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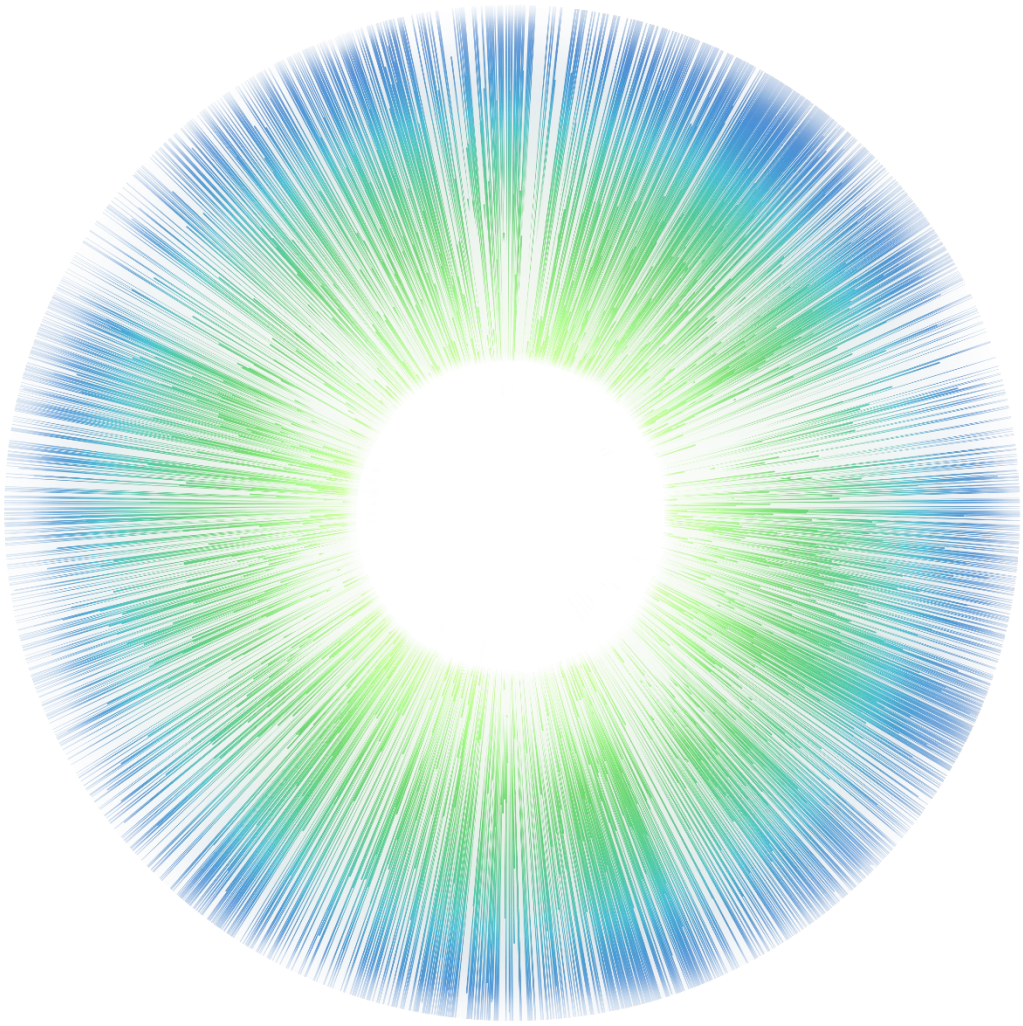


Deloitte in the Cayman Islands
Technical Brief for Investment Funds

Accounting, Auditing and Regulatory

January 2019

Audit & Assurance

In this issue

Introduction

The *Technical Brief for Investment Funds ("Tech Brief")* is an annual newsletter developed by the Deloitte Cayman Islands Investment Funds Technical Team.

There have been a few issued updates to United States and International accounting standards that will affect investment managers and/or investment funds. In this *Tech Brief*, we will summarize the most applicable new and upcoming accounting and financial reporting standards that investment funds and their managers may have to contend with.

On the regulatory front, it has been fairly quiet with few new developments that impact the investment management industry. This *Tech Brief* provides brief reminders on a few select regulatory matters covered in previous *Tech Brief*s.

Finally, we have again summarized some considerations in relation to fund liquidations in the Cayman Islands. We have included a sidebar discussion on circumstances where a fund manager is seeking a wind down of a fund with significant illiquid positions and have provided an example of the operation of a realization solution.

Cayman Islands investment funds – readers less familiar with the Cayman Islands as a jurisdiction will find our 2018 guide to ***Establishing Investment Funds in the Cayman Islands*** (*click to open*) a helpful resource in understanding the various legal, structural and operational considerations associated with Cayman Islands funds.

FASB and IASB Joint Projects

Revenue from Contracts with Customers

Introduction

The Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") completed a joint project to improve financial reporting by creating common revenue recognition guidance for both US GAAP and IFRS that clarifies the principles for recognizing revenue. The new revenue recognition guidance outlines a largely principles-based comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance. 'Customers' is a broadly defined term and, in an investment management environment, a customer might include a fund or the investor(s) (depending on the circumstances).

For investment funds, the new revenue reporting standards are unlikely to have much effect. Investment managers may be more significantly affected by these new standards.

