

Global Hedge Funds

Accounting & Regulatory Alert



Accounting Standards: US GAAP vs. IFRS

By Stuart Cohen

When forming an alternative investment fund, a hedge fund manager must decide which accounting standards the fund will follow, which often means selecting between United States Generally Accepted Accounting Principles (“US GAAP”) or International Financial Reporting Standards (“IFRS”). US GAAP is generally chosen as the standard for US domiciled funds, which are distributed to US investors. However, the decision for offshore funds may be different depending on the domicile of the fund and the country location of investors to which the fund will be marketed. Offshore funds have in many cases adopted US GAAP, as it is the standard for the world’s largest capital market. IFRS has however been receiving increasing acceptance and has become the global standard for financial reporting outside North America. A significant number of countries have adopted IFRS as their principal financial reporting regime—either directly (the European Union has adopted IFRS for EU listed companies preparing consolidated financial statements), or by aligning their national standards with IFRS (for example, Australia and South Africa).

When deciding which accounting standard to adopt for an alternative investment fund, a hedge fund manager should in addition to the marketing considerations also evaluate the differences between US GAAP and IFRS. These two standards

can result in different valuation of financial instruments and presentation of financial statements. This Accounting & Regulatory Alert summarizes the key differences between US GAAP and IFRS as they relate to alternative investment funds. It is not intended to be a comprehensive summary of all the issues but rather an introduction to the nature and type of issues which may arise.

Presentation of financial statements

IFRS and US GAAP both require a full set of financial statements to include a balance sheet, income statement, statement of changes in equity, cash flow statement and accompanying notes. Alternative investment funds reporting under US GAAP must also present a condensed schedule of investments and financial highlights (i.e., total return, expense ratio, and net investment income ratio). Some regulatory agencies require that certain US GAAP disclosures also be included when non-US GAAP financial statements are prepared. For example, an investment fund filing IFRS financial statements with the US Commodity Futures Trading Commission would be required to include a condensed schedule of investments and an investment fund filing IFRS financial statements with the Irish Stock Exchange would be required to include an analysis of the investment portfolio.

An investment fund of a SEC registered investment adviser (“RIA”) relying on the audit exemption provision of the Custody Rule¹ must have its financial statements prepared in accordance with US GAAP. However, if the investment fund is organized outside the United States, or has a general partner or other manager with a principal place of business outside the United States, the RIA may have the financial statements of the investment fund prepared in accordance with accounting principles other than US GAAP so long as they contain information substantially similar to financial statements prepared in accordance with US GAAP and any material differences are reconciled.

IFRS financial statements must present two years while US GAAP financial statements for an alternative investment fund do not need to be comparative unless required by a regulatory agency.

Consolidation

There is no exemption from consolidation of subsidiaries available under IFRS for investment funds. A subsidiary is defined as an enterprise controlled by another enterprise. Control is presumed to exist when the “parent” entity owns, directly or indirectly, more than half of the voting power of a “subsidiary” entity, unless it can demonstrate that such ownership does not constitute control.²

Control can also be deemed to exist when the “parent” entity has:

1. Power over more than half of the voting rights.
2. Power to govern the financial and operating policies.
3. Power to appoint or remove a majority of the board (or equivalent body).
4. Power to cast the majority of votes at meetings of the board (or equivalent body).

The existence of control will necessitate the preparation and presentation of consolidated financial statements for a group of entities. This may apply to master/feeder type arrangements i.e., the master fund will be a subsidiary of a feeder fund, if the

feeder fund has the ability to govern the financial and operating policies of the master fund enabling it to obtain benefits from the master fund’s activities. In general, a feeder fund will have control when the feeder fund has a majority of voting rights in relation to substantive matters of operating and financial policy of the master fund such as the determination of investment management policy, the selection or removal of investment managers, advisers or the fund manager, or making changes to the fund’s constitution. Other factors such as the terms of the fund’s constitution and any control agreements that may exist must also be considered. For example, the Irish Stock Exchange requires that a listed feeder fund have the ability to control the underlying master fund. Where the feeder fund holds non-voting shares control can be effected through an agreement between funds. This would result in a control relationship that would require consolidation.

