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INSIDE

AICPA Launches Working Draft of Accounting and Valuation Guide

After a five-year development process, the American Institute of Certified Public Accountants (AICPA) released in May 2018 a working draft of an Accounting and Valuation Guide titled "Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies" (The Guide).

The Guide is intended to aid valuation experts, auditors, fund staff, students and other investment industry participants, whether they're learning about the valuation process for the first time, or require guidance and/or clarification on valuation judgments in particular situations.

Fund Managers will be able to build from the Guide's articulated best practice, and investors in funds will have a measuring stick for the robustness of a Fund Manager's valuation process.

The Guide provides a comprehensive overview of the valuation process, clarifying the roles and responsibilities of various parties involved. Readers of the Guide will find that it:

- **Makes best-practice recommendations** for complying with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 946,[ii] and FASB ASC 820 fair value measurement concepts. Given that the definition of fair value is currently being harmonized across most global accounting standards, these recommendations are relevant to international users;[iii]
- **Provides guidance** on market participant assumptions, unit of account, and an overview of valuation approaches;
- **Addresses restrictions** on transfer, calibration, back-testing, and factors to consider at or near a transaction date; and
- **Answers frequently asked questions** and provides appendices addressing documentation considerations and case studies.

Written to be both informative and user-friendly, the Guide supplements its advice with case studies that help reason through the valuation decisions made by auditors, investment fund managers, and valuation experts. Specialists in particular fields can delve into individual chapters that cover their areas of interest in more detail.

The Guide broadens the formerly limited guidance on valuation best practice for alternative investment managers, who have not historically applied fair value techniques to their debt investments. Practitioners and users of fair value information may now consider the Guide's advice in the working draft as a consistent basis for valuing private investments, including debt investments, thereby allowing a common basis to monitor investments and make investment decisions.

"Because of its thorough vetting process, AICPA guidance has a tendency to be applied uniformly by auditors," explained David Larsen, Managing Director in the Portfolio Valuation Practice at Duff & Phelps. "As such, we believe that over time auditors, investors and regulators will expect all alternative asset valuation practices to be in harmony with the Guide."

The Guide is not intended to change the present consensus on accounting guidance. While considered non-authoritative, the Guide offers advice that should be regarded as best practice, given its thorough vetting by the AICPA, major accounting firms, and experts in the valuation industry.

i. Working Draft of the AICPA Accounting and Valuation Guide. (2018, May 15). Retrieved September 14, 2018, from https://www.aicpa.org/interestareas/frc/accountingfinancialreporting/working-draft-of-pe-vc-guide.html

ii. Financial Services—Investment Companies (Topic 946). Retrieved September 14, 2018, from https://www.fasb.org/cs/r?blobkey=id&blobnocache=true&blobwhere=1175827361697&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs

iii. Fair Value Measurement (Topic 820). Retrieved September 14, 2018, from https://asc.fasb.org/imageRoot/00/7534500.pdf

Hong Kong Legislates Long-Awaited Transfer Pricing Framework

On July 13, the publishing of Inland Revenue (Amendment) (No. 6) Ordinance 2018 ("the Amendment Ordinance") [i] marked a long-awaited alignment of the Hong Kong transfer pricing framework with international consensus on Base Erosion and Profit Shifting (BEPS).

The Amendment Ordinance affects Part 8AA of the Inland Revenue Ordinance (IRO), implementing BEPS Action Plan recommendations [ii] promulgated by the Organisation for Economic Co-operation and Development (OECD).

With the Amendment Ordinance now in force, the Hong Kong Inland Revenue Department (IRD) can more effectively counteract tax structuring and planning practices that create misalignment between value creation and profit and tax outcomes.

The following BEPS-centered principles and concepts have been codified by the Amendment Ordinance:

- **Formalization of Arm's Length Principle**. In cases where related party transactions are deemed to be inconsistent with the arm's length principle, [iii] resulting in an undue tax advantage, the IRD may intervene and adjust transfer pricing arrangements accordingly.
- **Affirmation of Separate Entity Concept**. Any Permanent Establishment (PE) operating in Hong Kong will be treated and taxed as a distinct and separate enterprise in accordance with accepted OECD PE principles. In addition, the IRD will adopt the Authorized OECD Approach as a recognized method of attributing profits to a Hong Kong PE, therefore requiring a well-documented functional analysis.
- **Codification of Advance Pricing Arrangements (APAs)**. The IRO will now allow for unilateral, bilateral and multilateral APAs, securing tax and transfer pricing certainty for both the taxpayer and the IRD. Instead of charging a fixed application cost, the IRD will have the discretion to charge fees for an APA application based on its officers' hourly rates, capped at a maximum of 500,000 Hong Kong dollars.

