



Annual Investment Industry Update

November 18, 2023

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GIPS Update

Thomas A. Peters
Director, Audit & Accounting and
Investment Industry Group Leader

Joshua E. Kramer
Manager, Audit & Accounting
Investment Industry Group

Ashley Jiang
Manager, Audit & Accounting
Investment Industry Group

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Agenda

1. Discuss current projects and upcoming guidance
2. Review new GIPS tools and resources for firms
3. Summarize recently issued guidance statements and Q&As
4. Review key findings in the USIPC's net of fee performance survey



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OCIO Update

- This year the CFA Institute created a committee (The OCIO Working Group) to address GIPS Standards for OCIOs.
- What does OCIO stand for?
 - Outsourced Chief Investment Officer
- Why the need for additional standards?
 - There is concern in the industry that the current GIPS Standards do not meet the needs of users of the OCIO firm GIPS reports.
 - Much custom / ad hoc reporting done outside of GIPs composites
 - Much diversity in practice for how to group accts and present



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OCIO Update

- Who are the Users of OCIO GIPS Reports?
 - Consultants and asset owners
- What are the goals of the OCIO Working Group?
 - To write a consultation paper (like the GIPS 2020 consultation paper) soliciting feedback on key concepts proposed by the working group
- Where do OCIOs currently fit in GIPS Standards?
 - In the GIPS for Firms section
 - Note that Fiduciary Management Providers (FMPs) in the UK currently have a separate chapter of the GIPS standards as their requirements are unite.
 - OCIOs (which are largely US) might end up with a similar chapter.



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OCIO Update

- If your firm has an OCIO business, keep an eye out for the paper later in 2023. It will be announced in the GIPS newsletter and everybody will be provided the opportunity to provide feedback during the public comment period.
 - Please take the time to comment.



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New Tool

- In addition to the GIPS Standards and the Handbook, the CFA Institute has developed several handy tools to help firms with GIPS compliance.
- On their website, click Resources, then Tools, then Firms
- There are lots of useful tools, including:
 - Sample policies
 - Supporting calculations for various methodologies
 - Model RFP Template
 - SEC Marketing Rule information



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New Tool

- In 2022 the CFA Institute added another tool – a disclosure checklist for firms.
- Format is an Excel Workbook with sheets for each applicable section of the GIPS Standards
 - For example: Section 4 Composite Time Weighted Return Report
- All required and recommend disclosures are presented
- All requirements are x-ref back to specific provision of the GIPS Standards or Handbook.
- This is a useful tool which can aid in your review of a GIPS Report.



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Whitepaper: Reconciling the GIPS Standards and the SEC Marketing Rule

- In September 2022, CFA Institute released a valuable resource reconciling the GIPS Standards with the new SEC marketing Rule
- New Marketing Rule took effect for all registered advisors beginning November 4, 2022
- Whitepaper outlines key areas where differences exist between the GIPS standards and the SEC Marketing Rule
- Provides an overview of the performance requirements of the Marketing Rule
- Provides insights and interpretations of SEC Marketing Rule and how it could impact GIPS-compliant firm
- Includes list of disclosures required by the Marketing Rule that all firms should consider.



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Preliminary Performance

- SEC FAQ “The staff believes that a reasonable period of time to calculate performance results based on the most recent calendar year-end generally would not exceed one month.”
- Interim performance is acceptable during the one-month period following year-end
- May include preliminary performance in a GIPS Report and identify it as preliminary performance
- Subsequent changes made to the preliminary performance information based on more up-to-date information is subject to the firm’s error correction policy
- Alternative: supplemental information



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Benchmark Return Reduced by Transaction Cost

- Benchmark returns may be net of transaction costs
- Must disclose and label to make clear that the benchmark returns are reduced by transaction costs and the period for which transaction costs are deducted
 - For example, “XYZ Fixed Income Index (net of transaction costs).”
- Must also disclose any benchmark change
 - For example, “Effective July 2022, benchmark returns reflect the deduction of transaction costs that are calculated using the bid-offer spread for all new additions to the index, as well as any security whose weight increases in the index at each monthly rebalancing, beginning with the 30 June 2022 rebalancing. The beginning-of-month calculated transaction cost adjustment is applied to index returns daily for the following calendar month. Benchmark returns prior to July 2022 do not reflect the deduction of transaction costs.”



