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Methodological Problems of Accounting for Carried Interest and Waterfall Distributions in Investment Funds

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Abstract: This article systematizes the main issues: the boundaries of the accounting object (fund vs. management company), the moment of recognition and assessment of carry as variable compensation/profit share, the impact of waterfall conditions (deal-by-deal vs whole-of-fund, preferred (Return, catch-up, escrow, cla wback) on accruals, classification of liabilities and capital instruments, comparability of financial statements, and control procedures. Based on the requirements of IFRS (IFRS 10, IAS 32, IFRS 15) and practice-oriented guidance (AICPA, KPMG, PwC, EY, ILPA), a set of methodological principles for developing accounting policies and disclosures is proposed.

Keywords: Carried interest, waterfall, private equity, performance fee, variable consideration, clawback , escrow, IFRS , US GAAP, ASC 946, ASC 606.

Introduction: The scientific novelty lies in the systematization of methodological problems of accounting carried out interest and waterfall distributions and the justification of the principles of their accounting, taking into account the economic essence, level of accounting and specifics of the contractual mechanisms of investment funds.

Carried interest (hereinafter referred to as carry) and related distribution Waterfalls are fundamental economic mechanisms in the structure of private investment funds, such as private Equity and venture capital funds. Carry is typically the share of the fund's profits that accrues to the general partner (GP) after reaching certain levels of profitability for limited Partners (LPs), while a waterfall is an algorithm for distributing returns among fund participants. The combination of these elements creates a complex, multi-stage mechanism that is much more difficult to account for and interpret than simple management fees or percentages of assets under management [1].

In the classic Waterfall cash flow distribution goes through the following stages: return of initial capital to LP, provision of LP preferred return (hurdle rate), a catch-up mechanism for the GP, the final profit split between the LP and GP, usually at a pre-determined percentage (e.g. 80/20).

This structure is not only multi-layered, but can also vary significantly between funds, including additional tiers, multi- hurdle, or tiered-carry schemes (different carry rates depending on the level of return). This complicates the uniform application of standard accounting methods and requires accurate documentation within the Limited. Partnership Agreement (LPA) [2].

carry is a reward for fund management's performance, not a fixed fee for services rendered or a simple shareholding. However, in accounting practice, a contradiction arises: on the one hand, carry can be considered an element of profit distribution among partners, and on the other, as a variable management fee, similar to performance. Fee . The latter is especially relevant when the GP receives carry after the LP achieves a certain level of profitability, making carry sensitive to future performance estimates and the uncertainty of condition fulfillment. This nature complicates income/expense recognition in financial statements and may require scenario and probabilistic analysis [3].

There are fundamental differences between the European (whole-of-fund) and American (deal-by-deal) waterfall approaches . In the European model carry is distributed only after the entire fund has returned the required capital plus preferred return , which makes the moment of recognition of carry later and more certain. In deal-by-deal A waterfall GP can receive carry on each successful exit individually, which facilitates earlier recognition but also increases the risk of subsequent clawbacks (return of overpaid carry when results deteriorate) [4]. These differences lead to significant flexibility in revenue recognition, which complicates standardized accounting and requires accounting for different contract terms in the financial reporting model.

Accurate verification of carry accruals is often hampered by poor transparency on the part of GPs and a lack of standardized disclosures for LPs. Multiple waterfall components , including hurdles , catch-ups , escrow mechanisms, and lookback rules , make the carry calculation model so complex that LPs are often forced to "recreate" the calculations themselves, increasing the risk of errors. This factor is reflected in the specialized literature, which emphasizes the need for standardized calculations and disclosures to ensure a reliable understanding of carry and its impact on investor returns.

In addition to the technical aspects of calculation and distribution, carry is often considered in the context of tax treatment and recognition timing. Unlike regular salaries or management fees, carry can be considered an element of capital income and subject to taxation considerations in certain jurisdictions (for example, long-term capital gains in the US). This tax characteristic further complicates both accounting and reporting in different legal systems.

