Accounting evolution for investment companies

The gaps between the different accounting standards regimes are closing, but some remain, as Ben Leung and Rennie Khan explain.

Although there has been significant progress since the Memorandum of Understanding (MoU) was developed between the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) in 2002, there are still differences between International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (US GAAP) [Accounting Standards Codifications (ASC)]. Investment company (IC) accounting is mainly governed by the standards set out in Tables 1 and 2, opposite.

Table 3 shows the main differences when comparing a set of financial statements prepared under IFRS and one prepared under US GAAP 9.

The impact of the 'written but not yet effective' and 'proposed' standards

IFRS 9

IAS 39 sets out the requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. Many users of financial statements and other interested parties told the IASB that the requirements in IAS 39 were difficult to understand, apply and interpret. They urged the IASB to develop a new standard for the financial reporting of financial instruments that was principle-based and less complex. Although the IASB amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it had not previously undertaken a fundamental reconsideration of reporting for financial instruments.

IFRS 9 contains guidance on recognition and derecognition, classification and measurement of financial instruments. The IASB intends that IFRS 9 will ultimately replace IAS 39 in its entirety. However, in response to requests from interested parties that the accounting for financial instruments should be improved quickly, the IASB divided its project to replace IAS 39 into three main phases. As the IASB completes each phase, it will delete the relevant portions of IAS 39 and create chapters in IFRS 9 that replace the requirements in IAS 39.

The IASB has agreed to change the mandatory effective date of IFRS 9 to annual periods beginning on or after January 1, 2015, rather than for annual periods beginning on or after January 1, 2013, as was initially the case.

It appears that IFRS 9 will not have a significant impact on the differences noted above.

IFRS 13 and ASU 2011-04

Inconsistencies in the requirements for measuring fair value, and for disclosing information about fair value measurements, have contributed to diversity in practice and have reduced the comparability of information reported in financial statements. IFRS 13 remedies that situation by creating one standard that defines fair value, sets out in a single IFRS a framework for measuring fair value and requires disclosures about fair value measurements. An entity shall apply this IFRS for annual periods beginning on or after January 1, 2013.

The amendments in ASU 2011-04 change the wording used to describe the requirements in US GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments include the following:

Table 1: IFRS		
Currently in effect	**Written but not yet effective**	**Proposed**
International Accounting Standard 32 – Financial Instruments: Presentation	International Financial Reporting Standard 9 – Financial Instruments	Exposure Draft 2011/04 Investment Entities
International Accounting Standard 39 – Financial Instruments: Recognition and Measurement	International Financial Reporting Standard 13 – Fair Value Measurement	
International Financial Reporting Standard 7 – Financial Instruments: Disclosures		

Table 2: ASC		
Currently in effect	**Written but not yet effective**	**Proposed**
Topic 946 Financial Services – Investment Companies		Proposed Accounting Standards Update 2011-200 – Financial Services – Investment Companies (Topic 946). Amendments to the Scope, Measurement, and Disclosure Requirements Proposed Accounting Standards Update 2011-210 – Real Estate – Investment Property Entities (Topic 973)
Topic 820 Fair Value Measurement	Accounting Standards Update No. 2011-04 – Fair Value Measurement (Topic 820). Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in US GAAP and IFRSs	

Table 3: Current Standards			
Issue	**IFRS**	**US GAAP**	**Comment**
Fair value of investments	Bid prices for long positions and ask prices for short positions.	Last quoted sales price. Bid and ask prices used if a last quoted price is not available.	This difference may result in the net assets of an identical fund being different.
Consolidation	IAS 27 requires an entity to consolidate other entities over which it has control.	Topic 946 allows entities to show investments at fair value (consolidation is required only in certain situations).	Under IFRS a feeder fund will consolidate a master fund over which it has control. Under US GAAP the master financial statements are attached to the feeder's financial statements.
Ownership interest	IAS 32 requires a financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset (a 'puttable instrument') is a financial liability of the issuer, unless certain conditions are met.	Transactions with owners of the investment entity are generally accounted for as equity.	IFRS discloses "Net assets attributable to holders of redeemable shares" as a liability. US GAAP discloses "Net Assets" as equity.
Condensed schedule of investments	No specific requirement, however general disclosure requirements under IFRS 7.	Specific requirements on the format and content of this statement.	
Realised and unrealised gains and losses	IFRS does not require disaggregation of these balances.	Required to be disclosed separately in the statement of operations and statement of changes in equity.	This would result in different financial statement captions for investment companies applying US GAAP or IFRS and may affect the comparability of financial information.
Cash flow statement	Required in all instances.	If certain conditions are met, an investment entity can be exempt from disclosing a cash flow statement.	
Disclosures	IFRS 7: Qualitative and Quantitative disclosures on the nature and extent of risks arising from financial instruments.	Required risk disclosures not as extensive compared to IFRS 7, however ASC 815 does contain specific derivative disclosures.	
Financial highlights	No specific requirement, however general disclosure requirements under IFRS 7.	Specific requirement on the format and contents of financial highlights.	
Fair value of investee funds	No such practical expedient in the standards.	Use of the NAV per share as a practical expedient for fair value is allowed	Although the guidance is silent under IFRS, NAV per share is commonly used as an indication of fair value.
Disposal of securities	IFRS does not prescribe how to calculate the cost of disposed securities.	Topic 946 requires an IC to determine the cost of disposed securities using the average cost of the securities or specifically identifying the cost of each security sold.	The amount of realised gain (or loss) on the disposal of a security could be different under US GAAP and IFRS depending on the method used to determine the cost of the security disposed.