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USIPC Survey on Calculation & Presentation of Net Returns

- During Q2 2021, the USIPC conducted a survey to gather information pertaining to the calculation & presentation of net returns.
- Purpose of the survey was to determine how firms were addressing the requirements related to the calculation and presentation of net returns.
- Demographics – responses were gathered from firms of all sizes.
 - Less than \$250 million (9%)
 - \$250 million - \$1 billion (7.5%)
 - \$1 billion - \$5 billion (13.5%)
 - \$5 billion - \$20 billion (17%)
 - \$20 billion - \$50 billion (13%)
 - \$50 billion - \$250 billion (15%)
 - Greater than \$250 billion (25%)



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USIPC Survey on Calculation & Presentation of Net Returns

- As a quick reminder, the requirements for firms as it relates to net returns are:
 - For composites, firms have the option of calculating NOF returns using actual management fees or a model fee that is appropriate to prospective clients.
 - For pooled funds, firms have the option of either calculating net returns using actual total pooled fund fees or a model fee that is appropriate to prospective investors.
 - When using model fees, either for composites or pooled funds, the returns calculated must be equal to or lower than returns that would have been calculated using actual returns.
 - When including pooled funds in composites, as opposed to a separate pooled fund report, firms are only required to reduce gross returns by the pooled fund's management fee.
 - Wrap fee returns must be net of the entire wrap fee applicable to the prospective client.
 - For bundled fees, if a firm cannot segregate transaction costs and investment management fees from other costs, returns must be reduced by the entire bundled fee.



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USIPC Survey on Calculation & Presentation of Net Returns

- Key Takeaways

- Larger firms find it more practical to use a model fee, whereas smaller firms more often will use actual fees.
- When using actual fees, approximately 46% of respondents will reflect fees on the accrual basis while 35% reflect them on a cash basis.
- When using model fees, most firms surveyed (approx. 75%) utilize the highest fee in the tiered schedule for each strategy.
- When including a non-fee paying portfolio, firms are more likely (approx. 67%) to use actual fees.



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USIPC Survey on Calculation & Presentation of Net Returns

- Key Takeaways, *continued*
 - When including pooled funds in composite, a majority of respondents (approx. 50%) indicated that they only reduce the pooled fund gross returns by the pooled fund investment management fee.
 - Approx. 75% of survey respondents indicated that they use the safe harbor 3% model fee for wrap fee equity composites and 40% indicated that they use the safe harbor 1.5% model fee for wrap fixed income composites.
 - A majority of firms (60%) indicated that they only maintain one GIPS report for each composite, which presents a single net return.



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After-Tax Performance and Guidance

- Performance results that take into consideration the effects of taxes that would be incurred under the United States taxation rules.
- Historically (i.e. prior to 1/1/2011), the GIPS standards included country-specific guidance on taxation issues.
- Currently, firms are encouraged to comply with the UISPC After-Tax Performance Standards.
- Standards have become stale.
- UISPC conducted a survey to gauge the need the for an updated set of after-tax standards.
- The USIPC has undertaken the project and is currently working to update the standards.



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SEC Marketing Rule and Impact of Consulting Databases

- The new SEC Marketing Rule is posing challenges for Advisors who submit performance to databases.
- Industry participants are wondering whether providing performance information to consultant databases could be considered an indirect advertisement.
- Depending on database and how information is provided, investment advisors may not be able to input or provide all of the performance information required by the SEC marketing rule.
- Forcing investment advisors to make difficult decisions.
- USIPC is currently collecting information to get a better understanding of what firms are doing and how they are dealing with the potential conflict.



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Contact the Presenter



Thomas A. Peters
Director, Audit & Accounting and
Investment Industry Group Leader
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Tom has a wide range of experience providing audit, Global Investment Performance Standards (GIPS), operational due diligence, and compliance and consulting services to firms in the investment industry. In addition, he:

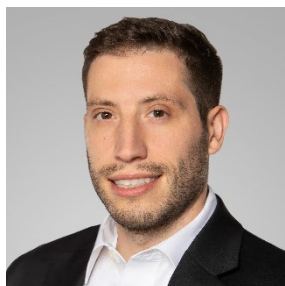
- Helps clients maintain GIPS compliance while presenting their performance in the best light possible. We offer a complimentary GIPS initial assessment to help clients understand their current status.
- Assists entrepreneurs with starting investment firms and investment funds
- Performs operational due diligence
- Assists with hiring personnel
- Has volunteered for several CFA Institute GIPS Committees and is currently Chair person of the OCIO Working Group

As the Investment Industry Group Leader, Tom works with a variety of investment managers, broker-dealers, investment funds, and institutional investors.

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Contact the Presenter



Joshua E. Kramer
Manager, Audit & Accounting, Investment Industry Group
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Josh has a wide variety of experience within the investment industry, including providing traditional audit and attestation services to investment managers, broker-dealers, and closely-held funds. In addition, he performs operational due diligence throughout the United States and Europe to help investors in understanding the operational risk inherent in their investment managers' operations.

Josh also specializes in the performance of firm-wide verifications and composite examinations for investment managers claiming compliance with the Global Investment Performance Standards (GIPS). In addition, Josh has assisted investment firms, seeking to make a claim of compliance with the GIPS Standards, in developing sound policies and procedures consistent with widely accepted practices related to the calculation and presentation of investment performance.



