

International Financial Reporting Standards for US Investment Companies

What are the issues?

Today, more than 100 countries require, permit or are converging to International Financial Reporting Standards (IFRS), including the members of the European Union, Australia, Canada, Brazil, India, China and other major capital markets. Nine of the top 10 global capital markets either already employ IFRS or are in the process of converting to them: only the United States continues to employ US Generally Accepted Accounting Principles (US GAAP) as its exclusive accounting and reporting framework.

In November 2008, the SEC released a proposed roadmap delineating a plan for moving US companies to IFRS, with a potential mandatory phased-in transition in 2014. The roadmap identifies several milestones, including improvements that should be made to IFRS reporting and governance of the International Accounting Standards Board (IASB). In 2011, the SEC will assess progress made on the roadmap milestones, and decide whether to finalize the mandatory conversion date. The release also proposes a rule to allow US companies that meet certain criteria to adopt IFRS beginning in 2009.

(While the proposed roadmap does not include issuers that are investment companies registered under the Investment Company Act of 1940 (the 1940 Act), in its request for comment, the SEC does ask whether it is appropriate to have this exclusion. Comments are due on February 19, 2009.)

An IFRS conversion will present some upheaval and uncertainty as investment managers and the users of their financial statements grapple with the new regime of accounting. IFRS is not only an accounting and reporting matter, but will also affect operations including

fund design, marketing and investor relations. Conversions typically take well more than a year to complete, and involve not only internal accounting functions but also shareholder servicing, management and vendor contracts, information systems, debtor/lender agreements and tax reporting and compliance. Most people working in these functions for investment companies are not trained in IFRS.

Background

The shift to IFRS is being driven by a confluence of factors, including the globalization of business and finance, the increasing complexity of US GAAP standards, the costs of maintaining and complying with two separate sets of standards by some and the potential for substantial savings and efficiencies from a common set of global accounting standards. There is a growing consensus among regulators, standards-setters and leading public companies that IFRS adoption is desirable, and the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have had IFRS-US GAAP convergence projects underway since 2002.

However, progress on convergence has been slow. Although the frameworks and concepts underlying both IFRS and US GAAP are essentially similar, even the few converged standards issued thus far do not offer perfectly identical accounting treatments for all transactions. Numerous, sometimes significant, differences remain between IFRS and US GAAP, adding to the complexity of convergence efforts.

Regardless, US regulatory bodies are moving ahead with steps designed to advance adoption of IFRS. Prior to releasing its proposed roadmap, the SEC eliminated

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the US GAAP reconciliation requirement for non-US companies listed on US exchanges that use IFRS, and has found stakeholder support for allowing US issuers to report using IFRS as well.

If adoption is mandatory in 2014, the public company requirement to provide 3 years of comparative data effectively means that the “transition date” or opening balance sheet for such companies would be the end of 2011. (The transition date for investment companies is uncertain.) Given the relatively short timeframe and the demands associated with IFRS conversion, many companies have already begun to consider a conversion process, identify what resources will be required for adoption and evaluate the impact of conversion on their operations and financial positions. Many of investment companies' non-SEC-regulated counterparts, offshore hedge funds, already report under IFRS and there is increasing demand from investors for hedge funds and other private funds to report under IFRS.

What is our response?

We believe that adoption of IFRS in the US is inevitable. IFRS has become the *de facto* global accounting language, and the growth of globalization alone will result in a market-driven change to IFRS in the US. Increasingly, investors, exchanges, regulators and counterparties are likely to request or even require IFRS financial statements from US companies, including US investment companies. We do not expect any permanent “carve-out” for investment companies from this conversion movement.

Companies contemplating the conversion should consider taking a “clean sheet of paper” approach and not simply try to force their historical US GAAP policies and procedures to fit into IFRS in order to short-cut the conversion process. The “clean sheet of paper” approach allows you to take advantage of the benefits provided by IFRS principles. Also, conversion project teams should include broad representation from within the company, since new financial reporting principles can affect many aspects of operations. Integrating IFRS principles into operations from the ground up is important since layering IFRS on top of a GAAP system will burden internal controls over financial reporting and increase the risk of reporting errors.