Status – US GAAP

The US GAAP amendments in ASU 2014-09, *Revenue from Contracts with Customers* (Topic 606), are effective for public entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2018, and interim periods within annual period beginning after December 15, 2019. A reporting entity should apply the amendments either (i) retrospectively to each reporting period presented; or (ii) retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early application is permitted, with certain limitations.

Status – IFRS

IFRS 15, *Revenue from Contracts with Customers,* is effective for annual reporting periods beginning on or after January 1, 2018. Earlier application is permitted. When first applying IFRS 15, entities should apply the standard in full for the current period, including retrospective application to all contracts that were not yet completed at the beginning of that period. In respect of prior periods, the transition guidance allows entities an option to either (i) apply IFRS 15 in full to prior periods (with certain limited practical expedients being available); or (ii) retain prior period figures as reported under the previous standards, recognizing the cumulative effect of applying IFRS 15 as an adjustment to the opening balance of equity as at the date of initial application (beginning of current reporting period).

Summary

Impact on investment funds: Revenue arising from investment contracts is outside the scope of the new revenue standards and, therefore, the accounting for interest and dividends, and realized and unrealized gains and losses, will not be affected. Accordingly, there will be no impact on investment funds, unless a fund has ancillary sources of revenue such as incoming fees for various activities.

Impact on investment managers: Investment managers may be more significantly affected by the new revenue standards, depending on how investment managers previously accounted for various items. The new guidance requires investment managers to make a number of judgments in various areas. The following highlights some of the matters requiring consideration.

Revenue from Contracts with Customers (continued)

Summary (continued)

Performance-based compensation: Investment management contracts commonly include fees or allocations payable to the investment manager based on the performance of the fund managed. Under the new standards, variable consideration in a contract can only be recognized when it is highly probable that the revenue recognized would not be subject to significant future reversals as a result of subsequent re-estimation. Accordingly, if the performance-based compensation is subject to clawbacks, reimbursements or forms of cumulative hurdles, such that the compensation is not substantially crystallized at the end of the reporting period, the investment manager is prohibited from recognizing such variable compensation until the uncertainties or contingencies are resolved. In a fund where the investment manager's compensation is crystallized at period end, the determination of revenue is more straightforward. In other scenarios, the determination is more complex and requires judgment.

There are many nuances in the interpretation of aspects of the standards that can affect the timing of revenue recognition. For example, the revenue recognition constraint of "significant future reversals" may be overcome if, for example, a private equity fund has exited substantially all of its risky investments, or the fund is nearing final liquidation, or remaining assets within the fund have substantially decreased such that a significant reversal is highly improbable.

It is important to note that the recognition of revenue at the investment manager does not affect how a fund recognizes performance-based fees and allocation.

Contract costs: Under the new guidance, incremental costs of obtaining a contract (those costs that the entity would not have incurred had the contract not been obtained) that the entity expects to recover must be recognized as an asset. To account for costs incurred to fulfill a contract an entity should apply the requirements of other standards (for example ASC 330 – *Investments – Debt and Equity Securities*) or the costs should be recognized as an asset to the extent certain criteria are met.

FASB noted that depending on the specific facts and circumstances of the arrangement between an investment manager and the other parties in the relationship, the application of the guidance on incremental costs of obtaining a contract might have resulted in different accounting for sales commissions paid to third-party brokers (that is, in some cases the commission would have been recognized as an asset, while in others it would have been recognized as an expense). FASB observed that it had not intended the application to result in an outcome for these specific types of sales commissions that would be different from applying existing US GAAP. Consequently, FASB decided to retain the specific cost guidance for investment companies in FASB ASC 946-605-25-8 which has been moved to Subtopic 946-720, *Financial Services—Investment Companies—Other Expenses.*

Identification of contract and customer: For investment managers, there is a need to identify who the customer is when applying the new guidance. Depending on the circumstances, the customer may be considered the fund or the investor(s). This determination could affect the timing of revenue recognition (for example, if an asset manager has multiple contracts or promises in a contract, that would either be accounted for separately or together, depending on who the customer is for each individual contract or promise) and the accounting for certain costs (for example, costs associated with launching a new fund or obtaining new investors could be either expensed as incurred or capitalized depending on whether they are associated with obtaining customers or fulfilling performance obligations). An example of a situation in which a fund is the customer would be a registered investment company with hundreds of investors, including relationships through omnibus accounts, whereby none of the investors are deemed to have influence over the contracts between the funds and their service providers. An example of a situation in which an investor may be considered the customer is a single investor fund where the investor has influence over the service arrangements, including pricing, and the design of the fund provides for no corporate governance through a board of directors or other form of governance, which is independent of management of the fund. In *Chapter 4 – Asset Management* of the *AICPA Audit and Accounting Guide: Revenue Recognition*, the Financial Reporting Executive Committee (FinREC) has identified characteristics that may help entities in determining whether the customer is the fund or the individual investor.