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Contact the Presenter



Ashley Jiang
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Ashley has experience providing audit and attestation services to investment funds, asset managers, and broker-dealers. She serves clients who manage a wide range of asset classes including equity, traditional fixed income, private placements, private equity, and real estate with various investment structures including hedge funds, funds of funds, and master-feeders. In addition, she provides consulting services including fee recalculation services for traditional and alternative investments.

Ashley performs operational due diligence to assist investors in understanding the operational risk inherent in their investment managers' operations. She also performs custody examinations in accordance with the Securities and Exchange Commission Rule 206(4)-2. Ashley also specializes in performing verifications and composite examinations of investment firms claiming compliance with the Global Investment Performance Standards (GIPS).



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The next session will begin at 1:25pm.

SEC Compliance Update

Chenery Compliance Group

January 18, 2023

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COMPLIANCE
GROUP

Prepared by:

John Canning

SEC Rules Coming Effective - Slated Spring 2023

- **Cybersecurity Risk Governance—Funds and Investment Advisers**
- **Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers**
- **Money Market Fund Reforms**
- **Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews**
- **Form PF; Reporting Requirements for All Filers and Large Hedge Fund Advisers**
- **Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps; Prohibition Against Undue Influence Over Chief Compliance Officers; and Disclosure of SBS Positions**

SEC Rules Coming Effective Slated Fall 2023

- **Investment Company Names**
- **Enhanced Disclosures by Certain Investment Advisers and Investment Companies about Environmental, Social, and Governance Investment Practices**
- **Short Sale Disclosure Reforms**

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Other SEC Proposed Rules

- **Investment Company Names**
- **Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting**
- **Outsourcing by Investment Advisers**

Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

The Securities and Exchange Commission proposed new rules and amendments under the Investment Advisers Act of 1940 (Advisers Act) to enhance the regulation of private fund advisers. The proposed new rules would:

- Require private fund advisers registered with the Commission to provide investors with quarterly statements detailing information about private fund performance, fees, and expenses;
- Require registered private fund advisers to obtain an annual audit for each private fund and cause the private fund's auditor to notify the SEC upon certain events;
- Require registered private fund advisers, in connection with an adviser-led secondary transaction, to distribute to investors a fairness opinion and a written summary of certain material business relationships between the adviser and the opinion provider;
- Prohibit all private fund advisers, including those that are not registered, from engaging in certain activities and practices that are contrary to the public interest and the protection of investors; and
- Prohibit all private fund advisers from providing certain types of preferential treatment that have a material negative effect on other investors, while also prohibiting all other types of preferential treatment unless disclosed to current and prospective investors.
- Additionally, the SEC is proposing to require all registered advisers, including those that do not advise private funds, to document the annual review of their compliance policies and procedures in writing.

Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews

- One comment letter encourages the Commission to consider applying certain of these rules solely to new funds formed after a specific point in time, so as to avoid the necessity of renegotiating existing fund agreements and other documents, the cost and uncertainty of which would be borne by LPs.

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Outsourcing by Investment Advisers

The Securities and Exchange Commission proposed a new rule and related amendments to prohibit SEC-registered investment advisers from outsourcing certain services or functions to service providers without meeting minimum requirements. The proposal includes:

- New requirements for advisers to conduct due diligence before outsourcing and to periodically monitor service providers' performance and reassess whether to retain them;
- Related requirements for advisers to make and/or keep books and records related to the due diligence and monitoring requirements;
- Amendments to the adviser registration form, Form ADV, to collect census-type information about advisers' use of service providers; and
- A requirement for advisers to conduct due diligence and monitoring for third-party recordkeepers, along with a requirement to obtain reasonable assurances that the third-party will meet certain standards.

Outsourcing by Investment Advisers - Comments

- Does the rule effectively accomplish the Commission's stated goals, and instead likely to diminish opportunities to, or discourage investment advisers from, outsourcing functions that are best provided by independent third-parties with specific expertise?
- Covered function is far too broad and subjective - should be narrower.
- Prescriptive due diligence requirements will be difficult to comply with in many cases and will most certainly cause due diligence to be performed in a check the box manner - eroding the effectiveness of the practice in many cases.
- Cost and time requirements for small investment advisors to bear will have the effect of decreasing available investment options for investors by creating barriers to entry for smaller investment advisers as well as exits and consolidation within the industry.
- Is the rule necessary at all in light of an investment advisors existing fiduciary duty of care.
- Encourage behaviors that are intended to mitigate risk through various means, including conducting periodic assessments and providing disclosures to clients and investors regarding risks and conflicts associated with the practice of outsourcing.
- The lack of specificity in the definition will force compliance teams to spend substantial amounts of time analyzing whether the services provided by various service providers are in fact Covered Functions.
- Recommendation to narrow the definition by specifying particular "Covered Functions" that are core to investment decision making as opposed to operational or technological functions, for example, sub advisory relationships where a third party adviser takes responsibility for trading a portion of the investment portfolio.
- Due diligence requirements (1) identify the nature and scope of the Covered Function, (2) conduct risk analysis, mitigation, and management, (3) determine the service provider has the competence to perform the Covered Function in a timely and effective manner, (4) determine whether subcontracting arrangements exist that would be material to the performance of the Covered Function, (5) obtain reasonable assurances from the service provider that it will coordinate with the investment adviser for purpose of compliance with the federal securities laws, and (6) ensure for orderly termination.

