

Fund Accounting Update 2008

US GAAP

Mary Bruen, PricewaterhouseCoopers

Critical concepts, clear direction



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US GAAP vs IFRS

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Norwalk agreement signed in October 2002 between the FASB and the IASB
Commitment to:

- Make existing pronouncements compatible
- Work together on future projects

Six key initiatives to achieve this:

1. Joint projects being conducted with the IASB (eg Conceptual framework)
2. Short-term convergence project [eg Income Tax Accounting]
3. Liaison IASB member on site at the FASB offices
4. FASB monitoring of IASB projects [eg Fair Value Option]
5. The convergence research project [What are the differences?]
6. Explicit consideration of convergence potential in all Board agenda decisions.

US GAAP/IFRS convergence

Latest developments:

- Converged business combinations standard (FAS 141 revised and IFRS 3 revised) recently . Many other projects ongoing.
- SEC approval of rule amendments under which financial statements from foreign private issuers in the U.S. will be accepted without reconciliation to U.S. Generally Accepted Accounting Principles only if they are prepared using International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board.

US GAAP/IFRS convergence

Business combinations:

- Joint project between the FASB and the IASB
- Boards reconsidered the existing guidance for applying the purchase method of accounting for business combinations (now called the *acquisition method*).
- Objectives of the project were to improve and simplify the accounting for business combinations and to develop a single high-quality standard of accounting for business combinations that could be used for both domestic and cross-border financial reporting
- FASB completed its project on business combinations: applying the acquisition method in December 2007 with the issuance of FASB Statements No. 141 (Revised 2007), *Business Combinations*, and No. 160, *Noncontrolling Interests in Consolidated Financial Statements*
- IASB completed its business combinations project in January 2008 with the issuance of a revised version of IFRS 3 *Business Combinations* and an amended version of IAS 27 *Consolidated and Separate Financial Statements*.

US GAAP/IFRS convergence

Fair Value Measurement – IASB project

Where does the project currently stand?

The following documents are now available:

- The final report of the expert advisory panel and
- The IASB staff summary setting out the content of the expert advisory panel report

Next step: Development and publication of an exposure draft

- Based on the comments received on the Fair Value Measurements discussion paper, the Board is developing an exposure draft of an IFRS on fair value measurement guidance. The Board plans to publish an exposure draft in the first half of 2009.
- When preparing the exposure draft the Board will consider the requirements of FASB's Statement of Financial Accounting Standards No.157 Fair Value Measurements (SFAS).

However, the IASB's exposure draft might differ from SFAS 157 in its requirements and wording.

Upcoming changes in US GAAP

Conversion to IFRS

Conversion not Convergence!!

In September 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).



Foreign Private Issues are already permitted to use IFRS
(with no need for a reconciliation to US GAAP)

Upcoming changes in US GAAP

Conversion to IFRS

- 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.
- It is inevitable that US public companies will have to report using IFRS because:
 - Much of the rest of the world has shifted to IFRS—the US is the largest of the few remaining holdouts.
 - The SEC is now accepting financial statements of foreign private issuers prepared in accordance with IFRS (as issued by the IASB), without requiring a reconciliation to US GAAP.
 - The proposed roadmap clearly demonstrates the SEC's intent to move to IFRS, but in a measured fashion.

Section two

US GAAP vs IFRS

Accounting for Funds – a reminder

The Latest News

What is US GAAP?

Accounting for Funds – a reminder

- ‘Accounting Principles Generally Accepted in the United States of America’
- One of the two most widely used sets of global accounting standards
- Characteristics are:
 - Industry Focused (eg Accounting and Audit Guide: Investment Companies)
 - Very Detailed (you never become an expert in US GAAP you need to focus)
 - A vast number of different organisations participate in the setting of accounting rules.
 - Those organisations include:
 - FASB (Financial Accounting Standards Board)
 - AICPA (American Institute of Certified Public Accountants)
 - SEC (Securities & Exchange Commission)
 - Other Regulatory Bodies (eg NASD, SBA, FDIC)
 - Government (GASB)

What is US GAAP?

How do I make sense of this for Investment Companies?

AICPA Audit & Accounting Guide: Investment Companies Purpose of the Guide

“This Guide has been prepared to assist preparers of financial statements in preparing financial statements in conformity with generally accepted accounting principles and to assist auditors in auditing and reporting on such financial statements in accordance with generally accepted auditing standards.”