FASB and IASB Joint Projects (continued)

Leases

Introduction

The leases project began as a joint project between the FASB and the IASB culminating with the issuance of ASU 2016-02, which amends US GAAP with the creation of Topic 842, and IFRS 16, which replaces IAS 17. Many of the new requirements are the same in ASU 2016-02 and IFRS 16; however, there are a number of differences between US GAAP and IFRS in the final standards, particularily in relation to certain aspects of the lessee accounting model (see below). The main changes from the existing standards is the requirement, with some limited exceptions, to recognize all leases on the balance sheet (i.e. the removal of off-balance sheet leases) and the definition of what constitutes a lease. The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed. Accounting by lessors remains substantially unchanged from the previous standards.

While the updated guidance will not likely have an effect on investment funds, investment managers may be impacted to the exent they have leased assets that were previously accounted for under the guidance for operating leases (and thus not reported on the balance sheet). Under the new guidance, the rights and obligations associated with most of these leases will be recognized on the balance sheet. The income statement will be impacted as well but to a lesser extent.

Status – US GAAP

The US GAAP amendments in ASU 2016-02, *Leases* (Topic 842), are effective for public entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the amendments in this ASU are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Earlier application is permitted.

Status – IFRS

IFRS 16, *Leases*, is effective for annual reporting periods beginning on or after January 1, 2019. Early application is permitted if IFRS 15*, Revenue from Contracts with Customers*, has also been applied.

Summary

Balance sheet recognition of all leases: The main change between previous US GAAP and ASU 2016-02 is the requirement for lessees to recognize operating leases on their balance sheet. Both US GAAP and IFRS now require the recognition of substantially all lease assets and lease liabilities on the balance sheet, with the exception of short-term leases (i.e., those with a lease term of 12 months or less), and, in the case of IFRS, leases of assets with values of less than $5,000. Certain disclosures of key information about leasing arrangements have also been amended. Under the new guidance, a lessee would record a right-of-use ("ROU") asset representing its right to use the underlying asset during the lease term and a corresponding lease liability.

FASB and IASB Joint Projects (continued)

Leases (continued)

Summary (continued)

Definition of a lease: ASU 2016-02 and IFRS 16 diverge somewhat in the definition of what constitutes a lease. Under US GAAP, ASU 2016-02 defines a lease as a "contract, or part of a contract, that conveys the right to control the use of identified property, plant, and equipment (an identified asset) for a period of time in exchange for consideration". Under IFRS 16, "a contract is, or contains, a lease if it conveys the right to control the use of an identified asset for a period of time in exchange for consideration". In both cases, control is conveyed where the customer has both the right to direct the identified asset's use and to obtain substantially all the economic benefits from that use. An asset is typically identified by being explicitly specified in a contract, but an asset can also be identified by being implicitly specified at the time it is made available for use by the customer.

While these separate definitions under US GAAP and IFRS may seem straightforward, judgment is crucial to identifying a complete population of leases. At first glance, a contract may not seem to meet a conventional understanding of a lease. In preparation for the application of the new standard, investment managers should evaluate each of their contracts to determine their complete population that falls within the definition of a lease.

Lease accounting model: ASU 2016-02 and IFRS 16 diverge in the lessee's classification of the lease upon initial recognition and, therefore, the lease accounting model applied. Under ASU 2016-02, US GAAP continues to distinguish between finance leases and operating leases based on classification criteria that are substantially similar to previous US GAAP. In contrast, the lessee accounting model in IFRS 16 requires all leases to be accounted for consistent with the US GAAP approach for finance leases. Consequently, leases historically classified as operating leases under US GAAP will be accounted for differently under US GAAP than under IFRS and will have a different effect on the income statement under IFRS 16 than under previous IFRS guidance. Note that within US GAAP, the designation of a lease as finance or operating does not affect the reporting of such leases on the balance sheet, as the rights and obligtions of all such leases will be reported on the balance sheet.

Present value measurement: The rights and obligations associated with the lease are recognized and measured on the balance sheet based on the present value of the lease payments. Both US GAAP and IFRS require a lessee to record its lease arrangements by using the interest rate implicit in the lease (i.e. the rate the lessor charges in the lease), if readily determinable, or, alternatively, to use the lessee's incremental borrowing rate. As a result, upon adoption of either ASU 2016-02 or IFRS 16, an investment manager will be required to determine the appropriate discount rate to apply when the lease arrangements are initially recorded on the balance sheet.

FASB and IASB Joint Projects (continued)

Financial Instruments

Introduction

The IASB and FASB initiated a joint project with an intended goal of improving the accounting for financial instruments and moving toward convergence on a single recognition and measurement model. Subsequently, the FASB issued ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* and ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and the IASB issued IFRS 9, *Financial Instruments*. Although most of the general principles and objectives underlying the amendments to US GAAP and IFRS are the same, there are some existing and evolving instances of divergence that will apply in specific circumstances.

Broadly speaking, there are two general areas where certain reporting entities might have changes. One is the measurement and recording of certain financial instruments. The other is the introduction of a new impairment model for recognition of credit losses.

For investment funds reporting using a fair value model (as is already required under US GAAP and generally under IFRS for investment funds), these amendments are unlikely to have much effect. For investment managers and investors in investment funds, these amendments might have some effect.

Status – US GAAP

ASU 2016-01 is effective for public business entities with fiscal years beginning after December 15, 2017 and all other entities with fiscal years beginning after December 15, 2018.