"Inconsistencies in the requirements for measuring fair value, and for disclosing information about fair value measurements, have contributed to diversity in practice and have reduced the comparability of information reported in financial statements."

- Those that clarify the FASB's intent about the application of existing fair value measurement and disclosure requirements; and
- Those that change a particular principle or requirement for measuring fair value or for disclosing information about fair value measurements.

The amendments in this ASU are effective for annual periods beginning after December 15, 2011.

Once IFRS 13 and the amendments from ASU 2011-04 are implemented, the definition, measurement criteria and disclosure requirements for fair value measurements will be almost identical under IFRS and US GAAP, with only minor differences. This will, therefore, eliminate the difference on fair value of investments noted above.

Exposure Draft 2011/04 (IASB) and Proposed Accounting Standards Update (PASU) 2011-200 (FASB)

ED 2011/04 proposes criteria for an entity to qualify as an investment entity. The proposals would require an investment entity to measure its investments in controlled entities at fair value through profit or loss in accordance with IFRS 9 and to provide additional disclosures to enable users of its financial statements to evaluate the nature and financial effects of its investment activities.

This exposure draft also proposes that in its consolidated financial statements, a parent of an investment entity should not retain the fair value accounting that is applied by its investment entity subsidiary to controlled entities, unless the parent qualifies as an investment entity itself. As a consequence, a parent of an investment entity should consolidate all entities it controls, including those that are controlled by an investment entity subsidiary, unless the parent is an investment entity itself. Comments on this ED were due on January 5, 2012.

The main elements of PASU 2011-200 are to:

1. Amend the IC definition in Topic 946 to make it almost identical to that of ED 2011/04.
2. Require an IC to consolidate another IC or an investment property entity (IPE) if it holds a controlling financial interest in the entity in a fund-of-funds structure. The IC parent would retain the specialised guidance when consolidating another IC or an IPE.
3. Amend the financial statements and financial highlights presentation requirements for situations in which an IC consolidates a less-than-wholly-owned IC or a less-than-wholly-owned IPE.
4. Prohibit an IC that is able to exercise significant influence over another IC or an IPE from accounting for its interest using the equity method of accounting. Rather, those investments would be measured at fair value.
5. Require additional disclosures including changes in an entity's status as an IC, whether the IC has provided support to any of its investees, and any significant restrictions on an investee's ability to transfer funds to the IC.

There are two significant differences in the proposed scope of entities that would be an IC under US GAAP compared with IFRS. Under PASU 2011-200, an entity that is regulated as an IC under the Investment Company Act of 1940 would be an IC. The IASB decided not to base its definition of an investment entity under any local regulations.

The other significant difference under PASU 2011-200 is that if an IC meets the criteria to be an IPE in the FASB's proposed Update on IPEs, it would apply the requirements in that proposed update. The IASB has not proposed specific guidance to define an IPE. Therefore the entity would account for its investment properties in accordance with IAS 40, Investment Property. Comments on PASU 2011-200 were due on January 5, 2012.

Conclusions

The IASB and the FASB are making progress in addressing the main differences between IFRS and US GAAP for investment companies regarding financial instruments and fair value. However, while Topic 946 remains in effect there will be differences in the format of a set of financial statements prepared under IFRS compared to one prepared under US GAAP as Topic 946 provides specific guidance for investment entities. The IASB has made a start on specific guidance for investment entities (with the publication of ED 2011/04), but it may be some time before all the differences noted above are eliminated. ■

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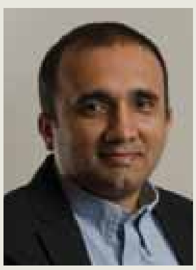

Rennie Khan has 15 years of accounting experience, including 11 years in the Cayman Islands. Prior to joining the firm, he served with another major accounting firm in Trinidad and Tobago and the Cayman Islands. He gained his experience working on audits of investment funds, private banks, insurance captives and trust companies.