Similarities & differences
A comparison of US GAAP and IFRS for investment companies

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Dear clients and friends:

PwC offers this publication for those who wish to gain a general understanding of the key similarities and differences between the accounting principles generally accepted in the United States (US GAAP) and International Financial Reporting Standards (IFRS) as they are applicable specifically to investment companies as well as an appreciation for the level of change on the horizon.

IFRS does not provide industry-specific standards for investment companies, whereas under US GAAP investment companies follow a set of industry-specific accounting standards and practices, generally summarized in the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide for Investment Companies (AAG-Inv). In June 2009, the Financial Accounting Standards Board (FASB) issued the Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, which established the FASB Accounting Standards Codification as the single source of authoritative accounting principles to be applied in the preparation of financial statements in conformity with US GAAP. The industry-specific guidance noted in AAG-Inv was codified primarily into ASC 946 Financial Services—Investment Companies.

The first chapter of this publication summarizes the similarities and differences between IFRS and US GAAP as they affect investment companies. The subsequent chapters explain these differences in detail. In conjunction with reading this publication, users may want to refer to Illustrative IFRS Financial Statements—Investment Funds, also published by PwC.

This publication is not intended to capture all of the similarities and differences between IFRS and US GAAP, but rather only the provisions that affect investment companies. In addition, this publication primarily compares the accounting and reporting requirements of nonregistered investment companies and not those registered with the US Securities and Exchange Commission (SEC). When applying the standards, readers should also consult all the relevant accounting standards and, where applicable, their federal and state laws and regulations. Such laws and regulations are not covered by this publication. Furthermore, this publication is not intended to cover the accounting by investment managers and general partners of investment companies.

For a general comparison of IFRS and US GAAP, please see PwC’s publication IFRS and US GAAP—similarities and differences.

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PwC investment management industry IFRS champions
Executive summary

Executive takeaways

• Global transition to IFRS continues to gather pace and is increasingly impacting affiliates of US investment companies. Transition is occurring in Brazil, Canada and South Korea by 2011, and Mexico and India beginning in 2012. Japan has allowed IFRS use for certain domestically listed companies since March 2010 and there is a proposal to adopt IFRS for statutory purposes in the UK and Ireland in 2014.

• In the US, the SEC has taken steps toward a transition from US GAAP to IFRS. In November 2007, the SEC allowed foreign companies filing in the United States to use IFRS without reconciling their financial statements to US GAAP. In November 2008, the SEC released its proposed road map for voluntary application of IFRS for certain qualifying US registrants followed by a plan for mandatory adoption of IFRS if certain milestones are met. In February 2010, the SEC published a statement of continued support for a single set of high-quality accounting standards and acknowledged that IFRS is best positioned to serve that role. The statement introduced a Work Plan to be executed by the SEC staff that considers concerns raised by respondents about the road map. The SEC issued the first work plan progress report in October 2010. As expected, it did not provide a definitive indication of where the SEC is heading with its decision in 2011, but rather only summarized the analysis the staff has done to date.

• A member of the SEC Staff floated a trial suggestion in December 2010 that the US may wish to consider a slower transition process to IFRS consisting of endorsing new international standards for use in the US, changing other US standards to conform to IFRS and allowing some form of optional full IFRS adoption. Recognizing the public policy and political challenges the SEC faces in making its 2011 IFRS decision, we believe the SEC Staff’s suggestion is designed to be an invitation to begin a productive dialog around how the US might commit to move to IFRS over a longer time period, in response to concerns raised by US businesses. We believe such a dialog is worthwhile.
• The FASB and the IASB are working on approximately a dozen projects under the Memorandum of Understanding (MoU). The FASB and IASB originally targeted completion of the convergence projects by June 2011. In mid-2010, the FASB and IASB announced a modified strategy for completion of the convergence agenda that extended some projects into the second half of 2011 and beyond. The boards also committed to perform additional stakeholder outreach to allow for more participation in the standard-setting process. More recently, in their November updated progress report, the boards retained the target completion date of June 2011 or earlier for the convergence projects they consider most urgent (i.e., financial instruments, revenue recognition, leases, statement of comprehensive income and fair value measurement) and made changes to the timeline on certain lower-priority projects.