ASU 2016-13 is effective for public business entities with fiscal years beginning after December 15, 2019 and all other entities with fiscal years beginning after December 15, 2020.

Status – IFRS

The amendments under IFRS 9 are mandatorily effective for periods beginning on or after January 1, 2018.

Summary – US GAAP

Classification and Measurement: ASU 2016-01 will not have an effect on investment funds that report under Topic 946, *Financial Services – Investment Companies,* due to a specific scope exception. Investment managers, however, might be affected to a certain extent depending on the nature of any financial instruments they hold. While this ASU retains many existing requirements, it changes the measurement and classification of investments in equity securities and the presentation of certain fair value changes of financial liabilities measured at fair value. With respect to equity securities, entities will now be required to record all investments in equity securities (except for those accounted for using the equity method) at fair value with changes in fair value through net income. For financial liabilities for which the fair value option has been elected, the amendments require a reporting entity to separately recognize in other comprehensive income that portion of the change in fair value associated with instrument-specific credit risk. This ASU also amends certain disclosure requirements. For example, other than for public entities, the methods and significant assumptions for fair value measurement are no longer required and the fair value for financial assets and liabilities measured at amortized cost do not need to be disclosed.

Impairment: ASU 2016-13 introduces a new impairment model based on expected credit losses rather than incurred losses. This model is intended to better represent the recognition of conditions, economic or otherwise, giving rise to an eventual credit loss throughout the life of the instrument rather than all at the time an incurred loss occurs. This ASU will likely not have an effect on investment funds as its amendments will not affect entities holding financial assets accounted for at fair value through net income (as expected credit losses are already embedded in the fair value). Investment managers that hold instruments carried at amortized cost, including loans receivable, will be affected. This ASU removes the thresholds to measure and recognize credit losses for financial instruments at amortized cost. Instead, these will be measured as the difference between amortized cost and the entity's estimate of credit losses (i.e. amount expected to be collected over the life of the financial instrument).

FASB and IASB Joint Projects (continued)

Financial Instruments (continued)

Summary – IFRS

IFRS 9 is the IASB's replacement of IAS 39 *Financial Instruments: Recognition and Measurement* and includes requirements for recognition and measurement, impairment, derecognition, and hedge accounting. The amendments to measurement and impairment are discussed below.

Classification and Measurement: The measurement of financial instruments is not expected to change for investment funds. Under IFRS, investment funds have historically measured, and will generally continue to measure, their financial instruments at fair value. Other entities, such as investment managers, could be affected. The remaining measurement summary should be read in the context of a non-investment fund.

Under IFRS 9, for subsequent measurement of financial assets after initial recognition, IFRS 9 divides all financial assets that are currently in scope of IAS 39 into two classifications – those measured at amortized cost and those measured at fair value. For those instruments measured at fair value, gains and losses must either be categorized entirely in profit or loss (fair value through profit or loss "FVTPL") or in other comprehensive income (fair value through other comprehensive income "FVTOCI").

Only debt instruments can qualify to be subsequently measured at amortized cost and FVTOCI based on the business model and cash flow tests. If the debt instrument is held to collect contractual cash flows until its maturity (business model test) and the contractual terms of the instrument indicate that cash flows are only payments of principal and interest (cash flow test), it must be measured at amortized cost. If, however, the instrument is held to both collect contractual cash flows and to sell it to realize any unrealized gains/loss (business model test) and cash flows are only payments of principal and interest (cash flow test), it must be measured at FVTOCI. All other debt instruments are measured at FVTPL. That being said, IFRS presents an irrevocable election to measure debt instruments that meet the business characteristic and cash flow tests, on initial recognition, at FVTPL in order to reduce a measurement or recognition inconsistency.

With regard to equity investments, these are required to be measured at FVTPL. However, in situations where the equity investment is not held for trading, IFRS allows for this instrument to be classified at FVTOCI at initial recognition. This election is irrevocable. Only dividend income would be recognized in profit or loss.

Furthermore, per IFRS 9, all derivatives are to be measured at fair value. Therefore, changes in fair value are to be recorded in profit or loss, unless the entity chooses to apply hedge accounting, in which case gains/losses on the hedged instrument would match the gains/losses related to the hedged risk.

If the entity's business model for its financial asset has changed, only then can a reclassification occur. Reclassification is not permitted for any of the above mentioned irrevocable elections (i.e. debt instruments measured at FVTPL or equity instruments measured at FVTOCI).

Finally, the accounting for financial liabilities remains the same as IAS 39, whereby financial liabilities held for trading are measured at FVTPL and all others at amortized cost. Again, a fair value irrevocable election is available to recognize the liability, at initial recognition, at FVTPL to reduce measurement or recognition inconsistencies or if it is part of a group of liabilities evaluated on a fair value basis.

Impairment: Under IFRS, impairment is required to be measured based on an expected loss allowance. This allowance is equal to the expected credit losses that result from default events on the financial instrument that are possible within 12 months of the reporting date or the expected credit losses that result from all possible default events over the life of the financial instrument.

Similar to US GAAP, these amendments to the impairment model would not affect financial instruments measured at FVTPL and thus would not likely affect investment funds but may affect investment managers.