The next session will begin at 1:45pm.

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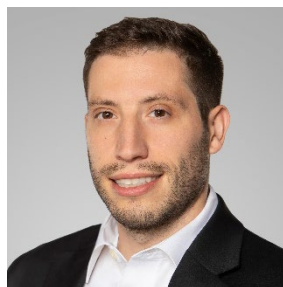
SEC Marketing Rule Panel Discussion

Moderator:



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Break

The next session will begin at 2:25pm.



Fair Value Guidance

Todd E. Crouthamel,
Director-in-Charge,
Audit & Accounting,
Investment Industry Group

Craig B. Evans,
Director, Audit & Accounting,
Investment Industry Group

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Agenda

1. Background of ASU 2022-03
2. Main provisions
3. Disclosure requirements
4. Effective dates and transition



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ASU 2022-03 - Background

- Accounting Standards Update (“ASU”) 2022-03 issued in June 2022
 - Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions
- Goal – increased comparability of accounting and disclosure of investments in equity securities subject to contractual sale restrictions



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ASU 2022-03 - Background

- What is a contractual sale restriction?
 - Restriction imposed on a specific holder of an equity security (an entity-specific restriction)
- Compare that to a regulatory sale restriction?
 - Characteristic of the equity security itself (an asset-specific restriction)



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ASU 2022-03 – Main Provisions

- Contractual restrictions should not be considered when measuring fair value
 - Example: Lock-up agreement
 - Note: Entities cannot, as a separate unit of account, recognize and measure a contractual sale restriction
- Conversely, regulatory restrictions should be considered when measuring fair value
 - Example: Restricted security



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ASU 2022-03 – Disclosure Requirements

- New required disclosures for equity securities subject to contractual sale restrictions
 - The fair value of equity securities subject to contractual sale restrictions reflected in the balance sheet
 - The nature and remaining duration of the restriction(s)
 - The circumstances that could cause a lapse in the restriction(s)



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ASU 2022-03 – Effective Dates and Transition

- Public business entities – Years beginning after December 15, 2023
- All other entities – Years beginning after December 15, 2024
- Early adoption is permitted



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ASU 2022-03 – Effective Dates and Transition

- Investment Companies (i.e. 946 Entities)
 - Apply only to investments executed or modified after adoption date
 - Do not alter the valuation methodology/accounting policy of equity securities already held at the adoption date until contractual restrictions expire or are modified
- All other entities
 - Apply prospectively
 - Any adjustments from adoption recognized in earnings and disclosed on the date of adoption



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Section Break

1. Provided some background on ASU 2022-03
2. Covered the main provisions
3. Provided the new disclosure requirements
4. Covered the effective dates and transition

Contact the Presenter



Todd E. Crouthamel
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Todd has extensive experience in the investment industry, including providing traditional audit services to investment managers, hedge funds, and broker/dealers, as well as performing custody examinations, in accordance with the Securities and Exchange Commission Rule 206(4)-2. Todd also performs GIPS verifications and composite examinations, and assists firms in implementing the GIPS standards. In addition, Todd performs due diligence throughout the United States and Europe to assist investors in understanding the operational risk inherent in their investment managers' operations.

Todd provides services to investment industry clients who manage virtually all asset classes, including equity, fixed income, private placements, structured credit, and private equity. He also has significant experience with various investment structures including hedge funds, funds of funds, and master feeders.

Todd also serves as the leader of Kreischer Miller's Audit and Accounting Practice. In this role, Todd is responsible for managing the resources of the Audit and Accounting Practice, including training and recruiting, budgeting, serving as a resource on technical matters, and development and maintenance of compliance policies and procedures.



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Contact the Presenter



Craig B. Evans
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Craig has a wide range of experience providing traditional audit and accounting services to a variety of businesses, including investment companies, government contractors, manufacturers, distributors, and retailers. Craig also has significant experience with contract analysis, specifically compliance with Most Favored Nation provisions. Craig has a deep technical understanding of U.S. GAAP and has assisted clients with acquisitions and their assessment of business combinations as well as with the implementation of FASB ASC 606, Revenue from Contracts with Customers, including the development of accounting policies and process in order to be in compliance with the revenue recognition standard.

