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

by **Ben Leung** and **Rennie Khan**

Exposure draft for IFRS investment entities

One of the primary differences between a set of financial statements prepared under International Financial Reporting Standards 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).

Exposure Draft ED/2011/4 Investment Entities was published in August 2011. The ED 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 ED proposes to create an exception to the principle of consolidation in IFRS 10.

The ED proposes that an investment entity (see below) should be required to measure investments in entities that it controls at fair value through profit or loss (in accordance with IFRS 9) 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. A parent of an investment entity shall consolidate all entities that it controls, including those controlled through an investment entity, unless the parent itself is an investment entity.

An investment entity is an entity that meets all of the following criteria:

(a) The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income (such as dividends or interest), or both. Therefore the entity should have no significant assets and liabilities other than those relating to investing activities.

(b) The entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income, or both.

(c) Ownership in the entity is represented by units of investments, such as shares or partnership interests, to which proportionate shares of net assets are attributed.

(d) The funds of the entity's investors are pooled so that the investors can benefit from professional investment management. The entity has investors that are unrelated to the parent (if any), and in aggregate hold a significant ownership interest in the entity. Thus, on this criterion, a fund with a single investor unrelated to the fund manager, such as a sovereign wealth fund would not qualify as an investment entity.

(e) Substantially all of the investments of the entity are managed, and their performance is evaluated, on a fair value basis.

(f) The entity provides financial information about its investment activities to its investors. The entity can be, but does not need to be, a legal entity.

Similar requirements exist under Topic 946, however if Proposed Accounting Standards Update 2011-200 is finalised the above requirements will be the same for US GAAP and IFRS. This would represent a major step forward in accounting standards convergence for hedge funds.

Disclosure requirements

An investment entity shall provide information to enable users of its financial statements to evaluate the nature and financial effects of the investment activities in which it engages.

In addition to disclosures required by IFRS 7 Financial Instruments: Disclosures, IFRS 12 Disclosure of Interests in Other Entities and IFRS 13 Fair Value Measurement, an investment entity shall disclose the following information:

(a) When an entity's status has changed, the entity shall disclose in the notes the change of status and reasons for the change. In addition, an entity that becomes an investment entity shall disclose the effect of the change of status on the financial statements for the period presented, including the effects of the change on the amounts of investments as of the date of the change of status and the related effects on profit or loss and total comprehensive income.

(b) Whether the investment entity has, during the reporting periods presented, provided financial or other support to investees it controls, without having a contractual obligation to do so, including:

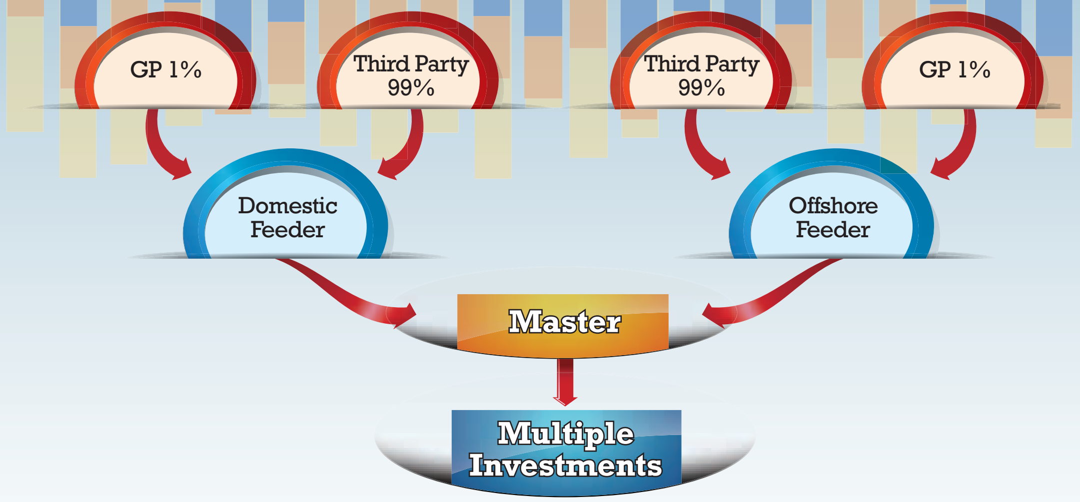
(i) the type and amount of support provided, including situations in which the investment entity assisted the investee in obtaining financial support, and

(ii) the reasons for providing the support.