US GAAP Update

Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement (ASU 2018-13 | Topic 820)

Introduction

This amendment to US GAAP Topic 820 eliminates or simplifies certain disclosure requirements of ASC 820 for nonpublic entities. The amendments are potentially relevant to all investment funds reporting under US GAAP and provide considerable disclosure relief to funds holding investments with level 3 fair value measurements. It is anticipated that many entities will early adopt these amendments in order to streamline financial reporting.

Status

ASU 2018-13, *Changes to the Disclosure Requirements for Fair Value Measurement*, is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Earlier adoption is permitted for any eliminated or modified (simplified) disclosures upon issuance of this ASU.

Summary

Though this ASU includes changes to disclosure requirements for both public and nonpublic entities, the summary below focuses solely on the key amendments to the fair value disclosures requirements of ASC 820 for nonpublic entities.

Eliminated Disclosures

Valuation Processes for Level 3 Fair Value Measurements: Nonpublic entities are no longer required to disclose a description of the valuation processes used by the reporting entity, including, for example, how an entity decides its valuation policies and procedures. Entities are still required to disclose a description of the valuation technique(s) and the inputs used (including quantitative information for level 3 fair value measurements) in the fair value measurement.

Policy for Timing of Transfer Between Levels: Nonpublic entities are required to consistently follow its policy for determining when transfers between levels of the fair value hierarchy are deemed to have occurred, but are no longer required to disclose the policy within the financial statements.

Changes in Unrealized Gains and Losses for Recurring Level 3 Fair Value Measurements: Nonpublic entities are no longer required to disclose the changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period.

Simplified Disclosure Requirements

Level 3 Rollforward: In lieu of a level 3 rollforward, nonpublic entities are now required to disclose only the transfers into and out of level 3 of the fair value hierarchy and purchases and issues of level 3 assets and liabilities. Entities are no longer required to disclose sales and gains/losses of level 3 assets and liabilities.

Investments in Certain Entities that Calculate NAV: An entity is now required to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly.

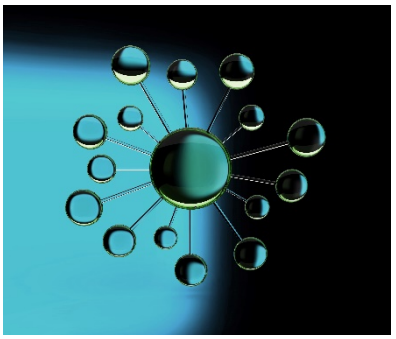
US GAAP Update (continued)

Statement of Cash Flows (Topic 230): Restricted Cash (ASU 2016-18)

Introduction

The US GAAP amendments to the presentation of restricted cash within the statement of cash flows are broadly applicable to all companies and are not specific to investment funds. However, under US GAAP Topic 946 *Financial Service – Investment Companies*, an investment company remains exempt from preparing a cash flow statement if substantially all investments are classified in Level 1 or 2 of the hierarchy, has little or no debt, and presents a statement of changes in net assets.

For those investment companies that are required to present a statement of cash flows, or that opt to include one, the amendments are applicable but are unlikely to have much effect. For investment managers, these amendments might have some effect.



Status

The amendments in ASU 2016-18, *Restricted Cash*, are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Earlier adoption is permitted. A reporting entity should apply the amendments retrospectively to all periods presented.

Summary

This ASU requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. As a result, the new guidance requires that amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows.

A reconciliation between the statement of financial position and the statement of cash flows must be disclosed when the statement of financial position includes more than one line item for cash, cash equivalents, restricted cash, and restricted cash equivalents.

The ASU does not define the terms "restricted cash" and "restricted cash equivalents" but states that an entity shall disclose information about the nature of restrictions on its cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The ASU's amendments are not intended to change practice for what an entity reports as restricited cash or restricted cash equivalents and thus entities should continue to disclose its accounting policies pertaining to restricted cash in accordance with US GAAP.

IFRS Update

IFRIC 23 – Uncertainty over Income Tax Treatments

Status

International Financial Reporting Interpretations Committee ("IFRIC") 23 – *Uncertainty over Income Tax Treatments*, is effective for annual periods beginning on or after January 1, 2019, with earlier application permitted. This standard is comparable to guidance within US GAAP, ASC 740-10 – *Tax Provisions* (formerly known as FIN 48 - *Accounting for Uncertainty in Income Taxes*). IFRIC 23 clarifies how to apply the recognition and measurement requirements in IAS 12 - *Income Taxes when there is uncertainty over income tax treatments*.

On initial application, full retrospective application is permitted, if an entity can do so without using hindsight. However, an entity can also apply the requirements by recognizing retrospectively the cumulative effect in retained earnings, or in other appropriate components of equity, at the start of the reporting period without adjusting comparative information.

