Ben
Leung

Rennie
Khan

IFRS for investment entities

For the first time the International Accounting Standards Board (IASB) has issued industry specific guidance for investment entities. Under US Generally Accepted Accounting Principles (US GAAP) similar guidance has existed for some time and is currently documented in Accounting Standards Codification (ASC) 946 Financial Services-Investment Companies (Topic 946).

One of the primary differences between a set of financial statements prepared under International Financial Reporting Standards (IFRS) and US GAAP is consolidation of controlled investee companies. This difference has resulted in an IFRS feeder fund consolidating its master fund, which it has control over, while under US GAAP the master's financial statements are attached to the feeder's investment in the master accounted for at fair value.

Investment Entities – Amendments to IFRS 10, IFRS 12 and IAS 27 (the "Guidance") (IFRS 10 – Consolidated Financial Statements, IFRS 12 – Disclosure of Interests in Other Entities, IAS 27 – Separate Financial Statements) was published in October 2012 and is required for annual periods beginning on or after 1 January 2014 (early application is permitted). The Guidance was developed due to questions raised on the usefulness of financial statements of investment entities if IFRS continued to require the consolidation of entities that an investment entity controls. The Guidance creates an exception to the principle of consolidation in IFRS 10.

The Guidance requires an investment entity (see below) to measure investments in entities that it controls at fair value through profit or loss (in accordance with IFRS 9 Financial Instruments or IAS 39 Financial Instruments: Recognition and Measurement) rather than consolidating such investments. This requirement will have a significant impact on the presentation of financial statements for master feeder structures, private equity funds and fund of funds.

An investment entity is an entity that:

(a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services,

(b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both, and

(c) measures and evaluates the performance of substantially all of its investments on a fair value basis.

One feature that differentiates an investment entity from other entities is that it does not plan to hold its investments indefinitely; it holds them for a limited period. Because equity investments and non-financial asset investments have the potential to be held indefinitely, an investment entity shall have an exit strategy documenting how the entity plans to realise capital appreciation from substantially all of its equity investments and non-financial asset investments.

In assessing whether it meets the definition described above, an entity shall consider whether it has the following typical characteristics of an investment entity:

(a) it has more than one investment,

(b) it has more than one investor,

(c) it has investors that are not related parties of the entity and

(d) it has ownership interests in the form of equity or similar interests.

The absence of any of these typical characteristics does not necessarily disqualify an entity from being classified as an investment entity. An investment entity that does not have all of these typical characteristics provides additional disclosure as discussed below.

More than one investment

Examples of when an entity can still be considered an investment entity even though it only has one investment:

a. is in its start-up period and has not yet identified suitable investments and, therefore, has not yet executed its investment plan to acquire several investments,

b. has not yet made other investments to replace those it has disposed of,

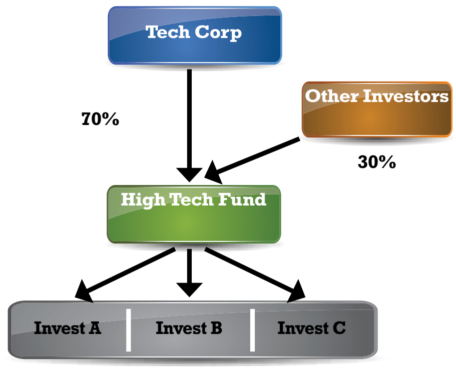
c. is established to pool investors' funds to invest in a single investment when that investment is unobtainable by individual investors (eg when the required minimum investment is too high for an individual investor) or

d. is in the process of liquidation.

EXAMPLE 1

Purpose	Invest in entities with rapid growth potential with the objective of realising capital appreciation.
Investments	Controlling interest in one entity acquired in Year 2 of operations. Other investments made in Year 3
Reporting	Fair value basis, provided to the general partner and investors.
Exit Strategy	Dispose of investee and distribute cash or shares to investors.
Investment Entity?	Yes – from inception

EXAMPLE 2 – HIGH TECH FUND



Purpose	Invest in technology start-up companies for capital appreciation
Scenario	Tech Corp holds options to acquire Invest A/Invest B/ Invest C, at fair value, if the technology developed by A, B or C would benefit the operations of Tech Corp.
Exit Strategy	None currently reported.
Investment Entity?	No – because the options provides a benefit in addition (ie the technology of the investee companies) to capital appreciation or investment income and no exit strategy exists.