Compliance requirements for taxpayers will be revised accordingly. Among other changes, the Amendment Ordinance enforces a three-tier documentation framework – master file, local file, and Country by Country Report (CbCR) – recommended by BEPS Action 13, [iv] which requires Hong Kong taxpayers of a certain scale to prepare formal transfer pricing documentation.

The Amendment Ordinance authorizes the IRD to charge administrative penalties up to 100% of undercharged tax in cases where tax returns are filed on the basis of non-arm's length transfer pricing positions. The IRD is also empowered to seek criminal charges against directors and tax agents of offending entities.

Finally, the Amendment Ordinance introduces a statutory dispute resolution mechanism by way of Mutual Agreement Procedure. On one hand, any proposed double tax relief must be negotiated and effected by the Commissioner of Inland Revenue; on the other, taxpayers can take some comfort that cases can be further referred for arbitration under a relevant Comprehensive Double Taxation Agreement.

i. The Inland Revenue (Amendment) (No. 6) Ordinance 2018. (2018, July 13). Retrieved September 12, 2018, from https://www.ird.gov.hk/eng/pdf/2018/ira_no6b_e.pdf

ii. OECD (2013), Action Plan on Base Erosion and Profit Shifting, OECD Publishing. http://dx.doi.org/10.1787/9789264202719-en

iii. Neighbour, J. (2002, June). Transfer pricing: Keeping it at arm's length. Retrieved September 13, 2018, from http://oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html

iv. Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting. (2015). Retrieved September 12, 2018, from https://www.oecd.org/ctp/beps-action-13-guidance-implementation-tp-documentation-cbc-reporting.pdf

CFIUS Reform Nearing Passage in Washington, with Implications for Companies

Nine months after its introduction as a bill, the passage of the Foreign Investment Risk Review Modernization Act (FIRRMA) looks like a foregone conclusion.

The recently finalized National Defense Authorization Act for Fiscal Year 2019 (NDAA), released in its final form in a July 23 Conference Report, contains the text of FIRRMA. [i] Its high impact provisions are expected to take effect as soon as President Trump signs the bill into law.

The legislation – a long-awaited update to the Committee on Foreign Investment in the United States (CFIUS) review process – represents a sea change in how the U.S. assesses and manages national security risks arising from foreign direct investment.

In terms of policy, FIRRMA lays out a consistent foundation that serves as the basis for a better-organized, more robust CFIUS review process. In terms of implementation, FIRRMA is broadly drafted. It is not written to address Chinese investments per se, though historically high levels of Chinese investment and fears of a trade war have certainly increased the perceived urgency of FIRRMA's passage.

"This legislation takes a carefully tailored approach to updating the review process without hamstringing our ability to meaningfully engage in trade with partners around the world," explained U.S. Senator John Cornyn (R-TX), a fervent advocate for CFIUS reform. "A newer, stronger CFIUS process will better protect us from evolving investment-driven threats to our national security." [ii]

FIRRMA's most decisive changes to the CFIUS review process include:

Four new types of "covered transactions," or transactions falling under CFIUS's jurisdiction. These transactions consist of nonpassive foreign investment in critical infrastructure and technology companies; real estate investments in "close proximity" to sensitive areas affecting U.S. security; changes in a foreign investor's rights regarding a U.S. business; and transactions designed to avoid CFIUS's jurisdiction.

Mandatory CFIUS notifications for certain investments. Notifications may be triggered if nonpassive foreign investors buy into certain U.S.-based "critical technology" companies or if investors substantially owned by a foreign government acquire a "substantial interest" in certain U.S. businesses.

Expanded definition of "critical technology." A broader range of investments in "critical technology" companies could be subject to CFIUS review after the definition of "critical technology" was widened to include "emerging and foundational technologies."

Extension of committee's timeframe for review. The present 30-day review period will be expanded to 45 days under FIRRMA, followed by a further 45-day investigation phase that may be extended by an additional 15 days given "extraordinary circumstances."