In academic literature, the main focus in studying carried interest is placed on its economic and accounting aspects, reflection in financial statements, and impact on investor returns. Thus, in the work "A Note on Carried Interest in Private Equity » emphasizes that the profit distribution structure and carry calculation are complex due to their nonlinearity and significant impact on investor performance, making them an important subject of economic analysis in terms of understanding income distribution and assessing fund performance [5].

In addition, industry overviews such as the Understanding guide Private Equity Funds: A Guide to … emphasize that carried Interest is the main element of GP incentives, but its reflection in financial statements requires careful consideration of the specifics of profit distribution and the structure of the fund [1].

Industry practical sources, book The Definitive Guide to Carried Interest, provide an in-depth overview of the mechanisms of waterfall distribution and discuss the practical issues of its modeling and reflection in reporting for both GP and LP , including aspects of recognition, accrual and possible clawback situations depending on the terms of the fund agreements [3].

Review materials on the terminology and varieties of waterfall structures emphasize that different models (e.g. European vs. American) have different implications for the recognition of carried interest and comparability of financial statements, which requires accounting specialists to have a deep understanding of these mechanisms and disciplined reflection in the documents of the fund/manager.

Although there are no direct academic publications strictly related to IFRS / US GAAP by carried interest , less than for classical assets and liabilities, financial reporting standards create a framework within which these constructs should be analyzed:

1. IFRS 15 “Revenue from Contracts with Customers”, although not directly related to private equity , applies to performance - based conditions and variable compensation, making it conceptually important for assessing the timing of revenue recognition from carried interest , especially when viewed through the prism of accruals and the waiver of significant reversals (constraint).

2. US GAAP (ASC 946 Investment Companies) details the requirements for reporting distributions and capital accounts of partnership entities, including examples of carried interest and clawback in financial statement examples (see KPMG example , where carried interest is reflected in capital accounts with deferred recognition until the final liquidation of the fund).

3. In the context of IFRS , there is also a practical application of carried interest and clawback in illustrative financial statements for partnership structures, where such accruals may be recognized based on the estimated fair value of the investment, subject to the contractual performance and distribution conditions being met at the reporting date [6].

Research into fund management practices (e.g. MJ reports Hudson , ILPA) show that escrow obligations and clawback mechanisms are widespread and important for the correct reflection of carry in reporting, especially when using deal - by - deal waterfall , where the risks of subsequent negative results are higher and require reserving a portion of the carry for possible return to investors [7].

Despite the widespread use of carried Interest (carry) and waterfall distributions in private investment fund practice remain methodologically heterogeneous. This is due to the fact that carry combines features of a fee for services, a share in profits, and a contingent claim, the implementation of which depends on the fund's future financial performance. The literature emphasizes that it is the hybrid nature of carry that underlies key accounting contradictions [5].

One of the fundamental methodological issues is the question of the economic essence of carry . Depending on the fund structure and the legal registration of the GP's rights carry can be interpreted as a variable remuneration of the manager for services rendered (performance fee); or as a distribution of residual profits among the fund's partners. In the work " A Note on Carried Interest in Private Equity " the author points out that for investors, carry is economically equivalent to a commission, but legally it is often formalized as a share of profit, which complicates uniform reflection in reporting [5]. From the perspective of accounting standards, this creates a tension between the logic of IFRS 15 "Revenue" (variable remuneration) and the partnership accounting approaches used in investment funds (ASC 946).

Carry is accrued only when certain financial indicators of the fund are achieved (preferred return , IRR , multiple), which makes it a conditional income dependent on future events. The scientific and professional literature emphasizes that premature recognition of carry can lead to a distortion of the financial results of the manager [8]. According to the concept of variable remuneration, income can be recognized only to the extent that the absence of a significant reversal (constraint) is probable. However, in private This condition is difficult to verify due to the high volatility of unrealized investment valuations. As a result, in practice, a cash or quasi -cash approach is often used, which reduces the comparability of reporting between funds.

The type of waterfall mechanism (whole - of - fund / deal - by - deal) directly influences the timing and magnitude of carry recognition. In the deal - by - deal model Carry may be paid before the end of the fund's life cycle, which increases the risk of subsequent clawback of excess paid remuneration . ILPA notes that it is deal - by - deal Waterfall is the source of the greatest methodological and control problems, as it requires taking into account the probability of future losses and adequate reserves (escrow). However, accounting standards do not contain detailed guidance on the assessment of clawback liabilities, leaving considerable room for professional judgment [9].