Under US GAAP, financial statements of a master/feeder fund would not be consolidated. Financial statements for feeder funds should contain two sets of financial statements, one for the master and the other for the specific feeder fund.³

Investments

IFRS requires that financial instruments be classified into one of four categories⁴:

1. Fair value through profit or loss
2. Held-to-maturity instruments
3. Loans and receivables
4. Available-for-sale financial assets

The “fair value through profit or loss” category is sub-divided into (i) held for trading and (ii) financial instruments designated as fair value through profit or loss at initial recognition.

The accounting treatment of financial instruments required by IFRS is determined by the category into which the instrument is classified. The basis of the valuation, recognition of unrealized gains and losses and treatment of transaction costs differs by category, as summarized below.

¹ Rule 206(4)-2 of the Investment Advisers Act (the “Custody Rule”) provides that a registered investment adviser does not need to engage an accountant to perform a surprise custody examination if the investment fund has an annual audit and distributes its audited financial statements to its investors within 120 days of the end of its fiscal year, or in the case of a fund of funds within 180 days of its fiscal year.

² IAS 27, Consolidation and Separate Financial Statements.

³ AICPA Audit and Accounting Guide: Investment Companies.

⁴ IAS 39, Financial Instruments: Recognition and Measurement.

Instrument Classification	Measurement	Fair Value Change	Transaction Costs Capitalized in Cost of Investment
Fair value through profit/loss	Fair value*	Yes - recognized in P&L	No
Held to maturity	Amortized cost	No	Yes
Loans and receivables	Amortized cost	No	Yes
Available for sale	Fair value*	Yes - recognized in equity until realized P&L recognition of permanent diminution in value	Yes

* In circumstances where fair value cannot be readily determined, IFRS sets out specific provisions.

After initial recognition, when determining fair values, no deduction should be made for transaction costs that may be incurred on sale or other disposal.

Under IFRS, fair value is defined as “the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction”. In determining fair value, stale prices may be adjusted but blockage discounts are prohibited.

The use of a published price in an active market is the best evidence of fair value and the appropriate value for a quoted security is the current bid price for securities held long and the ask price for securities sold short.⁴ When an alternative investment fund has assets and liabilities with offsetting market risks, it may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or ask price to the net open position as appropriate.

The use of mid-market (i.e., the average of bid and offer prices), and the last traded price or the closing price for valuing quoted

securities is generally the pricing methodology followed by an alternative investment fund as outlined in its offering memorandum for purposes of calculating the dealing Net Asset Value (“NAV”) for investor transactions.

As a result of the application of the bid/ask valuation basis in accordance with IFRS, the valuation of investments for purposes of financial statement presentation may be different to the valuation which is used for the purposes of calculating the NAV for investor transactions. In such cases, a reconciliation between the fair values recognized on the balance sheet and the prices used for calculating the NAV for investor transactions may be included in the financial statements.

Fair value for investments that are not traded in an active market should be determined by establishing a valuation technique most commonly used by the market. Fair value should be based on observable market data and the use of entity specific inputs should be minimized. Fair value should be determined consistently.

US GAAP for alternative investment funds requires that financial instruments be presented at fair value through profit and loss. Fair value is defined as “the price in an orderly transaction between market participants to sell an asset or transfer a liability in the principal (or most advantageous) market”.⁵ The use of bid prices for long positions and ask prices for short positions is permitted but not required.

Classification of redeemable participating shares as liabilities

Under IFRS 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.⁶ The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. An alternative investment fund may provide their investors with a right to redeem their interests in the fund at certain times for cash equal to their proportionate share of the net asset value of the fund. Accordingly, an investor’s interest

⁵ FASB Statement No. 157, Fair Value Measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007.