Within the investment industry, Craig provides traditional audit and accounting, GIPS verifications, and composite examinations to a variety of clients. He also performs custody examinations in accordance with the Securities and Exchange Commission Rule 206(4)-2, assists firms in implementing the GIPS standards, and performs operational due diligence throughout the United States and Europe to assist investors in understanding the operational risk inherent in their investment managers' operations. Additionally, he has assisted entrepreneurs with starting investment firms and hedge funds. He works with a variety of clients, including investment management companies, funds, funds of funds, master feeders, broker-dealers, family offices, trust companies, and pension plans and their investments.



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The next session will begin at 2:40pm.



Valuation Drivers in an Investment Firm

Jen Kreischer,
M&A Advisory Consultant,
Investment Industry Group

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Agenda

1. Why does value matter?
2. How is value determined?
3. The multiplier effect
4. Key value drivers



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Why Does Value Matter?

- Purchase or sale
 - Investment News Research, together with SkyView Partners and Live Oak Bank, surveyed 554 firms about the firms' intentions regarding transactions. 72% said they “have either completed a transaction in the last two years or are contemplating one in the coming two.”
- Succession planning
 - Lack of planning for a transition can limit the options and value
 - Doesn't mean you must commit to one option immediately – some value drivers improve any option
- Growth
 - May require financing



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Why Does Value Matter?

- Objective of valuation:
 - Protect the interests of the owners
 - Allow a new investor (new owner or source of capital) to assess the opportunity as compared to other uses of their funds
 - Measure the impact of initiatives for growth
 - Incentivize team



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How is Value Determined?

- Valuation is an art and a science
- Discounted cash flow
 - Uses all revenue and expenses of the business
 - Forecasted out a number of years
 - Discounted back to present value
- Multiple model is a shortcut for DCF
 - Uses multiple of revenue or earnings (usually EBITDA – earnings before interest taxes, depreciation and amortization)
 - Simpler exercise, but the real art is picking the multiple
 - Multiples always fall in ranges
 - Revenue multiples tend to come in bigger ranges
 - Earnings multiples tend to be better proxy for DCF



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The Multiplier Effect

- We'll assume the valuation uses a multiple as our shortcut
- Value increases as earnings increase
- Value also increases by positioning the business to command multiples at the higher end of the range of multiples
- Example:
 - Assume a business earns \$75,000. Multiples range from 4 to 6 times earnings.
 - At low end, value is \$300,000. At high end, value is \$450,000.
 - Adding earnings of \$100,000 results in \$400,000 value low end.
 - That plus move to high end of the range and value is \$600,000.
 - We'll call that the multiplier effect.



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The Multiplier Effect

- It's clear that the multiplier effect works to improve value in a transaction (sale or financing), but does it matter if you don't plan on doing either?
- Actions that move the multiple up the range tend to be those that produce a more sustainable business
- Produces more income in the current periods
- Increases likelihood of producing the same income (or more) into the future



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Key Value Drivers

Data points considered in valuation are also consistent with industry key performance indicators (KPIs)

- Revenue related:
 - Client base – concentrations, turnover, age
 - Revenue growth
 - Services offered – basic or fully integrated with clients
 - Fee basis/percentages
- Expense related:
 - Compensation and expenses
 - Talent pipeline
 - Technology support



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Key Value Drivers

Revenue example:

- Start by understanding current revenue base. Consider how to make the analysis repeatable. Could include:
 - Age
 - Fee
 - Tenure with the firm
 - Range of services provided
 - Some measure of effort associated with providing the services
- Identify what has driven profit and growth
- Consider new trends that may impact future growth
- What areas have most promise for future?
- What barriers to growth exist?
- Put a specific plan in place for growth and track progress



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Key Value Drivers

Themes to keep in mind:

- An initiative in one area can help solve another challenge – example specific revenue initiatives can help retain key people.
- Investment in one of these areas doesn't add to the valuation until you can convince the valuer that it contributes to earnings:
 - Easiest to prove with actual earnings
 - Can show impact on forecast by pointing to shorter periods in the past
- Each initiative also demonstrates an ability to grow and address market changes. A long track record is evidence of a sustainable business.



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Contact the Presenter



Jennifer Kreischer
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Jennifer has over 25 years of experience providing services including financial due diligence for buyers and sellers, transaction structuring, purchase price adjustment advice, purchase agreement review, and related advisory services. She has advised on a variety of complex transactions, including cross border, carve-outs, recapitalizations, initial public offerings, and rollups.

Jennifer has experience performing quality of earnings analysis and operational due diligence. She has led projects to assess M&A process, purchase accounting, and implementation of IFRS for companies in a variety of industries. Additionally, Jennifer has a broad range of industry experience, including power and utilities, industrial products, healthcare, service businesses, and industry consolidations.



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The next session will begin at 3:00pm.



Tax Update

**Richard J. Nelson,
Director, Tax Strategies**

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Agenda

1. Washington Tax Update
2. IRS Update
3. Secure 2.0
4. Schedule K-2 and K-3 Update
5. Section 1256 Proposed Regs.
6. PFIC Proposed Regs.