(c) An investment entity shall disclose any current intentions to provide financial or other support to investees it controls, including intentions to assist a controlled investee in obtaining financial support.

(d) The nature and extent of any significant restrictions on the ability of controlled investees to transfer funds to the investment entity in the form of cash dividends, or repayment of loans or advances.

PASU 2011-200 also has similar disclosure requirements.



Example from the ED

An entity, Master Fund, is formed in 20X1 with a 10-year life. The equity of Master Fund is held by two affiliated feeder funds. The feeder funds are established to meet legal, regulatory, tax or other requirements. The feeder funds are capitalised with a 1 per cent investment from the general partner and 99 per cent from unaffiliated investors, with no party holding a controlling financial interest. The purpose of Master Fund is to hold multiple investments in order to generate capital appreciation and income (such as dividends or interest). The investment objective communicated to investors is that the purpose of the Master-Feeder structure is to provide investment opportunities for investors in separate market niches to invest in a large pool of assets. Master Fund has identified and documented exit strategies for the investments that it holds. In addition, investors receive periodic financial information, on a fair value basis, from the Feeder funds.

Master Fund and the Feeder funds each meet the definition of an investment entity. The following conditions exist:

(a) The Master-Feeder structure's activities consist of holding multiple investments for capital appreciation and income (such as dividends or interest). Even though the sole investment held by the Feeder funds is their investment in Master Fund, the Feeder funds meet the multiple investments criteria because they were formed in conjunction with another investment entity, Master Fund, which holds multiple investments.

(b) The Master-Feeder structure's business purpose, which was communicated directly to investors of the feeder funds, is investing for capital appreciation and income (such as dividends or interest). The Master-Feeder structure has identified and documented potential exit strategies for its investments.

(c) Ownership in Master Fund and the Feeder funds is represented by units of equity.

(d) Even though Master Fund is wholly capitalised by the Feeder funds, it was formed in conjunction with the Feeder funds, which are funded by investors who are unrelated to each other. In addition, no party holds a controlling financial interest in the Feeder funds.

(e) The investments are managed on a fair value basis and information about the investments made by Master Fund is provided to investors on a fair value basis through the Feeder funds.

(f) Master Fund and the Feeder funds are entities reporting financial information about their activities to their investors.

Current status

The deadline for comments on the ED was 5 January 2012. The IASB is conducting the project jointly with the Financial Accounting Standards Board ("FASB") and the following tentative decisions were made in June 2012;

- The boards tentatively decided that an investment entity should be required to measure all controlling financial interests in another investment entity at fair value (including in both master-feeder and fund-of-funds structures), rather than consolidating those subsidiaries.
- The IASB tentatively decided not to require an investment entity to attach the financial statements of its investees in any circumstances.
- The FASB tentatively decided to require a feeder fund to attach its master fund's financial statements along with its financial statements in a master-feeder structure.
- The IASB tentatively decided that a non-investment entity parent should not retain the exception from consolidation used for the controlled investees of an investment entity subsidiary.
- The FASB tentatively decided to retain the requirement in current U.S. GAAP that a non-investment company parent should retain the specialised accounting used by an investment company subsidiary.

The current target period for the final IFRS is the second half of 2012.

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), if the ED is finalised it will represent a huge step forward for comparing the financial statements of hedge funds prepared under IFRS and US GAAP.

BIO: AT A GLANCE

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Rennie Khan (FCCA) has joined PKF (Cayman) Ltd. as an Audit Director. He has fifteen years of accounting experience, including eleven years in the Cayman Islands. Prior to joining the firm, he served with another major accounting firm in Trinidad and Tobago and the Cayman Islands. He gained his experience working on audits of investment funds, private banks, insurance captives and trust companies.

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