Reflections on Accounting Recognition and Measurement of General Partner Income in Partnership Private Equity Investment Funds

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Abstract: Partnership private equity investment funds play a crucial role in the capital market as an essential organizational form. The unique status and role of general partners in these funds distinguish their income mechanism significantly from other limited partners. This paper, based on relevant provisions in the Enterprise Accounting Standards regarding long-term equity investments and income, provides a pathway to recognize the unrealized income of general partners before actual exits. It includes a detailed analysis with case studies and outlines future research prospects.
***Keywords*:** partnership private equity investment funds, general partners, long-term equity investments, contingent consideration

1. Background and Significance

Private equity investment funds have played an increasingly important role in China's economic and social development. They primarily contribute to the allocation of economic resources towards high-quality industries and companies, making them a vital organizational form in China's primary capital market.

Private equity investment funds are classified into partnership, corporate, and contractual forms based on their organizational structure. Among these, partnership funds, with advantages such as tax cost savings, ease of incentive arrangement setup, and organizational flexibility, have become the most important form of private equity investment funds.

The organizational structure of partnership private equity investment funds is that of a partnership enterprise, consisting of general partners and limited partners. General partners bear unlimited liability for the partnership's debts, while limited partners have limited liability based on their contributions. General partners typically act as the fund managers, responsible for the establishment, operation, identification of investment targets and opportunities, and post-investment operations of the private equity investment fund. Their identity has a dual meaning: they are both investors seeking returns on investments and managers providing investment management services and earning corresponding fees. The compensation mechanism for general partners is distinct from that of limited partners. In their income composition, benchmark income usually forms a smaller portion, and the excess portion beyond benchmark income, i.e., excess income, allows general partners to share a larger portion beyond their shareholding percentage. This results in a "same stock, different rights" situation in income distribution compared to limited partners. Additionally, some general partners not serving as fund managers typically do not enjoy excess returns. The general partners referred to in this paper are those serving as fund managers.

Due to the differences in the identity, responsibilities, and income distribution of general partners and limited partners in the partnership enterprise, the accounting treatment of their income is a worthy topic of discussion and has been relatively underexplored in research.

2. General Partner Income Mechanism and its Impact on Accounting Treatment

In partnership private equity investment funds, limited partners typically contribute a significant portion of the paid-in capital and their investment in the partnership entity is generally measured using the equity method. Due to the nature of partnership private equity investment funds, the investment in the target company by the partnership entity usually has no significant influence, and the objective is to realize investment returns through selling and exiting. Therefore, the equity interests held in the invested target company are subsequently measured at fair value for financial asset accounting. On a consolidated basis, limited partners measure and account for their investment in the target at fair value.

On the other hand, general partners in partnership private equity investment funds usually make only nominal contributions, with amounts significantly smaller compared to limited partners. Consequently, they hold a minimal proportion of equity in the partnership entity. Unlike limited partners, general partners do not derive compensation based on the investment returns proportionate to their contributed capital. Instead, they receive "excess compensation" due to

their roles as both general partners and fund managers. This excess compensation is typically the profit earned beyond their investment proportion, calculated after distributing benchmark returns to limited partners. The actual settlement and distribution of this excess profit occur only upon the actual exit of the equity interest in the invested target company.

While limited partners can calculate and recognize changes in fair value and associated gains or losses based on the fair value of the equity interest in the target company, as well as their ownership percentage, general partners face a challenge. As the equity interest in the target company has not been transferred or sold, and the excess compensation for general partners has not been settled, there is a controversy regarding whether general partners, with their nominal contributions, can recognize income based on the fair value of the equity interest before its sale, thus acknowledging the portion attributable to excess compensation.

This paper provides a detailed analysis of the accounting treatment of general partner compensation from the perspectives of "Enterprise Accounting Standards" on long-term equity investments and income. Practical applications are integrated into the discussion, offering preliminary insights into this accounting issue.