“This Guide describes operating conditions and auditing procedures unique to the investment company industry and illustrates form and content of investment company financial statements and related disclosures.”

- Key Chapters – 2, 5 and 7
- SOP 03-4 ‘Reporting Financial Highlights and Schedule of Investments by Non-registered Investment Partnerships
- SOP 07-1 ‘Clarification of the Scope of the Audit and Accounting Guide, Investment Companies...’

Why US GAAP?

The Good

- A set of standards tailored to the funds industry
- The accounting treatment makes more sense for funds
- New developments are also likely to make more sense
- Consolidation of investments not required
- Less disclosure than IFRS (esp. after IFRS 7)
- Investments are held at fair value/no separate categories

The Ugly

- Good for funds but not for other entities (eg GP's)
- Some of the requirements are complex (consider FIN 48)
- European investors are not used to US GAAP/require IFRS for their own reporting
- European exchanges do not all accept US GAAP financials as a matter of course. This may affect future plans to list the vehicle

Problem Areas under US GAAP

- Considering FIN 46 if it is not an investment company
- Understanding the disclosures:
 - Disclosing the detail in the investment schedule
 - Disclosing the detail behind the incentive allocation rules
 - Financial highlights (inc IRR)
- Determining what to do for Master-Feeder/ Fund of Fund/ Secondary Structures
- Receivables from investors (generally considered to be bad debts)
- The policy adopted for valuation of investments (refer FAS 157)

Why Funds Choose US GAAP

The Choice of Accounting Standards

The choice of accounting standards can significantly increase or reduce complexity in the accounting and reporting processes of the fund...

Accounting Issue	UK GAAP	IFRS	US GAAP
Overall framework	Nothing fund specific	Nothing fund specific	AICPA Audit and Accounting Guide: Investment Companies
Presentation of financial statements	<p>Driven by the requirements of multiple standards:</p> <ul style="list-style-type: none"> • Profit and Loss Account • Balance Sheet • Cash Flow Statement [unless small' entity] • Statement of Total Recognised Gains and Losses • Notes to the Financial Statements 	<p>Driven by the requirements of IAS 1:</p> <ul style="list-style-type: none"> • Income Statement • Balance Sheet • Cash Flow Statement • Statement of Changes in Net Assets Attributable to Partners • Notes to the financial statements 	<p>Drive by the requirements of Chapter 7 of the Audit and Accounting Guide:</p> <ul style="list-style-type: none"> • Statement of Assets and Liabilities • Schedule of Investments • Statement of Operations • Cash Flow Statement • Notes to the financial statements • Financial Highlights (may be included in the notes)

Why Funds Choose US GAAP

The Choice of Accounting Standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Consolidation – The Fund	<p>Ability to exercise dominant influence. But...</p> <ul style="list-style-type: none"> ▪ severe long term restrictions; ▪ held exclusively with a view to resale 	Requires consolidation of underlying investments where those structures are controlled.	<p>Does not require consolidation of underlying investments.</p> <p>One exception to this general principle is an investment in an operating company that provides services to the investment company.</p>
Consolidation – General Partner	<p>Ability to exercise dominant influence.</p> <p>Generally less likely to lead to consolidation.</p>	Requires consolidation of the Fund where the GP controls it under the provisions of IAS 27.	<p>Requires consolidation of the Fund where the GP:-</p> <ul style="list-style-type: none"> • Is the primary beneficiary of the Fund under FIN 46(R); or • Controls it under EITF 04-5.
Equity accounting	<p>Generally requires associates to be equity accounted for where the investor holds a participating interest and exercises significant influence.</p> <p>However, PE funds holding such investments as part of their portfolio are exempted.</p>	Requires associates to be equity accounted for except where they have been designated as fair value through profit or loss.	Does not require equity accounting for underlying investments unless those entities are investment companies themselves.