Increased information sharing with foreign allies. In the interest of national security, CFIUS will share relevant information to non-U.S. regulators, subject to appropriate confidentiality and classification requirements.

Parties under CFIUS jurisdiction must increase their vigilance after FIRRMA's passage into law. They must assume that any information they divulge about foreign investment in a U.S.-based business may undergo regulatory scrutiny and intervention in extreme cases, their information may be shared with foreign allies of the U.S. They must also increase their diligence in preparing notifications and investment filings given FIRRMA's more robust requirements.

i. Conference Report, H.R. 5515 John S. McCain National Defense Authorization Act for Fiscal Year 2019 (June 2018). Retrieved September 12, 2018, from https://docs.house.gov/billsthisweek/20180723/CRPT-115hrpt863.pdf

ii. Cornyn: Final Defense Bill to Include Strong Bill Modernizing CFIUS (24 July 2018). Retrieved September 12, 2018, from https://www.cornyn.senate.gov/content/news/cornyn-final-defense-bill-include-strong-bill-modernizing-cfius

China Streamlines MOFCOM Approval for Outbound Investments by Local Enterprises

The State Council of the People's Republic of China issued its decision on abolishing a batch of administrative approval Items on July 28. The decision eliminates the two-step approval process for nonfinancial overseas direct investments (ODI) by local enterprises.

Specifically, provincial departments in charge of commerce (COFCOM) will no longer perform a preliminary review for approval of non-financial investments in overseas enterprises by local enterprises; the approval procedure will now be the same as the one required.

According to guidelines previously set out in Ministry of Commerce Order No. 3 of 2014, [i] the Ministry of Commerce (MOFCOM) must approve any nonfinancial ODI by central and local enterprises. The measures oversee ODI undertaken by enterprises established in mainland China in sensitive regions and industries, as well as industries affecting the interests of more than one country.

Pursuant to the new decision, the two-step approval procedure for nonfinancial ODI by local enterprises has been eliminated.

Oversight on such transactions was previously the domain of the Local Provincial COFCOM. Local enterprises were required to apply to MOFCOM through their Local Provincial COFCOM, which would forward its preliminary review conclusions and supporting documents back to MOFCOM for final approval. The decision eliminates this middle step, simplifying the approval process.

Not all ODI are covered by the new decision: Transactions by mainland China enterprises that do not involve "sensitive countries and regions" or "sensitive industries" must still be filed with MOFCOM (for central enterprises) or relevant Local Provincial COFCOM (for local enterprises). Financial ODI by mainland China enterprises still require an approval document or a no-objection letter from relevant Chinese financial authorities.

Nonfinancial ODI by Chinese investors reported growth of 25.2% year-on-year, amounting to US$16.82 billion in investments in over 1,400 overseas enterprises across 135 countries and regions. [ii]

i. 商务部令2014年第3号《境外投资管理办法》中华人民共和国商务部网站. (Ministry of Commerce Order No. 3 of 2014 on Measures for the Administration of Overseas Investment) (2014, September 6). Retrieved September 12, 2018, from http://www.mofcom.gov.cn/article/b/c/201409/20140900723361.shtml

ii. MOFCOM Department of Outward Investment and Economic Cooperation Comments on China's Outward Investment Cooperation in January-February 2018. (2018, March 16). Retrieved September 12, 2018, from http://english.mofcom.gov.cn/article/newsrelease/policyreleasing/201803/20180302719674.shtml

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PRC Regulators Ease Limits on QFII and RQFII Programs, Further Opening Capital Markets

Foreign fund manager outflows from China have been further eased with the introduction of two documents by the State Administration of Foreign Exchange (SAFE) and the People's Bank of China (PBoC). [i]

On June 10, 2018, SAFE released an updated Foreign Exchange Administrative Provisions on the Domestic Securities Investment by Qualified Foreign Institutional Investors (the QFII FX Rule). Two days later, on June 12, SAFE and PBoC jointly issued an updated Circular on Administration of Domestic Securities Investment by Renminbi Qualified Foreign Institutional Investors (the RQFII Circular).

Both documents streamline foreign exchange administration under the existing QFII and RQFII regime by removing relevant restrictions on funds remittance and repatriation, among other things. The rule changes should reassure overseas investors, who now face friendlier conditions for investing in the Chinese mainland.