3. Accounting Analysis of General Partner Investment Income under "Enterprise Accounting Standards - Long-term Equity Investments"

According to the "Enterprise Accounting Standards - Long-term Equity Investments," if an investor has significant influence over the investee, the equity method should be used for subsequent measurement and accounting. The investor recognizes investment income based on the net profit realized by the investee in the current year, in proportion to the actual share they enjoy. The "share" here refers to the proportion of actual profit enjoyed, rather than a simple calculation based on equity or paid-in capital ratios.

For general partners, their share in the partnership entity of the private equity investment fund has the characteristic of "same stock, different rights." This means that their entitlement to investment returns is greater than the share calculated based on their paid-in capital. In such cases, it is necessary to calculate the equity share they should enjoy each year based on the calculation method stipulated in their partnership agreement. If changes in net profit lead to variations in the income that general partners should enjoy, these changes should be included in the general partners' investment income.

Let's illustrate these principles with an example:

Suppose Partnership A is primarily engaged in equity investment operations, and the total subscribed capital of all partners is 1 billion RMB. Limited partners are represented by individuals A and B, who have subscribed 490 million RMB and 500 million RMB, respectively. General partner C is an affiliate of individual A, with a subscribed capital of 10 million RMB. The partnership agreement stipulates that when the partnership realizes an exit from a certain equity investment project (e.g., through an IPO or a transfer in a later round of financing), the exit amount is first distributed to the paid-in capital of each limited partner in that project. After distributing the paid-in capital, the remaining profit is then allocated based on an annualized return rate of 8% for each partner. If there is still surplus income after distributing the capital and return rate, a further distribution is made between general partners and limited partners based on a 20% and 80% ratio, respectively. This 20% is attributed to the compensation of general partners, i.e., excess profit.

Suppose the partnership invests 100 million RMB in a project, and the corresponding company successfully goes public through an IPO. However, by the end of the year, the partnership has not yet exited. At the end of the year, based on the IPO stock price and investment cost at that point, the calculated total income to be distributed upon exit is 20 million RMB. Using this total income as the basis, the simulated exit amount is 120 million RMB. This amount is first simulated to be distributed to each partner's capital and an 8% return. Afterward, there is still a remaining excess income of 12 million RMB, of which 20%, i.e., 2.4 million RMB, can be distributed to general partner C, and the remaining 9.6 million RMB of excess income is distributed according to the relative equity ratios of individuals A and B.

In this case, although the nominal contribution ratio of General Partner C is only 1%, he actually received 80,000 (benchmark returns) + 2,400,000 (excess returns) = 2,480,000 yuan (total returns) in this project, accounting for 12.4% of the total returns of 20 million yuan. This far exceeds the nominal contribution ratio of 1%, resulting in a "same stock, different rights" scenario. At the end of the year, General Partner C can recognize the expected investment income of 2,480,000 yuan based on the simulated distribution ratio of 12.4%, rather than the nominal contribution ratio of 1%.

This accounting treatment, based on long-term equity investments, allows General Partners to reflect their expected investment income at the end of each period before the exit, rather than recognizing income in the exit period when the investment project is fully or partially exited. This approach helps to achieve a relatively smooth overall income distribution across the various years of the investment period. However, when using this method, the following points should be noted:

(1) The percentage of income that General Partners possess depends on the proportion of excess returns to total returns.

The more excess returns a particular investment project generates, and the larger the proportion of total returns it constitutes, the higher the excess returns General Partners will enjoy. General Partners should calculate their share percentage based on the actual exit distribution terms for each investment project.

