HAS THE DOOR OPENED FOR INVESTMENT FUND GAAP?

Given Ireland's leading position in the investment fund industry, especially in all matters related to financial reporting, the recent Exposure Draft on Investment Entities could be seen as a watershed moment for the industry and its relationship with the International Accounting Standards Board (IASB). **Glenn Gillard** and **Goind Ram Khatri** look at the ED and ask whether this is the start of recognition by the IASB that investment funds need to be considered separately from other activities.

The Financial Accounting Standards Board (FASB) has always had special recognition within the United States Generally Accepted Accounting Principles (US GAAP) framework for investment entities. The IASB, however, has been reluctant to afford similar recognition in International Financial Reporting Standards (IFRS).

In Ireland, the Irish Fund Industry Association (IFIA) has consistently called for the IASB to provide industry-specific standards and guidance particularly when commenting on standards such as IAS 32 *Financial Instruments: Presentation*, IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*.

Similarly, the key industry body, the European Fund and Asset Management Association (EFAMA), has called for formal recognition within standards of the unique characteristics of investment funds and has recently reformed its IFRS working group. Indeed, when looking at convergence between US GAAP and IFRS, one of the most vociferous voices against convergence was the US investment fund community, based on a view that the general purpose, one size fits all approach of IFRS was a step backwards from the industry specific guidance in US GAAP.

Within all of this, one of the hottest topics has been the question of consolidation. If a fund is designed to allow investors to invest for capital appreciation and income generation without an intention to be involved in the strategy or operations of the target investment, should it have to consolidate that entity where it may hold a controlling interest?

Consolidation, it is argued, provides less meaningful information than simply providing a fair value of the investment. In addition, given the nature of fluctuating interests in entities, consolidation requirements can lead to complex scenarios of moving from controlling to not controlling and back again and all the related accounting complexity for little gain to the reader.

As a result, the IASB and the FASB jointly started a project that has resulted in the publication of ED/2011/14 *Investment Entities* and proposed amendments to Topic 946 in the FASB's Accounting Standards Codification®

IS THE IASB PROPOSING AN EXCEPTION TO THE CONSOLIDATION MODEL IN IFRS 10?

The ED proposes that an investment entity will not consolidate the entities that it controls. Instead, it will measure those entities at fair value through profit or loss in accordance with the requirements of IFRS 9 *Financial Instruments.* This is an exception to the general consolidation model in IFRS 10. However, an entity would need to meet strict criteria to be regarded as an investment entity before it can avail of the exemption from consolidation.

WHAT ENTITIES ARE CONSIDERED INVESTMENT ENTITIES?

Under the proposal an entity will be considered as an investment entity if it meets all of the following criteria:

1. The entity's only substantive activities are investing in multiple investments for capital appreciation, investment income, or both.

The majority of the assets, liabilities and other activities of an investment entity must be related to its own investment activities. Investment advisory services provided by an investment entity directly or indirectly, through an entity it invests in, are also regarded as substantive activities. One notable area where this criterion may not be met is in respect of real estate funds where the management of properties generally forms part of the activities of the fund.

In the case of an investment in collateralised investment products, an investment entity may temporarily hold collateral as a result of default of the investee without affecting the status of the entity, provided such investment is not acquired with the intention of controlling the collateral. In assessing whether collateral is being held temporarily, an entity would consider all facts and circumstances including:

- general policies and past practices for holding collateral and related risks;
- strategies regarding disposal of collateral including expected timing for such disposal;
- time required to sell similar assets in current market conditions;
- third party rights over the collateral.

An investment entity must have multiple investments either directly or indirectly through another investment entity which is formed for legal, regulatory, tax or other business reasons.

Example
Multiple investments in case of master-feeder structure

High yield feeder fund plc, an offshore feeder fund, invests in a master fund that holds multiple investments. While the only investment of the feeder fund is its interest in the master fund, the feeder fund would be considered to have multiple investments through its interest in the master fund.

Although the business purpose of an investment entity is to hold multiple investments, it is not required to hold multiple investments at all times during its existence. For example, an investment entity could hold cash during its initial offering period, identifying suitable investment opportunities or if it is in the process of liquidation. The activities of an investment entity must be directed towards generating investment income, capital appreciation or both.

2. The entity makes an explicit commitment to its investors that the purpose of the entity is investing to earn capital appreciation, investment income.

Such explicit commitment may be evidenced from prospectuses, offering memorandums, indenture agreements, marketing materials and partnership agreements.

3. 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

Having multiple classes of equity instruments, for example shares with preferential rights, currency classes or institutional and retail classes, does not preclude an entity from being an investment entity.