More than one investor

Examples of when an entity can still be considered an investment entity even though it only has one investor:

a. is within its initial offering period, which has not expired and the entity is actively identifying suitable investors,
b. has not yet identified suitable investors to replace ownership interests that have been redeemed or
c. is in the process of liquidation.

Unrelated investors

An entity may still qualify as an investment entity even though its investors are related to the entity. For example, an investment entity may set up a separate 'parallel' fund for a group of its employees (such as key management personnel) or other related party investor(s), which mirrors the investments of the entity's main investment fund. This 'parallel' fund may qualify as an investment entity even though all of its investors are related parties.

Disclosure requirements

Because a consolidated investee set of financial statements contains more disclosures than one shown at fair value, the Guidance has introduced the following disclosure requirements:

(a) An entity shall disclose that it meets the definition of an investment entity and the significant judgements and assumptions it has made in determining it is an investment entity.
(b) When an entity becomes, or ceases to be, an investment entity, it shall disclose the change of investment entity status and the reasons for the change.
(c) For each unconsolidated subsidiary, an investment entity shall disclose:
    1. the subsidiary's name
    2. the principal place of business (and country of incorporation if different from the principal place of business) of the subsidiary and
    3. the proportion of ownership interest held by the investment entity and, if different, the proportion of voting rights held.
(d) the nature and extent of any significant restrictions (eg resulting from borrowing arrangements, regulatory requirements or contractual arrangements) on the ability of an unconsolidated subsidiary to transfer funds to the investment entity in the form of cash dividends or to repay loans or advances made to the unconsolidated subsidiary by the investment entity and
(e) any current commitments or intentions to provide financial or other support to an unconsolidated subsidiary, including commitments or intentions to assist the subsidiary in obtaining financial support.
(f) An investment entity shall disclose the terms of any contractual arrangements that could require the entity or its unconsolidated subsidiaries to provide financial support to an unconsolidated, controlled, structured entity, including events or circumstances that could expose the reporting entity to a loss (eg liquidity arrangements or credit rating triggers associated with obligations to purchase assets of the structured entity or to provide financial support).

Note that the Guidance says the required disclosure may be provided by including, in the financial statements of the parent, the financial statements of the subsidiary that contains the information, however this is not a requirement. Therefore if a feeder's financial statements contain all the required disclosures it does not have to attach the master's, however attaching the master's may be the easiest option.

See Examples 1 and 2.

Exception to the rule

If an investment entity has a subsidiary that provides investment related services, such as investment management services, to the entity or other parties, the investment entity must consolidate this subsidiary.

Early adopt?

If an entity is considering whether to early adopt the Guidance, the following should be taken into account:

1. If it is early adopted all the requirements of the Guidance needs to be adopted and not just selected sections that will be of benefit to the entity.
2. As this is an amendment to IFRS 10 and IFRS 12, if the Guidance is early adopted, IFRS 10 and IFRS 12 will also have to be adopted (IFRS 11 Joint Arrangements would also have to be early adopted as IFRS 10, 11 and 12 go together, however IFRS 11 is very rarely encountered for investment entities).
3. Although there is no requirement to attach the master's financial statements to the feeder's this might be the best solution if there are multiple feeders into the master and in order to meet the risk disclosure requirements of IFRS 7 Financial Instruments: Disclosures.

Conclusion

Whether the marriage of IFRS and US GAAP goes down the path of convergence, endorsement or condorsement (term used by SEC Deputy Chief Accountant Paul Beswick), the Guidance represent a huge step forward for comparing the financial statements of hedge funds prepared under IFRS and US GAAP.

Ben Leung
Managing Partner

PKF Cayman, Cayman Islands
| T: +1 (345) 945 5889 | E: bleung@pkfcayman.com | W: www.pkfcayman.com

Rennie Khan
Audit Director

PKF Cayman, Cayman Islands
| T: +1 (345) 945 5889 | E: rkhan@pkfcayman.com | W: www.pkfcayman.com