(2) If General Partners want to recognize unrealized investment income through this approach before the exit, they need to conduct a reasonable valuation of the underlying investment projects. As the underlying projects have not yet completed an exit, the valuation returns for each period before the exit are unrealized. Inappropriate valuation may lead to significant fluctuations in annual investment income and even result in large losses in some years. This approach also has the potential to be used for earnings manipulation, and may face inquiries from audits and regulators. When cautiously valuing underlying projects, at least the following factors should be considered:

① Information directly reflecting the fair value of the underlying investment project, such as the stock price if the underlying project is an IPO-listed company. If the underlying project is a financial product, valuation can be based on the manager's valuation table. In the absence of a valuation table or similar information, appropriate valuation techniques need to be employed.

② Information related to the valuation risk of the underlying investment project, such as macroeconomic conditions, market environment, and expected factors. Adjustments to the valuation may be necessary, taking into account prospective considerations of the risks faced.

③ Consideration of the exit risk of the underlying project. Since the equity investment in the underlying investment project has not been realized, a discount may be applied to the valuation result if necessary. Factors to consider include the liquidity of the stock market, turnover rate, and the length of time to the expected exit point or the expected exit point itself. The longer the expected exit time, the higher the stock price volatility, the lower the turnover rate, and the less active the relevant trading market, the higher the exit risk discount. This consideration is similar to the liquidity discount considered in the valuation process of equity in the primary market.

(3) Using this method to recognize the unrealized investment income of General Partners at the end of each year during the investment period may result in significant fluctuations. Since General Partners enjoy excess returns at a high proportion, the valuation results of underlying investment projects will inevitably fluctuate in each year due to market volatility. This will lead to more dramatic variations in the unrealized investment income recognized by General Partners each year. Careful valuation should be combined with the aforementioned factors to avoid substantial fluctuations in income.

4. Analysis of Accounting Treatment for General Partner Investment Income under Enterprise Accounting Standards - Revenue

Enterprise Accounting Standard No. 15 - Revenue provides a logical "five-step" framework for recognizing revenue. In this article, we follow the logic of the five-step framework and consider the excess returns received by the general partner as the consideration for providing fund management services. We then confirm unrealized investment income within the framework of the Revenue Accounting Standards.

(1) Identify the contract with the customer. The agreement governing the rights and obligations between general partners and limited partners in private equity funds is the Fund Partnership Agreement. Both general and limited partners are required to exercise their respective rights and fulfill their obligations under the Fund Partnership Agreement. Typically, the general partner, acting as the fund manager, is responsible for the management and day-to-day operations of the fund. In practice, limited partners usually pay the general partner and fund manager fees based on a certain percentage of their contribution. Therefore, the Partnership Agreement can be considered as a contract between the general partner and its "customer," namely the limited partners.

(2) Identify the performance obligations in the contract. As the fund manager, the general partner has multiple obligations to fulfill. The Partnership Agreement specifies the duties generally undertaken by the general partner, essentially performing the role of the fund manager. The specific duties include convening and organizing partnership meetings, seeking investment projects according to the agreed-upon investment direction, analyzing and submitting investment decisions to the Fund Investment Decision Committee for review, and handling other managerial matters of the fund. These performance obligations can be regarded as individual obligations, each representing a specific aspect of the overall performance obligation in the capacity of the fund manager.

(3) Determine the transaction price. In practice, the general partner, as part of its compensation, typically receives management fees and general partner fees based on a certain percentage of the contributions made by limited partners. Additionally, when distributing excess returns, the general partner receives carried interest, reflecting its differentiated position compared to limited partners. Carried interest serves as an incentive for general partners and constitutes a significant

portion of the fund manager's compensation for well-performing private equity fund partnerships. Therefore, the transaction price for the services provided by the general partner, acting as the fund manager, includes general partner fees, fund manager fees, and carried interest.

(4) Allocate the transaction price to the individual performance obligations. In practical terms, the consideration for the general partner, whether it be general partner fees, fund manager fees, or carried interest, is not explicitly allocated among different individual performance obligations in the agreement. There is no clear guidance on how to split the consideration among various performance obligations. For example, the fund manager fees received each year correspond to performance obligations related to both the day-to-day operations of the partnership and the costs associated with finding, analyzing, and reporting investment opportunities. Since different performance obligations are often executed by the same team, it is challenging to allocate labor costs to each specific performance obligation. Given this situation, the consideration for different performance obligations, including general partner fees, fund manager fees, and carried interest, is treated as a single unit of account without further breakdown.