Why Funds Choose US GAAP

The Choice of Accounting Standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Valuation of investments	Entities required to apply FRS 26 - same as IFRS. Other entities - less prescriptive. May carry investments as cost less any provisions for impairment.	Requires investments (designated as 'fair value through profit or loss' or 'available for sale') to be stated at fair value. Transaction costs for financial assets at fair value through P&L should be expensed in the P&L.	Requires investments to be stated at fair value. FAS 157 issued in September 2006 will also require, amongst other things, new disclosures around the inputs used to determine fair value. Transaction costs are included in the cost of investments and flow through the P&L through the unrealised gain/loss.
Valuation of quoted securities	Less prescriptive – general practice is to value at quoted prices.	Requires quoted securities in active markets to be stated at bid price multiplied by the number of shares. Marketability discounts are generally not permitted.	Requires quoted securities in active markets to be stated at end of day market prices. Where a legal, contractual or regulatory restriction exists then the market price should be adjusted for the effect of the restriction (requirement of FAS 157).

Why Funds Choose US GAAP

The Choice of Accounting Standards

Accounting Issue	UK GAAP	IFRS	US GAAP
Treatment of Partners' Capital	Where the Fund has a finite life, partners' capital is generally treated as debt under FRS 25. Applicable to all entities (not just listed)	Where the Fund has a finite life, partners' capital is generally treated as debt under IAS 32.	Partners' capital is generally treated as equity unless there is an obligation to redeem the capital at a specific date at a specific amount.
Functional Currency	Entities required to apply FRS 26 – same requirements as IFRS. Other entities – not prescriptive.	IFRS and US GAAP requirements are substantially the same: An entity's functional currency is defined as the currency of the primary economic environment in which the entity operates.	
Derecognition of financial assets	Recognise and derecognise based on risks and rewards, focusing on substance rather than just legal form.	De-recognise financial assets based on risks and rewards first; control is secondary test.	Derecognise based on control. Requires legal isolation of assets.

Section three

US GAAP vs IFRS

Fund Accounting – a Reminder

The Latest News

FAS 157 Fair Value Measurements

- Effective for fiscal years beginning after November 15, 2007 (i.e. first quarter 2008). Comparatives will be required.
- Re-defines fair value and creates a framework for measurement (exit prices): "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

The latest standards

FAS 157 Fair Value Measurements

The standard establishes a fair value hierarchy consisting of levels of estimation techniques that should be followed in order:

- Level 1: Fair value is based upon quoted prices for identical assets or liabilities in active markets;
- Level 2: Fair value is based on market information which is indicative of fair value;
- Level 3: Fair value is based on entity inputs.

For each major category of assets and liabilities re-measured at fair value during the period the disclosures should segregate fair value amounts into three levels and include information about the valuation techniques used.

The latest standards

FAS 157 Fair Value Measurements

Will it change the disclosures?

YES!!.....

FAS 157 Requires disclosure of information that enables users of its financial statements to assess the inputs used to develop those measurements [of fair value] ...

- A requirement to disclose where within the fair value hierarchy the fair value estimates fall.
- For fair value measurements using level 3 inputs, ‘a reconciliation of the beginning and ending balances...’
- The total amount of level 3 unrealised gains/losses relating to those assets still held at the reporting date.
- The valuation techniques used to measure fair value and a discussion of [any] changes.

The latest standards

FAS 157 Fair Value Measurements

Exploring some new principles/concepts

Blockage discounts will no longer be allowed:

Fair valuation in “thin” markets is permitted where the market prices are deemed not to be representative of the fair value of any number of shares. For example if the shares are traded daily but in very small volumes it is likely that those prices should be used (without discount) for a block of shares held by a private equity fund;

However, securities with a legal, contractual or regulatory restriction should be valued at the market price of an equivalent unrestricted security ‘adjusted for the effect of the restriction’.

The latest standards

FAS 157 Fair Value Measurements

Exploring some new principles/concepts

Fair value should be based on 'exit price'

'The objective of a fair value measurement is to determine the price that would be received for the asset...that is an exit price..'

(The IFRS definition of fair value does not currently specify either an exit price or an entry price.)

The Board concluded that an exit price is appropriate because it embodies current expectations about future inflows of the asset...

Therefore:

- The transaction price may not be the fair value of the asset if:
 - The investment may be considered to be a 'forced sale' or a 'rescue package'
 - The absolute amount of the investment is relatively small
 - The investor is motivated by strategic considerations

The latest standards

FAS 157 Fair Value Measurements

Exploring the some new principles/concepts

Transactions Costs - Fair value should include attributes of the asset only

‘The price....used to measure the fair value of the asset should not be adjusted for transaction costs...’