The US GAAP financial reporting model for investment companies is designed to meet the specific needs of fund investors, and importantly, underlies the production of the net asset value of funds that is used to price and trade fund shares in the open market on a daily basis. Much of that US GAAP was developed specifically from regulatory rules and guidance over time and is codified in the *AICPA Audit and*

Accounting Guide: Investment Companies, rather than from FASB pronouncements. IFRS does not provide accounting standards or guidance specific to the investment company industry. Rather, IFRS is principle-based with very limited industry carve-outs or specifics. Though it may be too early to predict how Article 6 of Regulation S-X would be modified to enable registered investment companies to file under IFRS, current IFRS guidance would result in different asset and liability measurement and financial statement presentations for investment companies in certain areas, as well as different net asset valuation methods as compared to the 1940 Act. For example:

- IFRS requires the use of bid prices to value securities traded in active markets for financial reporting purposes. This could create a conflict with the values used for processing fund share transactions. FAS 157, *Fair Value Measurements*, and various SEC pronouncements permit the use of other estimates of fair value.
- Shares of open-end investment funds are typically redeemable at the holders' option, and meet the definition of a financial liability under IFRS, rather than equity under US GAAP. As a result, net assets, as traditionally defined as the value of assets minus liabilities, could be zero, impacting numerous contract terms (such as the calculation of management fees).
- The consolidation principles of IAS 27, *Consolidated and Separate Financial Statements*, and SIC Interpretation 12, *Consolidation Special-Purpose Entities*, require reporting entities to consolidate entities, including non-investment company entities, that they control. Control is presumed to exist if the fund has more than half of the voting power of another entity. Thus, a feeder fund would be required to consolidate the master fund if it owns a majority of the master fund's voting shares. Additionally, entities such as Business Development Companies (BDCs) or private equity funds owning greater than 50% of an operating company, would be required to consolidate the operating company. Depending on the circumstances, these consolidations may not be required, or may even be prohibited under US GAAP.

In addition to these significant differences, IFRS requires additional data regarding comparative risk disclosures, including sensitivity analyses. This two year information

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data historically has not been captured by fund complexes. Investment companies will need to consider data availability and the adequacy of their current systems. Additionally, investment companies need to review their inventory of offering documents and agreements (such as prospectus, statement of additional information, management agreements and other contracts) to determine the need for revisions in connection with the conversion to IFRS.

One thing which has become clear: the switch to IFRS is not simply an accounting exercise that can be tackled at financial year ends. Most IFRS conversions will take longer than initially expected. A key to success is starting early, before the investment company faces externally imposed deadlines, thereby allowing a systematic, methodical assessment and implementation.

What does this mean?

Decades of increasing complexity in US GAAP threaten to make it a competitive disadvantage for US capital markets. While IFRS is no silver bullet, adoption of IFRS by US companies is expected to help address this issue. US investment companies currently reporting under US GAAP generally are viewing the conversion to IFRS as an onerous undertaking without significant payback. However, based on our experience in other territories, the conversion to IFRS is very manageable if properly planned with sufficient lead-time. Additionally, IFRS will have benefits for US investment companies and investors, including a high-quality, principles-based framework, greater transparency for the economics of transactions, fewer rules and fewer exceptions, increased simplicity of application and the ability to exercise more professional judgment. Most significantly, IFRS will provide a common global platform that has the opportunity for further improvement.

Investment company managements and their agents should monitor IFRS and US GAAP developments, in particular the SEC's pronouncements, and make their voices heard in the ongoing industry debates. They also should begin to identify the implications of a shift to IFRS, identify financial reporting, operating, treasury and tax systems, processes and contracts that may require

modification and determine what resources will be required for a successful conversion. Training in IFRS should be considered early on for personnel affected by this conversion. As the demand from investors for IFRS reporting increases, hedge funds and other private funds may have to accelerate their conversion process.

This series presents the PricewaterhouseCoopers LLP point of view on a range of issues affecting our investment management and real estate practice clients.

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