(5) Recognize revenue when each performance obligation is fulfilled. As a general partner also acting as the fund manager, its "services" encompass both pre-investment decision-making services and post-investment management services. Consequently, its performance obligations typically span the entire investment period, allowing for revenue recognition in each annual period as performance obligations are fulfilled. When recognizing revenue, a key factor is determining the consideration for the services. In the previous case, at the end of the year, the general partner could calculate its entitlement to income based on the valuation of the underlying investment. The consideration for its performance obligation is then recognized as revenue. In this case, the consideration is the sum of the base return and excess return, i.e., 80,000 + 2,400,000 = 2,480,000 CNY, which is recognized as revenue in the current period.

When using the revenue recognition criteria to recognize the income of ordinary partners, the following points should be considered.

(1) Estimation of Variable Consideration. According to the "Enterprise Accounting Standards: Revenue," if there is variable consideration in the contract, the enterprise should determine the best estimate of variable consideration based on expected value or the most likely amount to occur. However, the transaction price that includes variable consideration should not exceed the amount that is highly probable not to be reversed when the related uncertainties are eliminated. In principle, the cumulative investment income recognized in the current period based on the above steps should not be reversed in subsequent years. The valuation of underlying investment projects is subject to high requirements under this rule, requiring cautious estimation rather than relying solely on observable fair value information, such as stock prices or manager valuation tables. This standard reflects the idea of avoiding profit manipulation and achieving smooth income recognition across periods. In practical terms, if the underlying investment target is an already listed company through IPO, a careful evaluation of the valuation, taking into account the distance from the expected exit or exit time, is essential. If there is significant volatility in the valuation of underlying investment projects, leading to substantial fluctuations in the investment income enjoyed by ordinary partners, it may be considered to refrain from recognizing investment income directly. Alternatively, the cautious recognition of the threshold income corresponding to the invested capital can be implemented to avoid the risk of reversing income in subsequent years, which may lead to inquiries by regulatory authorities or accounting firms regarding profit manipulation.

(2) Applicability of the Method. When using this approach to recognize income, it is assumed that the ordinary partner simultaneously acts as the fund manager, undertaking the relevant performance obligations and receiving compensation as consideration. However, in practical situations, it is common for ordinary partners not to concurrently serve as fund managers while still benefiting from excess returns. Since it may be challenging to identify performance obligations, this method may not be applicable in such cases. In such situations, ordinary partners may consider adopting the treatment methods under the long-term equity investment pathway mentioned earlier to address income recognition issues.

5. Prospects for Further Research

Ordinary partners, due to their relatively small capital contributions, typically recognize their income only upon investment exit. Their income structure fundamentally differs from that of limited partners, leading to ordinary partners often refraining from recognizing unrealized investment income before realizing distribution upon exit. The accounting treatment and recognition of investment income for ordinary partners under the two aforementioned accounting standards pathways provide methodological approaches. However, considering the issues or limitations emphasized under these two methods, further research can explore the following directions regarding the factors involved:

(1) When adopting the method of recognizing unrealized investment income under long-term equity investment,

formulating principles to confirm the actual income share ratio under the scenario of different rights with the same stock can be explored. This aims to avoid significant fluctuations in income across different periods.

(2) Under the revenue recognition criteria pathway, building a unified principle or model, based on the valuation of underlying investment projects, can be explored. This would involve adjusting from the theoretical allocated amount confirmed by the underlying investment project based on the currently observable fair value information. The goal is to align with the timely recognition of income requirements while also carefully considering the criteria's objective of "non-reversal."

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