Transaction costs refer to the incremental direct costs to transact in the principal (or most advantageous) market for the asset

Investment companies should initial record investments at cost (including transaction costs) and then subsequently re-measure to fair value potentially resulting in unrealised losses at the measurement date.

The latest standards

FAS 157 Fair Value Measurements

FSP FAS 157-3

FASB issued guidance clarifying how FAS 157, should be applied when valuing securities in markets that are not active.

Among other things, the guidance clarifies:

- How management's internal cash flow and discount rate assumptions should be considered when measuring fair value when relevant observable data do not exist
- How observable market information in a market that is not active should be considered when measuring fair value
- How the use of market quotes (e.g., broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable data available to measure fair value

The guidance states that significant judgment is required in valuing financial assets. For example, prices in disorderly markets cannot be automatically rejected or accepted without sufficient evaluation. In addition, a distressed market does not result in distressed prices for all transactions—judgment is required at the individual transaction level.

The latest standards

FIN 48 Uncertain Tax Positions

FIN 48 has currently been deferred for non-public entities.....but read on.....

In July 2006, the FASB released an Interpretation that is intended to reduce diversity: Accounting for Uncertainty in Income Taxes (FIN 48). Under the interpretation, companies' financial statements will reflect expected future tax consequences of uncertain tax positions.

The key points in the interpretation are:

- A tax position may be reflected in the financial statements only if it is “more likely than not” that the company will be able to sustain the tax return position, based on its technical merits;
- A tax position should be measured as the largest amount of benefit that is cumulatively greater than 50% likely to be realized.

The latest standards

FIN 48 Uncertain Tax Positions

FIN 48 has currently been deferred for non-public entities.....but read on.....

While promoting increased standardisation of current practice, the Interpretation could have significant consequences for a large number of companies (including investment companies). While the full impact of the interpretation on Alternative Investments has still to be analysed, it appears that investment companies will need to:

- Inventory all tax positions that they currently have within their structures
- Assume that they are going to be audited by the relevant tax authority - would they be sustained?

On October 15, the Financial Accounting Standards Board (FASB) voted to defer the effective date of FIN 48, for all non-public entities. As a result, FIN 48 will first go into effect for non-public companies for periods beginning after December 15, 2008.

However this does not eliminate the need the need to address tax risks.

The latest standards

FIN 48: Uncertain tax positions

Tax Landscape – Private Equity

- Tax policy-makers' focus on tax policies affecting PE
 - Leverage
 - Potential restrictions on the deductibility of interest on shareholder loans (e.g. Germany and Denmark)
 - Potential expansion of applicability of transfer pricing principles (e.g. UK)
 - Tax-favoured management compensation schemes
 - US proposal to tax listed PE management partnerships as corporations
 - UK proposals to tax carried interest at 18% and abolish taper relief
- More complex investment structures and robust operating procedures required to manage tax risks and attempt to achieve tax-optimisation:
 - Target country ownership restrictions limiting direct foreign ownership
 - Target country restrictions on leverage
 - Source country capital gains taxes
 - Tax residency issues
 - Permanent establishment issues
 - Management of investor-specific tax issues
 - Investors' need for more detailed tax information

The latest standards

FIN 48: Uncertain tax positions

Key areas of focus

- Each advisor/manager will have to assess their own tax positions and assess impact. However the frequent areas of focus have been set out below.
- Tax residence of Fund and Investment Group Member Cos:
 - Common sources of risk
 - Directors resident in countries other than country of incorporation and acting as directors while in their home country
 - Decision-making powers not exercised equally by all directors
 - Inadequate guidance and controls regarding the conduct of directors meetings
 - Inadequate documentation
 - Potential Consequences:
 - Taxation on world-wide income and gain (i.e. regardless of source)
 - Tax return filing requirements

The latest standards

FIN 48: Uncertain tax positions

Key areas of focus

Permanent Establishment Risk for Fund

- Common sources of risk:
 - Global mobility:
 - Key decision-making personnel (e.g., Investment Committee members) present in local investment markets
 - Authorized personnel executing contracts while in local jurisdiction
 - Inadequate guidance and controls regarding the conduct of personnel in local jurisdictions
 - Inadequate documentation