• No matter the outcome of the SEC’s decision and direction, the ongoing convergence and development of standards will result in significant changes in the United States. This, together with new regulations driven by the financial crisis and continued global adoption of IFRS, will result in an extended period of substantial change.

• Some areas where IFRS may significantly affect an investment company’s financial statements include valuation, classification of capital, and consolidation.

• It is important to remember that IFRS is not only an accounting and reporting matter, but also affects operations including fund design, marketing, and investor relations. Conversions involve not only internal accounting functions but also investor communication, management, vendor contracts, information systems, financing agreements including debt covenants, and tax reporting and compliance. Therefore, it is important to train people working in these functions for investment companies in IFRS.
Why would investment companies want to think about IFRS now?

• **Focus on the challenge.** The next several years will bring major changes to US financial reporting. Whether changes arrive through convergence, an SEC-mandated move to IFRS, regulation, or continued voluntary IFRS adoption by private investment companies, the effect on US asset managers will be considerable.

• **Maintain corporate oversight.** IFRS adoption for statutory reporting continues in many territories. Influence transition timing, strategies, and policy decisions of non-US affiliates that are increasingly likely to be on some form of IFRS in the foreseeable future. Closely follow international acceptance of IFRS for statutory purposes.

• **Use scenario planning.** Incorporate likely convergence and IFRS adoption expectations into your strategic thinking and business planning. Consider the effects various alternative paths could have. Identify and consider the implications of business, accounting, tax structure, financing, long-term contractual commitment, investor, control systems and workforce related issues.

• **Identify what you can do now.** Be mindful of aspects of convergence and conversion that will take the longest. If highly probable changes can be made efficiently and without waste, get started addressing those challenges. Consider smaller controlled one-off projects where desirable.

The many distinctions between IFRS and US GAAP may affect an investment company’s financial results. The biggest impact to investment companies is that IFRS is not industry-specific. Unlike US GAAP, there is no IFRS investment guide with an accounting framework designed specifically for the industry. As a result, investment companies reporting on IFRS will have to follow the same set of accounting principles applicable to all IFRS reporters in all industries around the globe. As such, investment companies will need to be aware of the effects that a potential move to IFRS could have on fund design, contracts, agreements, the calculation of net asset value (NAV), tax implications, etc., and to consider how these changes should be communicated to investors, regulators, and other users of financial data.

**Highlights**

Some US funds with global investors are already reporting under IFRS to enhance their competitiveness.
1.1 Overview of similarities and differences between US GAAP and IFRS

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<td>Framework</td>
<td>The AICPA AAG-Inv provides assistance for preparing financial statements in conformity with US GAAP and provides specific guidance on industry accounting standards and practices for both SEC registered and nonregistered investment companies.</td>
<td>In June 2009, the FASB issued <em>The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles</em>, which was codified in ASC 105-10. It establishes the FASB Accounting Standards Codification as the single source of authoritative accounting principles to be applied in the preparation of financial statements in conformity with US GAAP. The industry-specific guidance noted in AAG-Inv was codified primarily into ASC 946 <em>Financial Services—Investment Companies</em>. This publication will focus primarily on nonregistered investment companies.</td>
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<td>First-time adoption of accounting framework</td>
<td>Retrospective application of all US GAAP, effective at the reporting date, is required for a company’s first US GAAP financial statements.</td>
<td>Retrospective application of all IFRS effective at the reporting date is required for an entity’s first IFRS financial statements, with some optional exemptions and limited mandatory exceptions. An entity shall explain how the transition from previous GAAP to IFRS affected its reported financial position, financial performance, and cash flows. To comply with this transition requirement, reconciliations from previous GAAP to IFRS are required for reported equity at the date of transition to IFRS (i.e., the beginning of the earliest period presented in the first IFRS financial statements) and equity and profit and loss at the end of the latest period presented under the previous GAAP. The reconciliation should provide sufficient detail to enable users to understand the material adjustments to equity and the impact on profit or loss. If the entity also presented a statement of cash flows under its previous GAAP, it shall explain any material adjustments to the statement of cash flows. For annual periods beginning on or after January 1, 2009, a first-time adopter is also required to present its opening balance sheet at the date of transition to IFRS.</td>
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## Similarities & differences: A comparison of US GAAP and IFRS for investment companies