⁶ IAS 32, Financial Instruments: Disclosure and Presentation.

that is considered a redeemable participating share should be classified as a liability in the fund's financial statements under IFRS rather than as equity. Such amounts would be reflected on the balance sheet as "Net Assets Attributable to Redeemable Participating Shareholders" and on the profit/loss statement as "Net Increase/Decrease in Net Assets Attributable to Redeemable Participating Shareholders". In addition, dividend payments made to holders of such instruments should be recorded as finance costs in the profit and loss.

Under a proposed revision to IAS 32, this treatment is expected to change in the near future so that redeemable shares issued by investment funds will be reclassified as equity, resulting in the presentation of a full balance sheet format.

Under US GAAP an investor's interest in an alternative investment fund is generally classified as equity. If redemption of an equity interest is at the holder's option and the holder has elected to redeem its interest, such interests would be mandatorily redeemable and should be reclassified from equity to liability.⁷

Reporting currency

Under US GAAP assets, liabilities and operations of an entity should be recorded using the functional currency. This is defined as the currency of the primary economic environment in which the entity operates; normally it is the currency of the environment in which it generates and expends cash. If an entity's reporting currency is not the same as its functional currency then all elements of the financial statements should be translated using an appropriate exchange rate.

IFRS introduces the concepts of functional and presentation currencies.⁸ The functional currency of an entity is defined as the currency of the primary economic environment in which the entity operates and is the currency in which the books and records of the entity must be maintained. In determining the functional currency, an investment fund should also consider the currency in which funds from financing activities are generated and the currency in which receipts from operating activities are usually retained. The presentation currency is the currency in which the financial statements are presented. The currency in which the valuation is prepared as defined in the fund's prospectus may be different from the functional

currency, as defined in IFRS. Therefore, consideration must be given to whether a change in the currency in which the books and records of the fund are maintained is required.

Organization Costs

Under both US GAAP and IFRS, organization costs should not be amortized but are to be expensed as incurred.

Financial Statement Disclosures

Both IFRS and US GAAP require a significant amount of disclosure with respect to financial instruments and risks. Although the purpose of the financial instrument disclosures may not be dissimilar, the actual disclosures required by IFRS and US GAAP may differ.

IFRS requires the disclosure of risk exposures, their impact on the fund and the actions taken to mitigate. An alternative investment fund should provide disclosures related to:

1. Market price risk
2. Interest rate risk
3. Credit risk
4. Liquidity risk
5. Currency risk

The disclosures should be qualitative, disclosing for each identified risk how it arose, the objectives, policies and processes for measurement and any changes from the prior period. The disclosures should also be quantitative, including numerical disclosures of the risk exposures and concentrations at the reporting date.

There is no specific requirement to disclose individual holdings, however, the requirement to disclose concentrations of exposure would result in the need to disclose an analysis of investments by relevant categories (e.g. country, industry etc.) and disclosure is required of individual holdings (long and short) that represent a significant concentration of risk.

Other examples of quantitative disclosures that may be required include interest rate maturity analysis, exposure to other currencies and liquidity/lock-up restrictions.

⁷ FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity, as affected by FASB Staff Position No. FAS 150-3.

⁸ IAS 21, The Effects of Changes in Foreign Exchange Rates.

IFRS 7, which is applicable for 2007 year ends (with disclosure of comparatives for 2006) expands on these disclosure requirements. For market price risk, the additional disclosure includes the requirement to identify a range of reasonably possible increases and decreases in each market input. This will result in the disclosure of sensitivity analyses with respect to the variable factors that underly market risk.

Other disclosure requirements under IFRS 7 include disclosure of the age of financial assets that are past due but not impaired, disclosure of the fair value of collateral given and received, disclosure of allowances for credit losses and disclosure of defaults and breaches relating to financial instruments held.

For further information on this subject, please contact your local Ernst & Young representative or:

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