
- The security type must be the basic type "Private Equity Unit".

Only the first PEC and last PED transactions are entered with the desired quantity; all other PE transactions are entered with a quantity of 0.

These are prerequisites for the correct posting of PE transactions and the subsequent analysis of private equity investments.

### Other transactions with both accounting

There may be transactions other than PE transactions. External expenses (not charged to the PE account), for example, are posted "normally" with SPB transactions. This posting should not be posted with capitalised expenses. If the private equity investment is held in a foreign currency, a value adjustment with an unrealised foreign exchange gain/loss is posted at closing. Please note that managing the PE investment in foreign currency means that there is a realised foreign exchange gain/loss on a PEAZ transaction.

### Comparison of accounting as an account or as a position with number of units

For market value accounting, we recommend posting as an account; for lower of cost or market accounting, we recommend posting as an item with quantity.

	Account	Position with quantity
Quantity	Account balance is significant	Number of items has no significance
Price	Always 100%, does not need to be entered or imported	Can be any value, must be adjusted to the number of units. *)
Image from the custody account statement	Display in ePOCA not necessarily possible, as no number of shares	Display possible
Accounting at market value	Accounting and valuation possible without price entry	Accounting and valuation possible with price entry
Accounting at lower of cost or market	Accounting possible, valuation not possible if not equal to account balance	Accounting and valuation always possible

\*) If the number of units represents the value of the private equity, the price must always be one. If the number of units is always one, the price must be the market value of the private equity. In general, you must ensure that the number of units x price equals the market value of the private equity.

Both types of accounting are performed with the same transactions, but with different entries. This will be explained later in this document.

## Posting

Even when accounting for the private equity investment as an account, the entries are made to a "COST" account and not a "BANK" account.

Private equity transactions are posted in ePOCA using specific transactions whose codes begin with "PE" for quick identification. The transactions are the same for accounting by account and by position with number of units. The entries in the "Addition/Disposal" and "Income" masks are also identical; only the entry for the quantity differs. For posting by account, the quantity is always equal to the addition or disposal of the account. For accounting by position with quantity, the first deposit transaction is entered with the quantity. All subsequent transactions are entered with a quantity of zero. Any adjustment to the quantity can be entered with PEEZ or PEAZ.

The current transactions are the deposits and withdrawals that are posted when the corresponding **bank document** is received:

Posting code	Name	Description of entry / Description of the entry in ePOCA
PEC	Deposit <i>Contribution</i>	Entered and posted as a purchase.
PED	Payment <i>Distribution</i>	Entered as a sale. Posted as a disposal without exchange rate gain/loss.

The periodic transactions are posted upon receipt of the account statement (as in the example above):

Posting code	Name	Description of entry / Description of the entry in ePOCA
PEI	Dividend <i>Dividend</i>	Entered and posted as a dividend.
PEFEE	Expenses <i>Fees</i>	Entered and posted as an expense transaction.
PEGR	Realised gain <i>Realised gain</i>	The gain is entered as an addition and posted as a realised gain.
PELR	Realised loss <i>Realised loss</i>	The loss is entered as a disposal and posted as a realised loss.
PEGNR	Unrealised gain Unrealised gain	The gain is entered as an addition and posted as an unrealised gain.
PELNR	Unrealised loss Unrealised loss	The loss is entered as a disposal and posted as an unrealised loss.

When managed as an account, all these transactions are posted on the basis of the account statement, so that the balance of the private equity position in ePOCA matches the balance of the account statement, which is also the market value of the investment. This is therefore perfect for market value accounting.

When managed as a position with a number of units, we have more flexibility in posting. Of course, all transactions on the account statement can also be posted. For accounting at the lower of cost or market value, for example, we can post all transactions on the account statement except for unrealised gains. Clearly, the realised gains/losses given in the account statement are calculated relative to the market value, which does not correspond to our book value. However, it is the best approximation we can achieve in clean securities accounting.

We assume that the private equity management company only uses deposits, income and realised gains for distributions. This means that the balance of the private equity position always remains positive and only goes to zero when all investments are sold. If it is nevertheless to become negative with a distribution, we recommend posting a realised gain beforehand so that the balance of the position does not become negative.

## Posting of distributions

The posting of payouts must be examined very carefully. Private equity management companies often separate liquidity from the actual investment in private equity. This liquidity is invested in interest-bearing instruments and the income is distributed to investors. Since investors do not pay in at exactly the same time, this income is calculated and paid out individually. This payment is usually made directly from the liquidity account and not from the actual private equity account. Therefore, these returns must be posted in ePOCA with a "D" transaction and not a "PEI" transaction.

