



## Investment Management Industry Alert

### Recent Accounting Development Implicit Variable Interests under AcG-15

The Emerging Issues Committee of the CICA recently released a draft EIC (D53, Implicit Variable Interests under AcG-15) in response to a similar FASB release, FIN46(R)-5, in the United States. Once D53 becomes effective, it appears that an investment fund that gains exposure to an underlying fund implicitly, e.g. *via a derivative contract* (such as a total return swap or forward contract), would be required to consolidate the underlying fund when such exposure makes the investment fund the primary beneficiary of the underlying fund. Current transition rules for investment funds require application of AcG-15 *Consolidation of variable interest entities* for years commencing on or after July 1, 2005 making this EIC of significance almost immediately!

As a result of the current deferral/exemption for investment companies from FIN46R under US GAAP, we now find ourselves in the unusual situation that Canadian GAAP may require consolidation where such a result currently does not exist in the United States, nor might it ever.

We encourage you to consider the points outlined below and assess the impact on your current and potential future investment fund product structures. **Responses to the draft EIC are due by August 23, 2005.**

### Current US GAAP

Registered investment companies (RICs) in the US are equivalent to regulated mutual funds in Canada. Regulation S-X, which governs financial statements for RICs, provides specific rules on 'consolidated or combined' statements for investment companies and, as a result, all RICs are permanently scoped out of FIN46R.

For all other types of funds a temporary deferral currently exists under FIN46R; this was put in place pending finalization of an AICPA project to define 'an investment company'. An investment company, so defined, will then be required to follow investment company GAAP as detailed in the AICPA Audit Guide for Investment Companies. Although not guaranteed, we anticipate that, once this project is completed, the FASB will likely provide a broader 'investment companies' exemption from applying FIN46R.

## Potential Implications to Investment Fund Structures in Canada

In Canada there are a variety of investment fund products which utilize derivative contract structures in order to get effective exposure to an underlying fund. These product structures are most typically driven by tax structuring considerations and can be found in mutual fund complexes as well as in TSX-listed structured products and a variety of prospectus-exempt alternative products including hedge funds.

Application of this standard will require ongoing monitoring of the product structure, including assessment of potential variable interest entities and determination of whether your product is the primary beneficiary.

Items for consideration in the application of this standard include:

**The process of consolidation** Consolidation under CICA Handbook Section 1581 *Business Combinations* does not contemplate how to consolidate ‘implicit’ interests versus legal interests;

**Access to information** Where the underlying fund is not a related entity, will sufficient information be available to make appropriate assessments and to prepare the consolidated financial statements if applicable?

**Consistency of information** The funds in question may not follow the same generally accepted accounting policies (GAAP), such as with hedge fund of fund structures, thus requiring reconciliation between the top fund GAAP and bottom fund GAAP. Fund year ends may also not be co-terminous;

**Relevance and understandability** Given the objectives of an investment fund and the requirement to value investments at fair value, will application of this standard meet the needs of users of the financial statements and are there cost-benefit considerations?

**Comparability with US GAAP** Is it desirable to be out of step with US GAAP on this matter and would a deferral of the AcG-18 transition rules in applying AcG-15 be appropriate?

## Additional Considerations for Fund of Funds structures under AcG-15

Investment funds in Canada that are structured as fund of funds are currently directly impacted by the transition rule of AcG-18. In their case, direct ownership in over 50% of an underlying fund likely means a requirement to consolidate that fund into the top fund of the structure, *and this is effective immediately for years commencing July 1, 2005*. This impacts the mutual fund industry through their use of ‘tax class’ corporate funds as well as, for example, in asset allocation products. In the latter case the consolidation exercise could become more challenging if ownership in an underlying fund fluctuates above and below the 50% level during a reporting period.

As noted above, the AcG-18 transition rule regarding application of AcG-15 in investment funds appears to put Canadian standards on a different playing field compared to US GAAP in this regard given the exemption/deferrals in place at the current time.

Contact your PricewaterhouseCoopers client service team to discuss any specific concerns you have.