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Disclaimer

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Washington Tax Update

- Congressional Makeup
- December Impasse to an Extender Bill
- Debt Ceiling
- Future Tax Legislation



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IRS Update

- January 11, 2023 National Taxpayer Advocate released 2022 Annual Report To Congress
- Taxpayers and tax professionals “experienced more misery in 2022”
- IRS poised to start 2023 filing season in a stronger position



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IRS Update 2022

Refund Delays

- Paper filers – six months or longer to get refund
- E-filed returns – millions “suspended” because they tripped IRS processing filters requiring manual review
- Employee retention credit – hundreds of thousands refund claims delayed

Return Processing Delays

- 1/1/2022 unprocessed backlog of original returns
 - 4.7 million individual returns
 - 3.2 million business returns
 - 3.6 million amended returns (individual and business)



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IRS Update 2022

- Return Processing Delays 12/23/2022
 - 12/23/2022 unprocessed backlog of original returns
 - 400,000 individual returns
 - 1 million business returns
- Suspended Returns
 - 1/1/2022 – 4.2 million
 - 12/23/2022 – 5.9 million



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IRS Update 2022

- Correspondence Delays
 - During fiscal year (FY) 2022, it took the IRS an average of 193 days to process taxpayer responses to proposed tax adjustments – about six months.
 - That compares with 89 days in FY 2019, the most recent pre-pandemic year.
 - The report also calls the delays in resolving these cases unacceptable.
- Telephone Delays
 - The IRS received 173 million calls during FY 2022. Only 22 million (13%, or roughly one out of eight calls) got through to an IRS employee
 - In FY 2022, IRS employees answered only 16% of PPS (Practitioner Priority Service) calls (fewer than one out of six)



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IRS Update 2023

- IRS is optimistic and believes service will improve citing three reasons:
 - The IRS has largely worked through its backlog of unprocessed tax returns, even though it remains challenged with a high volume of suspended returns and correspondence;
 - Congress has provided the IRS with significant additional funding to increase its customer service staffing; and
 - with the benefit of Direct Hire Authority, the IRS has recently hired 4,000 new customer service representatives, and it is seeking to hire 700 additional employees to provide in-person help at its Taxpayer Assistance Centers. Direct Hire Authority has enabled the IRS to reduce the number of days from the time it posts an announcement on USAJobs.gov until it onboards a new employee by more than half



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Secure 2.0

- Included in the 2023 Omnibus Budget Bill which was signed by the president on December 29, 2022
- Most Plans will have to be amended to comply with some of the provisions
- Age increased for required distributions in two stages
 - From current age of 72 to 73 for those who turn age 72 after 2022
 - From 73 to 75 for those who turn 74 in 2032
- Reduced penalty on failure to take RMDs for tax years beginning after December 29, 2022
 - From current 50% to 25%
 - Further reduces it to 10% if the failure is corrected in a timely manner



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Secure 2.0

- Tax free rollovers from 529 college savings accounts to Roth IRAs
 - After 2023 beneficiaries of 529 plans can make a direct trustee-to-trustee rollover from a 529 account to a Roth IRA without tax or penalty
 - Limited to \$35,000
 - Account must be open for more than 15 years
 - Rollover amount limited to amount contributed to the 529 account and its earnings more than 5 years earlier
 - Subject to the Roth annual contribution limits, but not limited based upon taxpayers adjusted gross income



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Secure 2.0

- Larger catch-up contributions permitted in 2025
 - Greater of \$10,000 (\$5,000 for SIMPLE plans), or
 - 50% more than the regular catchup amount in 2024 (2025 for SIMPLE plans) for individuals who attain ages 60-63



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Secure 2.0

- More withdrawals permitted free of the 10% early withdrawal penalty
 - *Emergency Expenses* – \$1,000 distribution for emergency expenses with an option to repay in three years
 - *Domestic Abuse* – The lessor of \$10,000 or 50% of their account balance permitted for participants that self-certify that they have experienced domestic abuse. Can repay over three years and get a refund of taxes on money that is repaid
 - *Terminally Ill* – Penalty no longer applies to distributions to terminally ill individuals
 - *Long Term Care insurance* – Beginning December 29, 2025, up to \$2,500 for payment of premiums for certain long-term care insurance contracts



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Secure 2.0

- More withdrawals permitted free of the 10% early withdrawal penalty
 - Retroactive for disasters after January 25, 2021, up to \$22,000 may be made from employer retirement plans or IRAs for affected individuals. Regular tax on the distributions is taken into account as gross income over three years. Distributions can be repaid to a tax preferred retirement account



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Schedule K-2 and K-3

- Supplemental schedules required to be filed for passthrough entities
 - Partnerships (Form 1065) U.S. Returns of Partnership Income;
 - S Corporations (Form 1120-S) U.S. Income Tax Return for an S Corporation:
 - U.S. persons (Form 8865) Return of U.S. Persons with Respect to Certain Foreign Partnerships
- Schedule K-2, Partners' Distributive Share Items – International
- Schedule K-3, Partners Share of Income, Deductions, Credits, etc. – International



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Schedule K-2 and K-3

Who must file?