The distinction between "recallable distribution" and "non-recallable distribution" is not relevant for posting in ePOCA. However, they can still be posted separately with a corresponding posting text in order to calculate the "unfunded commitment".

## Note on booking

- Realised and unrealised foreign exchange gains/losses can be posted using the corresponding transactions PERDG (realised foreign exchange gain), PERDV (realised foreign exchange loss), PEUDG (unrealised foreign exchange gain) and PEUDV (unrealised foreign exchange loss). In most cases, gains/losses are reported without differentiating between capital and foreign exchange components.
- If the private equity investment is in a foreign currency, the currency fluctuation can be adjusted "normally" at the time of closing.

## Special feature of private equity accounting

### ***Value of the private equity investment or corrections***

The value of the private equity investment is only known when you receive a statement of account, which is usually on a monthly or quarterly basis. In the meantime, the value of the investment is unknown. You may even receive an unaudited account statement first and then a revised (*audited*) one later. This is because the value of the private equity investment requires the valuation of unlisted companies. This valuation is based on the company's accounting, which itself must be audited. This entire process cannot, of course, be carried out on a daily basis and requires a certain amount of time.

## Private equity performance

Calculating performance over a period of time requires the value of the investment at the beginning and end of the period, as well as the cash flows during the period. As seen above, the value of the investment is known on the days of a statement, and some of the cash flows (deposits and withdrawals) are known on an ongoing basis. Performance

between two points in time can be calculated with a high degree of accuracy using a bank statement, as only the timing of the internal flows of private equity is not known precisely. To determine performance at intermediate points, it must be assumed that the value of the investment has not changed, with the exception of deposits and withdrawals, which are always taken into account on an ongoing basis.

Of course, it is impossible to calculate true TWR performance, as the value of the investment is not known on a daily basis.

## Analysis of private equity investments

The analysis of an investment's private equity investments consists of an analysis of the past period and an analysis of future cash inflows.

- The analysis of the past period mainly consists of the value of the investment at the beginning and end of the period and the changes during the period. These changes in monetary amounts can also be expressed as performance in %.
- The analysis of future payments consists of the amount of money that still has to be paid in (*capital commitment minus contributions*). As these payments are made on demand, the exact timing of the payments is not known. However, it is known by when these payments will be requested. This date is a valuable component of the analysis.

This analysis can be carried out at the level of each individual private equity investment or at the level of all private equity investments together. An example of such an analysis is shown in the appendix (the table has been simplified for reasons of space: details of changes in value have been summarised in one column).

## Transfer of a private equity investment to ePOCA

- First, enter any payments already made with PEEZ and any disbursements with PEAZ (summarised on the transfer date).
- Enter the value difference with WPE.

This allows the analysis of future payments to be carried out correctly.

Let us assume that we would transfer the example "Private Equity ABC" presented at the beginning of this document to the accounting system at the end of September 2017. We would then have the following transactions as of 30 September 2017, with a corresponding USD/CHF exchange rate:

Posting code	Amount in USD	Description
PED	4,300,000	Deposits already made
PEC	-3,756,348	Payments already made
WPE	1,909,473	Difference from market value as delivery

The balance of the entries described is ultimately 2,453,125, which corresponds exactly to the balance of the example private equity as at 30 September 2017 on the account statement (*estimated capital account ending balance*).

## Appendix: Analysis of private equity investments

For the period from 1 October 2017 to 31 December 2017, in thousands of CHF:

Name	Value at beginning	Contribution	Distribution	Change in value	Value at end	Performance	Commitment	Remaining contribution	Until date
PE 1	2,573	100	-126	-94	2,453	-3.35	5,000	700	28 May 2021
PE 2	3,413	200	-84	124	3,653	3.77	6,000	2,200	22.04.23
PE 3	2,123	100	0	72	2,295	2.94	4,500	2,400	13.10.22
Total	8,109	400	-210	102	8,401	1.23	15,500	5,300	-

The first columns show the opening balances and entries for the period in terms of monetary value. The "Change in value" column shows the total expenses and realised and unrealised gains/losses. The result for the period is shown in the "Performance" column as MWR performance. The "Remaining contribution" column shows the difference between the commitment and the contributions already paid. In this example in particular, we can see that we still have to pay CHF 5,300,000 in contributions for private equities.