Summary

Both the existing ASC 740-10 and the new IFRIC 23 apply in situations where an entity has exposure to income-based taxes (whether local or foreign). An entity must consider whether it is more likely than not (ASC 740)/ probable (IFRIC 23) (as defined below) that the relevant authority will accept each tax treatment, or group of tax treatments, that it used or plans to use in its income tax treatment. This is based on the assumption that a taxation authority will examine amounts it has a right to examine and have full knowledge of all related information

Although the objective of both the US and International standards are similar, there are key differences in their application. A comparison is summarized in the table below:

	US GAAP – Existing Requirements ASC 740-10	**IFRS – New Requirements IFRIC 23**
Recognition Threshold	Per paragraph 25-6: An entity shall initially recognize the financial statement effects of a tax position when it is **more likely than not** that the position will be sustained upon examination. The term "more likely than not" means a likelihood of more than 50 percent.	Per paragraph 9: An entity shall consider whether it is **probable** that a taxation authority will accept an uncertain tax treatment. The term "probable" is defined as a likely scenario. The IFRIC "probable" threshold is thus higher (i.e. more likely) than the "more likely than not" threshold in US GAAP.
Basis for Measurement	Per paragraph 25-7: Each tax position shall be evaluated without consideration of the possibility of offset or aggregation with other positions.	Per paragraph 6: Each uncertain tax position can be considered separately or together with other uncertain positions based on the approach that better predicts the resolution of the uncertainty. Therefore, unlike US GAAP, a tax position can be assessed individually or collectively.
Measurement (recognition threshold met)	Per paragraph 25-6: If the "more likely than not" threshold is met, the entire tax benefit is recognized.	Per paragraph 10: If the "probable" threshold is met, the amount to recognize in the financial statements is consistent with the tax treatment used/planned to be used in the income tax filings. The recognized amount should therefore match the tax return.

IFRS Update (continued)

Financial Instruments (continued)

Summary (continued)

	US GAAP – Existing Requirements ASC 740-10	IFRS – New Requirements IFRIC 23
Measurement (recognition threshold not met)	Per paragraph 25-5: If the "more likely than not" threshold is not met, no amount is recorded.	Per paragraph 11: If the "probable" threshold is not met, contrary to US GAAP, an amount still needs to be recognized. The entity has to use the most likely amount (in a range of possible outcomes) or the expected value (the sum of the probability-weighted amounts in a range of possible outcomes) when determining the amount to recognize in the financial statements. The decision should be based on which method provides better predictions of the resolution of the uncertainty, which is, in most cases, the most likely amount. Therefore, the amount recognized does not necessarily match the tax return if the "probable" threshold is not met.
Information Available Subsequent to Reporting Date	Per paragraph 25-6: Only information at the reporting date is considered in determining whether the more-likely-than-not threshold is met. That being said, if new information is made available, subsequent changes to measurement are permitted in the period in which this new information is available. Therefore, the general guidance on subsequent events (ASC 855) is not applicable since measurement is based on information as of reporting date only.	Per paragraph 13: A change in facts and circumstances from new information may result in a change in estimate per IAS 8. IAS 10 is used to determine if this change is an adjusting or non-adjusting event. There is no exception in IFRS.
Disclosures	Per paragraph 50-15: Specific disclosures are required to indicate the open tax years that remain subject to examination by tax jurisdictions and to disclose information about unrecognized tax benefits for which it is reasonably possible that the amount will significantly change within 12 months of the reporting date. These disclosure are only required when an entity has unrecognized tax benefits recorded.	No new disclosures are introduced by this interpretation. Per paragraph A4, information made about the assumptions and estimates are to be disclosed per IAS 1 paragraphs 125-129. Further, judgments made must be disclosed per IAS 1 paragraph 122.

Note that the items in the above table have been copied and/or adapted from the respective standards (i.e. ASC 740-10/IFRIC 23).

IFRIC 23 – Uncertainty over Income Tax Treatments (continued)

Summary (continued)

IFRIC 23 could have an impact for investment funds that trade in, but do not necessarily prepare tax filings in, jurisdictions that impose taxes on capital gains as well as on dividend and interest income. Of particular practical concern to a fund is the trading of securities in countries that impose capital gains or other income taxes on non-residents, but do not automatically collect the taxes via a withholding or other mechanism. Certain countries have legislation in place that, at least in theory, impose capital gains taxes on transactions by non-residents. In practice, however, many of these countries, for administrative or other practical reasons, have not historically sought to levy and collect such taxes. A tax liability recorded resulting from this analysis may be theoretical only, as the probability of examination and subsequent enforcement may be remote; therefore, a liability may be recorded that may never actually be extinguished. While the accounting standards might lead practitioners to conclude that a tax liability needs to be recorded, significant practical issues are presented, including the following:

- Cumulative adjustment - The tax liability would be cumulative upon adoption of the standard, representing the taxes payable as a result of transactions conducted since the relevant statutory or other time limitations of the tax authority apply. In theory, this could go back to the inception of the fund. Absent of recording an offsetting receivable from the investment manager or even former investors, this cumulative adjustment may be borne solely by existing investors.

- Erosion of *recorded* fund value – As the adjustment is cumulative, the adjustment can be quite large. At the extreme, in the case of a once larger fund that is now smaller, such adjustment could eliminate the entire recorded net assets of a fund.

- Liquidating fund – At termination of the normal operations of a fund, a fund that has accrued a tax liability pursuant to IFRIC 23 but has not extinguished the liability, nor expects to extinguish the liability in the near term, or even ever, may have recorded assets completely offset by a tax liability and, therefore, no recorded net assets. Such a scenario puts a fund operator and its liquidator in a difficult position, as the fund could remain in such state for a prolonged period, if not indefinitely. Decisions would have to be made as to if and when such cash could be paid out, and to whom.