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<td>Components of financial statements</td>
<td>Comparative financial statements are not required for investment companies.</td>
<td>Two years’ balance sheets, income statements, statements of changes in equity (if any), cash flow statements, and notes to the financial statements are required.</td>
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<td>Financial statements generally include a statement of assets and liabilities with a schedule of investments (or a statement of net assets, which includes a schedule of investments therein)*; a statement of operations; a statement of changes in net assets; a statement of cash flows (if required); and notes to the financial statements.</td>
<td>In addition, an entity is required to present a statement of financial position for the beginning of the earliest comparative period when the entity applies an accounting policy retrospectively or makes a retrospective restatement or when it reclassifies items in its financial statements. For investment companies that do not have any equity (i.e., because the unit holder shares are classified as liabilities), the best practice is to include a statement of changes in net assets attributable to unit holders. Refer to “Equity—Classification” below (section 3.2.1).</td>
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<td>* At a minimum, a condensed schedule of investments should be provided for each statement of assets and liabilities.</td>
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<td>Statement of assets and liabilities</td>
<td>The statement of assets and liabilities has a nonclassified presentation and requires the presentation of specific items. Investments are usually presented as the first line because of their importance to the investment company.</td>
<td>IFRS does not prescribe a particular format for an investment company. A current/noncurrent presentation of assets and liabilities should be used unless a liquidity presentation provides more reliable information, which may be the case for investment companies given that generally all assets and liabilities are current.</td>
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<td>Equity—classification</td>
<td>Generally, capital shares are classified as equity. However, under ASC 480 <em>Distinguishing Liabilities from Equity</em>, shares or interests will meet the definition of a liability if they are unconditionally redeemable by transferring assets on fixed dates for amounts that are either fixed or determined by reference to an interest rate index, currency index, or another external index. Assuming capital shares are classified as equity, the distributions and dividends to the shareholders are recognized as transactions in equity.</td>
<td>In a typical open-end investment company, the shares or interests are redeemable at the option of the holder. A closed-end investment company typically has an obligation to redeem the shares or interests at the end of the life of the fund. As such, redeemable shares or interests generally will be classified as liabilities regardless of their legal form. The standard, however, provides an exception to the classification of these shares, whereby if stringent criteria are met, the shares may be classified as equity. However, we believe it will be rare in practice for investment companies to meet the criteria to achieve equity classification. If shares are classified as liabilities, changes in the liability, which includes related dividends or distribution of income to holders of redeemable shares and subsequent measurement of the liability, should be recognized in the income statement. Subscriptions and redemptions of redeemable capital are recorded directly to the statement of changes in net assets attributable to holders of redeemable shares.</td>
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<td>Net assets—measurement</td>
<td>Net assets represent the residual value of the assets, net of liabilities.</td>
<td>Similar to US GAAP, net assets represent the residual value of the assets, net of liabilities. For puttable instruments, which continue to be recognized as liabilities (i.e., if they do not meet the narrow criteria for equity classification in IAS 32), the liability is measured at the redemption amount with changes in that amount recognized in profit or loss.</td>
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<td><strong>Financial statements</strong> (continued)</td>
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<td>Schedule of investments</td>
<td>Investments should be presented and disclosed either on the face of the statement of assets and liabilities or in a separate schedule of investments. At a minimum, a condensed schedule should be provided as of the balance sheet date, with specific presentation and disclosure requirements.</td>
<td>A schedule of investments is not required to be presented as a separate statement. However, IFRS requires that the notes to the financial statements include risk management disclosures, which allows the reader to understand the nature and significance of the investments held by the investment company. Hence, the schedule of investments may be used to satisfy some of the disclosure requirements. Comparative information should be provided.</td>
<td>3.3</td>
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<td>Income statement</td>
<td>Specific items are required to be presented and disclosed on the face of the statement of operations.</td>
<td>IFRS does not prescribe a standard format for the income statement. The entity should select a method of presenting its expenses by either function or nature. Certain minimum items are required to be presented on the face of the income statement.</td>
<td>3.4</td>
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<td>Interest and dividend income recognition</td>
<td>Interest is recognized on an accrual basis using the effective interest method. Dividends are recognized when the right to receive payment is established. Premiums and discounts should be amortized using the effective interest method.</td>