- Pass-through entities that have items relevant to the determination of foreign withholding tax, foreign assets, or foreign partners
- Even if the entity does not have any foreign sourced income, foreign assets, or foreign partners it may be required to furnish a Schedule K-2 and K-3 if a partner or shareholder claims a credit for foreign taxes paid on Form 1116
- A partner or shareholder can request a Schedule K-3 up to 1-month prior to the filing of the Form 1065 or Form 1120-S



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Schedule K-2 and K-3

- In 2021 these schedules created significant administrative burdens at a significant cost
- There was much uncertainty surrounding the filing exception found in the *“frequently asked questions”*, that many firms opted to include the schedules in every partnership and S Corporation return
- In October 2022, the IRS posted new draft instructions to the schedules K-2 and K-3 for the 2022 tax returns. The instructions contained a new exception to the filing requirement which was similar to the one offered by the IRS in its 2021 frequently asked questions
- In December 2022, the IRS posted new draft instructions and made revisions to the exception that was in the October draft
- This is ongoing and not getting any better



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Schedules K-2 and K-3

Domestic Filing Exception – contains four requirements

1) Partnership has no or limited foreign activity in 2022

- No Foreign Activity
 - Foreign income taxes paid or accrued
 - Foreign source income or loss
 - Ownership in foreign partnership
 - Ownership interest in a foreign corporation
 - Ownership of a foreign branch
 - Ownership interest in a foreign entity that is treated as a disregarded entity



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Schedule K-2 and K-3

1) Partnership has no or limited foreign activity in 2022 (continued)

- Partnership has foreign activity but limited foreign activity defined as:
 - Passive category foreign income upon which not more than \$300 of foreign income taxes allowed as a credit are treated as paid or accrued by the partnership, and such income and taxes are shown on a payee statement that is furnished or treated as furnished to the partnership.



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Schedule K-2 and K-3

2) U.S. citizen/resident alien partners – all 2022 direct partners are:

- Individuals that are U.S. citizens or resident aliens
- Domestic estates with solely U.S. citizen or resident alien individual beneficiaries
- Domestic grantor trusts with solely U.S. citizen or resident alien grantors and beneficiaries
- Domestic non-grantor trusts with solely U.S. citizen or resident alien individual beneficiaries
- S Corporations with a sole shareholder
- Single member LLCs where the sole member is one of the persons listed above



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Schedule K-2 and K-3

3) Partner Notification for partnerships that satisfy criteria 1 and 2

- Partner must receive notification from the partnership that the partnership is not furnishing Schedule K-3
- The latest the notification can be furnished to the partners is when the partnership furnishes Schedule K-1 to the partner, and it can be provided as an attachment to the Schedule K-1
- Notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule



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Schedule K-2 and K-3

4) No 2022 Schedule K-3 requests by the 1-month date

- The partnership does not receive a request from any partner for Schedule K-3 information on or before the 1-month date. The “1-month date” is 1 month before the date the partnership files the Form 1065. For tax year 2022 calendar year partnerships, the latest 1-month date is August 15, 2023, if the partnership files an extension.



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Schedule K-2 and K-3

- Notification examples – there are four
 - If partnership receives a timely request
 - Partnership required to file schedules K-2 and K-3 with the IRS and furnish K-3 to requesting partner
 - The Schedules K-2 and K-3 are required to be completed only with respect to the parts and sections relevant to the requesting partner
 - Form K-3 not required for any other partner



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Schedule K-2 and K-3

- **Example facts for example 3 and 4**
 - H and W each own 40% in U.S. partnership and U.S. citizen A owns 20%
 - Partnership requests extension and files tax return August 31, 2023
- **Example 3** – A requests 2022 Schedule K-3 from partnership and partnership receives request on February 1, 2023
 - Partnership does not qualify for exception since A requested the K-3 by the 1-month date (July 31, 2023)
 - The Partnership must complete and file with the IRS the parts and sections of the Schedules K-2 and K-3 that are only relevant to A, nothing related to H and W
 - The partnership must provide Schedule K-3 to A on the date it files its return. H and W are not required to receive a Schedule K-3



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Schedules K-2 and K-3

Example 4 – A requests 2022 Schedule K-3 from partnership and partnership receives request on August 20, 2023

- Partnership qualifies for exception because A requested the Schedule K-3 after the 1-month date (July 31)
- Partnership not required to file 2022 Schedules K-2 and K-3 with the IRS or H and W
- Partnership is required to provide Schedule K-3 completed with the information related to A on September 20, 2023, the later of the date on which the Partnership files its tax return (August 31, 2023) or 1 month from August 20, 2023
- Because A requested a 2022 Schedule K-3, the partnership must file a 2023 Schedules K-2 and K-3 for A



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Schedules K-2 and K-3

- ***Form 1116, Foreign Tax Credit, Exemption Exception***
 - Certain partners are not required to file Form 1116.
 - A domestic partnership is not required to complete Schedules K-2 and K-3 if all partners are eligible for the Form 1116 exemption and the partnership receives notification of the partners' eligibility for such exemption by the 1-month date. If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners but must complete the Schedules K-2 and K-3 with respect to the other partners to the extent that the partnership does not qualify for the domestic filing exception.