Key developments under the QFII FX Rule and RQFII Circular include:

- **Removal of 20% remittance ceiling.** Formerly, a QFII license holder (or an open-ended fund managed by a QFII) could not remit more than 20% of the QFII's (or the fund's) total assets in China as of the end of the preceding year. The removal of the remittance ceiling now aligns QFII and RQFII regimes more closely with international regulations on cross-border funds flow.

- **Removal of three-month lock-up period**. Formerly, QFIIs and RQFIIs were prevented from taking capital out of the country for three months starting from the date on which the cumulative investment principal remitted into China reached US$20 million for QFIIs or RMB100 million for RQFIIs.

- **QFIIs and RFQIIs are now allowed to conduct hedging**. Investors can now offset foreign exchange risks by comparing pricing and terms between onshore and offshore markets.

Beijing hopes the rule changes increase the number of foreign investors qualified to participate in China's capital markets. Stringent regulations prohibit foreigners from fully investing in China's markets; investors seeking exposure can resort to the QFII and RQFII Schemes instead.

The Qualified Foreign Institutional Investor Scheme was introduced in 2002, allowing foreign investors direct access to China's capital markets; the Renminbi Qualified Foreign Institutional Investor Scheme began in 2011, allowing Hong Kong subsidiaries to use renminbi funds raised in Hong Kong to invest in China's domestic securities market.

As of May 2018, 287 overseas institutions had received quotas of US$99.46 billion under the QFII program, while 196 foreign institutional investors received quotas of 615.85 billion yuan (about US$96.2 billion) under the RQFII program. [ii] Both pale in comparison with China's onshore stock market, whose value is estimated at US$7 trillion. [iii]

i. Another Milestone – PRC Regulators Further Streamlined Foreign Exchange Administration of QFII and RQFII. (2018, June). Retrieved September 12, 2018, from https://www.cliffordchance.com/briefings/2018/06/clifford_chance_clientbriefingprcregulator.html

ii. China eases restrictions on institutional investor programs. (2018, August 1). Retrieved September 12, 2018, from http://www.xinhuanet.com/english/2018-06/12/c_137249270.htm

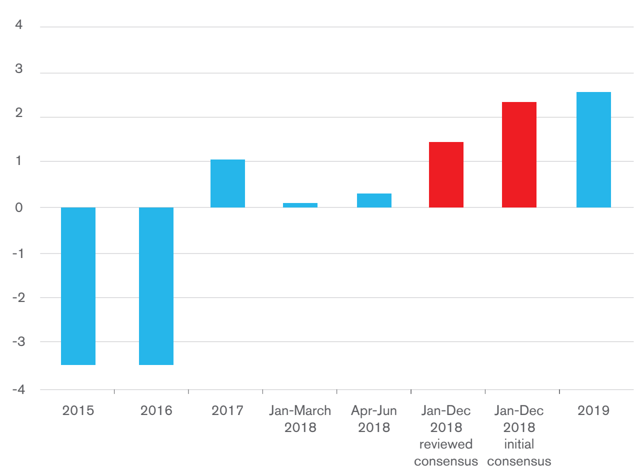
iii. Wang, O., & Zhou, X. (2018, June 14). China makes it easier for foreign investors to get money out, but who wants to qualify for it? Retrieved September 12, 2018, from https://www.scmp.com/news/china/economy/article/2150484/china-makes-it-easier-foreign-investors-get-money-out-who-wants

Political Uncertainty May Slow 2H 2018 Brazilian M&A Performance

As the election in Brazil approaches, political uncertainty may slow investment activity in the second half of 2018. Questions about who will lead the country has led many investors to delay closings until post-election in October.

Besides the election, a number of unexpected socioeconomic events have affected Brazil's gross domestic product (GDP), which grew at a slower pace than expected for the first half of the year. GDP for 2018 was initially predicted at 2.3% but is now closer to 1.5%, according to a Central Bank report. The change is attributed to the truckers' strike in May, higher than expected inflation, continuing high unemployment rate (at 12.3%, according to IBGE), a persistent fiscal deficit and high government debt (at 77% of GDP, according to the Central Bank) and the interruption of the voting in Congress.