4. 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.

To meet the definition of an investment entity, the entity must have investors that are unrelated to the entity's parent (if any), and they must in aggregate hold a significant ownership interest in the entity. However, the ED proposes that a single investor can still be considered as an investment entity provided it meets all other investment entity criteria. This would appear to be a sensible and pragmatic approach given that in many cases a fund structure will have only one investor for legitimate reasons; however, there is likely to be a need for more guidance in this area to prevent abuse.

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

Another fundamental criterion is that investments of the investment entity must be managed, and their performance evaluated, internally or externally, on a fair value basis. To meet this criterion, information provided to management of the entity for decision making purposes and information provided to investors must be prepared on a fair value basis.

6. The entity provides financial information about its investment activities to its investors. The entity can be, but

"IF A FUND IS DESIGNED TO ALLOW INVESTORS TO INVEST FOR CAPITAL APPRECIATION AND INCOME GENERATION WITHOUT AN INTENTION TO BE INVOLVED IN THE STRATEGY OR OPERATIONS OF THE TARGET INVESTMENT, SHOULD IT HAVE TO CONSOLIDATE THAT ENTITY WHERE IT MAY HOLD A CONTROLLING INTEREST?"

"THE INVESTMENT COMMUNITY SHOULD WELCOME THE NEW ED WITH OPEN ARMS."

does not need to be, a legal entity.

An investment entity need not necessary be a legal entity. Any entity meeting the six criteria above is regarded as an investment entity. This may be particularly important for structures such as common contractual funds.

IS THE EXCEPTION TO THE CONSOLIDATION MODEL ALSO EXTENDED TO THE PARENT OF AN INVESTMENT ENTITY?

The ED does not propose that the exception be extended to the parent of an investment entity unless the parent is itself an investment entity. 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. This is an onerous requirement and effectively reverses the exception at the parent company level. The intention appears to be an anti-abuse measure; however, it seems to ignore much of the rationale behind the development of the ED. For the majority of cases, continuing to allow the exception at the parent company level would be consistent with the objective of the ED; however, anti-abuse provisions do need to be included.

WHAT ADDITIONAL DISCLOSURES ARE REQUIRED FOR INVESTMENT ENTITIES UNDER THE PROPOSAL?

The disclosure requirements go further than just additional requirements specific to the consolidation exception. A broad requirement is also introduced requiring disclosure of such information considered necessary to enable the user of financial statements to evaluate the nature and financial effect of the investment activities. This is 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*. The application guidance provides examples of additional disclosures including detailed per-share information for each period presented, total return information and expense ratios.

The additional disclosure requirement on a per-share basis brings IFRS much closer to the requirement in US GAAP for what is termed 'financial highlights'. Many users will welcome this as financial highlights are considered to be investor friendly disclosures. However, preparers will be disappointed that there is no effort to consider the appropriateness of the existing disclosures in IFRS 7 which are, at present, very onerous and viewed by many preparers as uninformative for users.

CONCLUSION

The investment fund community should welcome with open arms the new ED. Without doubt, there are elements of the ED that don't sit comfortably with all stakeholders and, as with all standards, the devil is always in the practical application detail. However, the acceptance by the IASB of the need to address concerns of the investment fund industry and the introduction of the definition of an investment entity (or more importantly what constitutes investing activities) is a landmark step for the industry. Respondents to the ED are already calling on the board to look at the disclosures in IFRS 7 and further areas of concern are being highlighted, such as cash flow statements. While a separate GAAP for investment funds is neither likely nor consistent with the board's approach to industry-specific matters (see insurance contracts and exploration projects as other examples), the door is definitely ajar for the industry to make headway with addressing some of their key concerns with measurement and disclosure of investing activities.

Glenn Gillard, ACA is a partner with Deloitte and Goind Ram Khatri, ACA, FCCA is a manager in the same firm.

SUBSCRIBE TO

ACCOUNTANCY IRELAND

Annual Subscription Rate

€45 (Ireland, GB, Europe)
€95 (Rest of World)

Name ______

Company ______

Address ______

Email ______

Daytime phone ______

Cheques should be made payable to Chartered Accountants Ireland

Return this form with you payment to Accountancy Ireland
Chartered Accountants House
47 – 49 Pearse Street
Dublin 2

Subscribe by credit card online at www.accountancyireland.ie or ring +353 1 637 7392

Any personal data provided by you to Chartered Accountants Ireland will be held in accordance with the Data Protection Act, 1988 and the Data Protection (Amended) Act, 2003.