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Form K-2 and K-3

- ***Form 1116 Exception (continued)***
 - A partnership that does not have or receive sufficient information or notice regarding a direct or indirect partner must presume such partner is eligible to claim a foreign tax credit and such partner would have to file a Form 1116 or Form 1118 to claim a credit. As such, the partnership must complete the Schedules K-2 and K-3, including Parts II and III, accordingly.



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Polling Question



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Section 1256 Contracts – Overview

- Section 1256 Contracts are a type of investment, defined by the Internal Revenue Code (IRC), as the following:
 - Regulated futures contract,
 - foreign currency contract,
 - non-equity option,
 - dealer equity option, or
 - dealer securities futures contract
- Section 1256(a)(1) treats each "section 1256 contract" held by a taxpayer at the close of the tax year as sold for its fair market value on the last business day of that tax year
 - Requires taxpayers to recognize any gain or loss in that tax year



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Section 1256 Contracts – Overview

- For foreign currency options and forward contracts, the gain or loss is ordinary under IRC Section 988



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Section 1256 Contracts – How Are They Taxed?

- Taxation of Section 1256 contracts:
 - 60% subject to lower long-term capital gains rate
 - 40% taxed as short-term capital gains using the ordinary rates
- For foreign currency options and forward contracts
 - G/L is ordinary income under IRC Section 988, absent an election



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Section 1256 Contracts – Proposed Regulations

On Tuesday, July 5, 2022, the U.S. Treasury Department and the IRS issued proposed regulations under IRC Section 1256.

Effective Date:

- The Proposed Regulations would be generally effective for contracts entered into on or after the date that is 30 days after their publication as final regulations in the Federal Register.
- Taxpayers can generally rely on the proposed regulations for tax years ending on or after July 6, 2022.



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Section 1256 Contracts – Proposed Regulations *(continued)*

1. Proposed regulations would limit IRC Section 1256 mark-to-market accounting for foreign currency contracts to foreign currency **forward** contracts.
2. The proposed regulations confirm that over-the-counter foreign currency **options** are not subject to mark-to-market treatment under IRC Section 1256.
3. The proposed regulations would explicitly **overrule** the Sixth Circuit's decision in *Wright v. Commissioner* and directly affect taxpayers relying on that decision to mark foreign currency options to market under IRC Section 1256.



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Section 1256 Contracts – Proposed Regulations *(continued)*

- The proposed regulations provide clarity that foreign currency options are not treated as foreign currency contracts subject to the mark-to-market rules of Section 1256
- Taxpayers that relied on *Wright* to include foreign currency options in the definition of foreign currency contracts should:
 - Consider whether to early adopt or wait for final regulations
 - Determine if there are any software changes and accounting changes
 - Determine if an accounting method change is required to make the change



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Proposed PFIC Regulations

- Current PFIC Rules
 - Domestic partnerships are currently permitted to make a QEF election or a mark-to-market election for an equity investment in a PFIC.
 - When a domestic partnership makes a QEF election, it includes its proportionate share of ordinary earnings and net capital gains in income each year the foreign corporation is a PFIC
 - if a domestic partnership makes an MTM election, it includes the excess amount of the fair market value of PFIC stock at the end of the taxable year over the adjusted tax basis in the PFIC stock as taxable income for each year in which the foreign corporation is a PFIC.
 - The U.S. partners are then required to include their distributive share of such QEF or MTM inclusions in income.



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Proposed PFIC Regulations

- January 25, 2022 IRS issued proposed PFIC Regulations
 - U.S. partnerships would no longer be treated as shareholders of the PFIC. The U.S. partners would be required to make the QEF and MTM elections.
 - U.S. partners that make QEF or MTM elections would be required to notify the domestic partnerships of such elections so that the partnerships could provide assistance with the information reporting.
 - The information reporting would be reported to the partner on Schedule K-3.
 - Existing elections will remain in effect. Partnerships are permitted to continue to make elections under the current rules until the proposed PFIC regulations are finalized.



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Contact the Presenter



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Rich has extensive experience providing domestic and international tax strategies, planning and services to a variety of middle market companies and entrepreneurial businesses in a number of industries including manufacturing, distribution, real estate, financial, and professional services. He also has significant experience and expertise with high-net-worth individuals, investment companies and pass-through entities and has been involved in federal, state, and local tax audits, settlements, and appeals.

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