Brazil - GDP Growth (%)

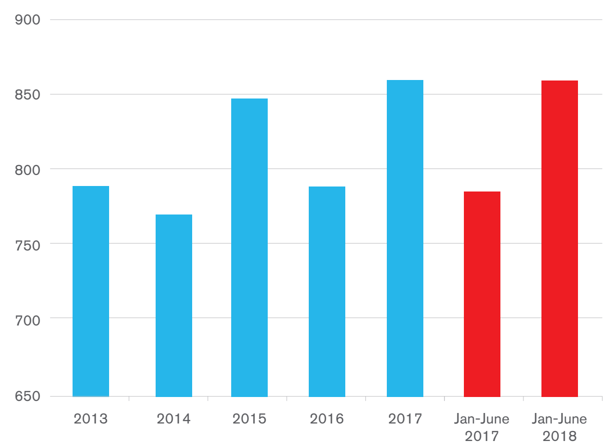


Source: 2014 - 2017 Brazilian Central Bank/2018-2019 market consensus

Despite these factors, M&A activity in Brazil has gained momentum. In the first half of 2018, M&A activity grew 18% compared to the same period in 2017, with 471 transactions announced and a total value of R$ 101 billion (US$ 28 billion), according to Fusões & Aquisições. Driving this are lower interest rates (the basic rate is at a record low of 6.5% per year) and a depreciated Real against the Dollar (a trend observed worldwide, where the Dollar has strengthened). As a result, Brazilian assets are very attractive propositions in terms of purchase price and many buyout opportunities are being explored. But in the second half of the year, business in general is awaiting the outcome of the election before making important decisions – a behavior that is holding back M&A transactions.

The deal flow would have been even more robust if there were no disagreement between buyers and sellers, particularly on target company valuations (driven mainly by different points of view on short and mid-term perspectives and projected risk). Sellers are asking higher prices, expecting the same value as those seen prior to Brazil's recent economic crisis. However, buyers are not in a position to pay.

Brazil - Number of Announced Transactions



Source: IBGE; Focus report

According to Transactional Track Record, technology was the most active sector in the first half of 2018, followed by financial services. The same report concludes that transactions involving venture capital funds increased 23% compared to the first half of 2017, showing an increased appetite for riskier assets even in a less-than-favorable economy.

Private equity investment remains strong, with fund managers expecting to raise between US$ 3.5 billion and US$ 3.7 billion in 2018 for their funds in Brazil, which Valor Econômico reports as the highest level since 2014. Although the domestic environment for raising capital is challenging, international investors continue to have an appetite for Brazilian investments.

Despite growth in some sectors, Brazil is below target investment rates. According to IBGE, Brazil has investment rates of about 15% of GDP, where it should be targeting 20%. A well-structured and ambitious program of privatization and concessions is one way to attract investments, strengthen growth and reduce unemployment. Brazil's investment needs will likely be funded privately, as the government is unable to satisfy the demand for funds.

Capital markets will also play a decisive role in Brazilian investment and development. According to an Accenture Strategy study, a stable growth scenario of 2% to 3% per year and an active capital market could bring Brazil an additional R$ 300 billion in funds and infrastructure investments from 2018 to 2022. This could generate an additional 1.7 million jobs and increase average per capita income about 12% in a period of four years.

Looking further ahead, M&A activity will likely increase over the next few years as investments are made to improve Brazil's infrastructure deficits in healthcare and education (mainly in K–12, EdTechs and corporate training). In healthcare, which is overall still regional and fragmented, there are many opportunities for consolidation.

Renewable energy and real estate may continue to be M&A hot spots. Brazil's natural resources, specifically wind power, and the increasing demand for energy have heightened interest in the sector. Low property prices, in addition to favorable foreign exchange rates and low local interest rates, have created opportunities for real estate investors.
Investments in the country will likely be maintained by investors who are already acquainted with Brazil's intricate deal environment and economy. According to a report published by Saint Paul Escola de Negócios and the Brazilian Institute of Finance Executives, CFO levels of confidence remain high (at 130 points) after sinking to levels below 100 points in the first and second quarters of 2016. The report notes that companies are holding on to investments but have market confidence and cash for expansion and M&A activity when the right opportunities arise.

Driving near- and long-term activity in Brazil will continue to be speculation over the political outcome. The market expects that the next president will succeed in gaining approval on important structural reforms (priority should be the pension reform), reducing the government's fiscal deficit and creating a sustainable framework for increased economic activity and investments.

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