The literature also points to the problem of limited transparency: carry calculation methods and waterfall parameters are often disclosed fragmentarily, making it difficult for investors and researchers to analyze returns and risks. ILPA emphasizes the need for standardized disclosures on carry , escrow , and clawback, but these recommendations are voluntary and not part of mandatory financial reporting standards.

Table 1 - Key methodological issues in accounting carried interest and waterfall

Problem	The essence of the contradiction	Accounting implications
Carry qualification	Manager's Income vs. Profit Distribution	Different models of recognition and representation
Moment of recognition	Dependence on future results	Risk of premature recognition
Deal-by-deal waterfall	Early payments carry	The emergence of clawback risk
Clawback and escrow	Contingent liabilities	Difficulties in assessment and disclosure
Disclosures	Lack of standards	Low comparability of reporting

Thus, the methodological problems of accounting are carried out Interest and waterfall are driven by a combination of contractual complexity, valuation uncertainty, and limited regulatory frameworks. Current literature agrees that without a clear distinction between the economic and legal nature of carry , as well as expanded disclosures, the comparability and analytical value of investment fund financial statements remain limited.

Taking into account the identified methodological problems, it seems appropriate to formulate a number of basic principles aimed at increasing the comparability, transparency and validity of accounting carried out Interest and waterfall distributions in investment funds.

1. The principle of priority of economic substance over legal form. Qualification is carried out interest should be based on an analysis of its economic function (management fee or residual profit participation) and not solely on the legal structure (share, class of shares, partnership) This allows for the correct determination of the accounting model and avoidance of formal distortion of financial results.

2. Distinction between the levels of accounting of the fund and the management company. The methodology should clearly distinguish between the accounting

carried out Interest at the investment fund level (as an element of results distribution among participants) and at the management company level (as income from services rendered). This distinction reduces the risk of double counting and improves the analytical comparability of financial statements.

3. A limited approach to recognizing carry . Carry should be considered a form of variable consideration with a high degree of uncertainty. Its recognition should occur only when there are sufficient grounds to believe that the likelihood of a material reversal is minimal, or when the conditions for final crystallization have been met.

4. Explicitly consider clawback risk. The methodology should include the identification, assessment, and disclosure of the risk of repayment of previously paid carry . The use of escrow mechanisms and reserves should be considered an element of accounting policy, and not just a legal measure to protect investors' interests.

5. Consider the specifics of the waterfall structure. The chosen waterfall type (whole-of-fund or deal-by-deal) must be explicitly taken into account when determining the moment of carry recognition and valuing liabilities. A one-size-fits-all approach without considering the distribution structure leads to methodological errors.

6. Standardization of calculation models and control procedures. Carry and waterfall calculations must be based on formalized and verifiable models consistent with the LPA terms. Verification of calculations and documentation of key assumptions are essential for the reliability of accounting.

7. Expanded disclosures in financial statements. It is advisable to disclose key carry and waterfall parameters (rates, hurdles, catch-ups, the presence of clawbacks, and escrows) as well as the accounting assumptions used. This increases the transparency and analytical value of the statements for investors and researchers.

The proposed principles do not replace current accounting standards, but form a methodological framework that allows for the adaptation of general accounting requirements to the specifics of private equity and venture funds, minimizing the risks of distortion of financial information.

Therefore, accounting is carried out The methodological complexity of interest and waterfall distributions is due to the intersection of three dimensions: legal architecture (LPA and multi-stage formulas), valuation uncertainty (fair value, probability of realization), and differences in reporting objectives (equity reporting for LPs vs. financial reporting for the manager/group). The most robust approach is an explicit separation of accounting levels, the use of a variable fee model with a recognition constraint for the manager, formalized accounting of clawback risk, and standardized disclosures of waterfall parameters consistent with industry standards. best practices (ILPA). This improves the comparability of financial statements, reduces the risk of premature recognition, and improves the quality of accounting controls.

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