There are no entirely satisfactory solutions to these decisions. US GAAP-reporting funds which have previously addressed similar considerations, have had various responses. Some funds are recording such adjustments, particularly where such adjustments are not significant. A small number of funds determined it more appropriate to accept an audit report qualification rather than recognize an income tax liability. Others use a "dealing net asset value" for capital transactions, while reporting a US GAAP net asset value solely for purposes of the annual financial statements. Fund operators should consider these alternative actions with a view to protecting interests of investors and maintaining a practical basis for ongoing operations, rather than for attempting to portray the fund's results of operations in a more favorable light.

Other Upcoming Pronouncements

The following upcoming accounting pronouncement may have an impact on investment funds and/or investment managers and will be covered more in-depth in a future ***Technical Brief for Investment Funds*** closer to the effective date.

US GAAP		
Accounting Standards Update	**Effective Date**	**Potential Effects**
ASU 2017-08, *Receivables - Nonrefundable Fees and Other Costs: Premium Amortization on Purchased Callable Debt Securities*	Public business entities - fiscal years beginning after December 15, 2018 All other entities - fiscal years beginning after December 15, 2019	Could affect investment funds that invest in securities issued at a premium and have call features consistent with the scope of this ASU.

Regulatory and Legal Update

Master/Feeder Redemption Mechanics Judgement

On July 17, 2018, in the matter of Ardon Maroon Asia Master Fund (in official liquidation), the Cayman Islands Grand Court delivered a judgement that if an investor requests a redemption from a feeder fund, an "automatic" back-to-back redemption from the master fund may not be appropriate and redemption procedures as set out in the master fund's articles should be strictly followed.

Based on this judgement, we encourage fund operators, investment managers, and administrators to revisit the operational procedures of how redemptions from master funds are being triggered to ensure the process is in line with the master fund's governing documents.

Common Reporting Standards Update

The Cayman Islands Tax Information Authority (TIA) published Tax Information Authority (International Tax Compliance) (Country-by-Country Reporting) Regulations, 2017 ("CbC Regulations") on December 15, 2017, bringing Action 13 of the OECD/G20 Action Plan on Base Erosion and Profit Shifting (BEPS) into force within the jurisdiction.

Beginning in 2018 and continuing thereafter, Country-by-Country (CbC) Reporting requires multinational enterprises (MNE) that meet certain criteria to file a CbC Report with tax administrations or tax authorities, for onward transmission to partner jurisdictions. The CbC Report provides a breakdown of the amount of revenue, profits, taxes and other indicators of economic activities for each tax jurisdiction in which the MNE Group does business. In the Cayman Islands, CbC only applies to MNE Groups with annual consolidated group revenue of at least US$850 million in the preceding fiscal year.

It is expected that CbC Reporting will have very limited effect on the investment management industry, as it is unlikely that many funds or investment managers will have a reporting requirement.

The obligation to file a CbC report on behalf of an MNE Group generally lies with the ultimate parent entity (UPE) of the MNE Group, unless a surrogate parent entity (SPE) has been appointed by the MNE Group, where appropriate.

The Cayman CbC Regulations also impose a notification obligation on all Constituent Entities resident in the Islands, and require Reporting Entities (UPEs/SPEs) resident in the Islands to collect, maintain and report information for exchange with partner jurisdictions. "Resident in the Cayman Islands" for a Constituent Entity means:

(a) being incorporated or established in the Cayman Islands; or
(b) having a place of effective management in the Cayman Islands; or
(c) being subject to financial supervision in the Cayman Islands.

Regulatory and Legal Update (continued)

Common Reporting Standards Update (continued)

A Cayman resident entity that is the UPE of a fund structure may have a CbC Reporting obligation if the fund structure meets the definition of a MNE Group, which is defined by the CbC Regulations as meeting all of the following criteria:

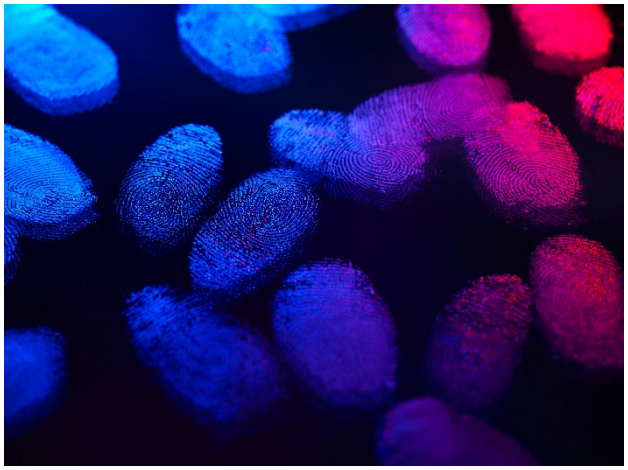
(a) It is a Group – that is, it is a collection of enterprises related through ownership or control such that it is either required to prepare Consolidated Financial Statements for financial reporting purposes under applicable accounting principles or would be so required if equity interests in any of the enterprises were traded on a public securities exchange; and

(b) The Group includes two or more enterprises for which the tax residence is in different jurisdictions or includes an enterprise that is resident for tax purposes in one jurisdiction and is subject to tax with respect to the business carried out through a permanent establishment in another jurisdiction; and

(c) The Group has total consolidated group revenue of at least US$850 million during the Fiscal Year immediately preceding the Reporting Fiscal Year as reflected in its Consolidated Financial Statements for such preceding Fiscal Year.