- Potential Consequences:
 - Local taxation on income and gains attributable to the permanent establishment
 - Tax return filing requirements
 - Fund manager or local sub-advisor jointly or secondarily liable for fund's income tax liability as fund's tax agent

The latest standards

FIN 48: Uncertain tax positions

Key areas of focus

- Portfolio-Level Tax
 - Common sources of risk
 - Direct investment into the PE target
 - Indirect investment into the PE target through a treaty platform that lacks sufficient substance
 - Portfolio company filing position
 - Potential Exposures:
 - Local taxation on capital gains sourced to country of investment and local filing requirement
 - E.g. Japan, South Korea, India, China, Mexico, Germany, etc.
 - Withholding tax on interest payments PE investment
 - Withholding tax on dividends paid by PE investment

The latest standards

FIN 48: Uncertain tax positions

Addressing PE Tax Risks :

- Understand the client's fund structure and investment group structures
- Understand the nature (e.g., debt vs. equity)
- Identify the jurisdictions that are relevant to the client's investments
- Identify key tax risks
- Understand and review the client's capabilities policies for identifying and reviewing tax risk
- Review client's assessment and conclusions on likelihood of incurring tax exposures and achieving tax benefits

The latest standards

Other Developments – FAS 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133

- FAS 133 is the Derivatives & Hedging Standard
- It permits hedge accounting (like IAS 39) and requires a number of disclosures
- Funds are not permitted to apply the hedge accounting rules of FAS 133 but they must include the disclosures
- FAS 161 extends those disclosure requirements....

The latest standards

Other Developments – FAS 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133

- The FASB recently issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133 (FAS 161), to enhance the current disclosure framework in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (FAS 133).
- Addresses concerns that the disclosures required by FAS 133 do not provide adequate information about the impact derivative instruments can have on an entity's financial position, results of operations, and cash flows.
- Amends and expands the disclosures required by FAS 133 so that they provide an enhanced understanding of “(1) how and why an entity uses derivative instruments, (2) how derivative instruments and related hedged items are accounted for under FAS 133 and its related interpretations, and (3) how derivative instruments affect an entity's financial position, financial performance, and cash flows.”
[FAS 161, par. 1 and 3(a), which amends FAS 133 par. 44(a)-(c)]

The latest standards

Other Developments – FAS 161, *Disclosures about Derivative Instruments and Hedging Activities*, an amendment of FASB Statement No. 133

- The **new disclosure guidance** will apply to all interim and annual reporting periods for which a statement of financial position and statement of financial performance are presented, beginning after November 15, 2008. Some of the more significant disclosure requirements include the following:
 - An entity's objectives for holding or using derivative instruments and its strategies for achieving those objectives discussed in the context of the instrument's primary underlying risk exposure (e.g. interest rate risk, credit risk, foreign exchange rate risk, overall price risk)
 - The level of an entity's derivative activity (e.g. total notional amount of contracts outstanding during the period)
 - The location and fair value amounts of derivative instruments, hedged items, and related gains and losses in the balance sheet and income statement, presented in a tabular format
 - The existence and nature of credit-risk-related contingent features and the circumstances in which those features could be triggered in derivative instruments that are in a net liability position at the end of the reporting period
 - Cross-referencing among the footnotes if the required disclosures are presented in more than one footnote
- FAS 161 encourages, but does not require, comparative disclosures for earlier periods at initial adoption

The latest standards

Other Developments – FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees

- FIN 45 requires disclosure and measurement of guarantees or warranties entered into;
- In many cases, such arrangements must be recorded as a liability at fair value on the balance sheet;
- FASB Staff Position (FSP) FIN 45-4 extends the disclosure requirements....

The latest standards

Other Developments – FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees

- FASB Issued FASB Staff Position (FSP) No. 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FAS 133 and FIN 45; and Clarification of the Effective Date of FAS 161
- FSP No. 133-1 and FIN 45-4 is intended to improve disclosures about credit derivatives by requiring more information about the potential adverse effects of changes in credit risk on the financial position, financial performance, and cash flows of the sellers of credit derivatives
- The FSP also amends FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, to require an additional disclosure about the current status of the payment/performance risk of a guarantee. This amendment of Interpretation 45 reflects the Board's belief that instruments with similar risks should have similar disclosures.

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