Most fund structures account for investments in underlying companies using fair value principles, and it is rare that fund structures are required, or would be required, to consolidate such investments as part of a set of consolidated financial statements for the fund structure. For the limited number of fund structures potentially affected by the CbC Regulations though, managers should work with their advisors to consider and respond to any CbC reporting or notification obligations they may have, on an annual basis.

Anti-Money Laundering



In April 2018, the Cayman Islands Monetary Authority ("CIMA") clarified that for an investment fund to comply with the Anti-Money Laundering Regulations (2018 Revision), a natural person must be designated to act as its Anti-Money Laundering Compliance Officer ("AMLCO"), Money Laundering Offer ("MLRO") and Deputy MLRO ("DMLRO") (collectively the "AML Officers"). Further, the same person can act as the AMLCO and either the MLRO or DMLRO, but the MLRO and the DMLRO must be separate persons.

In September 2018, the deadline for notifying CIMA of the appointment by a regulated fund of the AML Officers was extended to December 31, 2018. Unregulated funds also have an obligation to appoint AML Officers and should have had the appointments in place by December 31, 2018, but at this time are not required to confirm such appoints to CIMA via the REEFs portal.

Fund Liquidations

Wind down and liquidation considerations – realization solutions

Stakeholders of investment funds domiciled in the Cayman Islands may periodically encounter circumstances where a fund is no longer viable and is discontinuing operations. Typically a fund will realize its investments and redeem its investors prior to being placed into voluntary liquidation. However, with some investment funds, final realization of all investments can often be delayed for an extended period. Whether it relates to illiquid investments in fund-of-funds, private debt, private equity, or positions impacted by pending litigation or insolvency proceedings, many entities currently sit in a state of limbo and continue to incur unnecessary service provider costs without an effective strategy or plan for winding down.

Our Deloitte Cayman Financial Advisory team has developed a helpful document about wind down considerations and possible solutions for investment funds encountering such circumstances, which is available for download here: ***Alternative investment funds - wind down considerations and solutions***

A sidebar – Deloitte Cayman – realization agent services for investment funds

Our Financial Advisory team specializes in providing fund wind down, liquidation and dispute resolution services to the investment fund industry, acting for stakeholders including hedge fund managers, directors, general partners and investors. We are particularly knowledgeable about the challenges of maximizing realizations from illiquid asset positions and have proven processes and experience to do so.

We have completed an ever increasing volume of soft wind down projects where the fund is no longer trading and the manager's time is now best utilized on new projects. However the fund may still hold valuable but illiquid assets requiring a unique realization strategy or liabilities that cannot be readily extinguished, all of which need to be appropriately managed to maximize value for remaining investors.

Our objective is always the upfront identification and then execution of the right solution in the circumstances in order to achieve maximum value for stakeholders. Should you wish to discuss potential solutions to your fund's unique issues, do not hesitate to contact either Stu Sybersma at ssybersma@deloitte.com or Michael Penner at mpenner@deloitte.com on a no cost and fully confidential basis.

An example – developing and delivering a realization solution

A manager had elected to close operations in order to pursue other endeavors. Deloitte Cayman's Financial Advisory team were engaged as advisors to assist the manager in formulating a restructuring solution for an investment fund structure holding an illiquid fund-of-funds investment portfolio.

The solution included the incorporation of a low cost, fixed-term (3 years) special purpose vehicle ("SPV') with Deloitte engaged as "Realization Manager" to oversee the activities of the SPV and the realization of the investment positions. The investors received an in-kind distribution from the legacy funds for interest in the SPV, which was structured to include six separate share classes to account for six individual portfolios and specific investor interests.

The Realization Manager operated under the oversight of a board of directors, including a director who was a principal at the investment manager of the legacy investment fund structure.

Fund Liquidations (continued)

Wind down and liquidation considerations – realization solutions (continued)

An example – developing and delivering a realization solution (continued)

In this role, Deloitte as Realization Manager:

- Facilitated the transfer of over 50 underlying fund-of-funds investment positions to the SPV
- Undertook an initial auction process, offering investors an immediate liquidity option to realize their holdings in the SPV
- Calculated quarterly NAVs and issued statements to over 200 capital accounts, and provided dedicated investor support
- As sufficient cash realizations occurred, calculated and executed periodic distributions to the investors
- Realized five of the six share class portfolios naturally, and executed a competitive auction process for the sale of the portfolio of the last remaining share class at the conclusion of the SPV term
- Managed the SPV in accordance with its constitutional documents, and through a transparent and communicative approach with the board of directors of the SPV
- Oversaw distributions to the investors over the life of the SPV

This solution resulted in a newly formed SPV which reduced annual service provider fees by an estimated 75% and provided a better suited corporate vehicle to oversee the wind down of these funds. The manager still had oversight of the wind down process but without undertaking the administration of a three year run off period.

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