<td>Recognition is similar to US GAAP. However, there is no requirement to separate interest from the fair value movements for instruments carried at fair value through profit or loss.</td>
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<td>Realized and unrealized gains (losses) on investments—presentation</td>
<td>Net realized gains (losses) and net change in unrealized appreciation (depreciation) should be disclosed separately. A distinction should be made between realized and unrealized gains or losses on foreign currency transactions. The foreign currency element of gains or losses on investments may be presented either separately or together with the local currency market gains or losses on investments.</td>
<td>Unlike US GAAP, there is no requirement to separately disclose net realized gains (losses) and net change in unrealized appreciation (depreciation). IFRS requires net gains (losses) on foreign currency transactions to be disclosed separately except for those arising on financial instruments measured at fair value through profit and loss.</td>
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<td>Withholding taxes—presentation</td>
<td>Withholding taxes are not required to be presented as a separate component of income tax for the period but may be disclosed parenthetically if they are material.</td>
<td>Income should be included gross in the income statement. The withholding tax should be presented as a separate component of income tax for the period.</td>
<td>3.4.3</td>
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<td>Statement of changes in net assets/equity</td>
<td>Specific items are required to be presented and disclosed on the face of the statement of changes in net assets.</td>
<td>In most cases, an investment company that issues only puttable shares would not have any equity (unless the criteria in IAS 32 are met). Accordingly, if there are no other changes in equity (e.g., changes in an available-for-sale security through equity, cumulative translation adjustment, etc.), then a statement of changes in equity is not required. However, the best practice is to present a statement of changes in net assets attributable to holders of redeemable shares or interests.</td>
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<td>Statement of cash flows</td>
<td>There are standard headings and specific guidance for items included in each category. Either the direct or indirect method can be used for cash flows from operating activities. If certain conditions are met, an investment company may be exempted from presenting a statement of cash flows.</td>
<td>IFRS requires standard headings; however, there is limited guidance on what should be included within each heading. Either the direct or indirect method can be used for cash flows from operating activities. In practice, investment companies typically use the indirect method even though IFRS encourages the use of the direct method. Statement of cash flows is required for all entities; there are no exceptions.</td>
<td>3.6</td>
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<td>Definition of cash and cash equivalents</td>
<td>Generally, only investments with original maturities of three months or less qualify for cash equivalents. Movements in bank overdrafts should be shown as financing activities.</td>
<td>Cash and cash equivalents include cash or investments with maturities of three months or less from the date of acquisition and may include bank overdrafts if they are used as part of the investment company’s cash management.</td>
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<td><strong>Consolidation</strong></td>
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<td>Overview of the consolidation model</td>
<td>Consolidation by an investment company of a noninvestment company investee (i.e., an operating company) is not appropriate except in cases in which the investment company has a controlling interest in an operating company that provides services to the investment company. An investment company may apply either the master-feeder, the fund of funds, or the consolidation model in its financial statements to present its investment in the underlying investee investment company. If either the master-feeder or fund of funds presentation is considered more appropriate based on entity-specific facts, then the consolidation of an underlying investee investment company is not required.</td>
<td>Consolidation is based on the existence of control. This is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than one-half of an entity's voting power. Control also exists in the circumstances when a parent owns half or less of the voting power but has legal or contractual rights to control, or de facto control. The existence of currently exercisable potential rights is also taken into consideration. Thus, in a master-feeder structure where the master is not an SPE, the master fund should be consolidated into the feeder fund when a feeder fund has control over its master fund (such as through the ownership of voting shares, or other ability to direct the financial and operating policies of the investee). Similar principles would be applied to a fund of funds structure. If the investee is a special-purpose entity, the investee should be consolidated by the investment fund when the substance of the relationship indicates control.</td>
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<td><strong>Equity method of accounting for investments in common stock/investment in associates</strong></td>
<td>Generally, investments held by an investment company are accounted for at fair value even when the equity method would otherwise be applied. However, investment in an operating company that provides services to the investment company should be accounted for under the equity method where the criteria for the equity method of accounting are met (unless the fair value option is elected).</td>
<td>An investment company holds an investment in an associate where it has significant influence, which is the power to participate in financial and operating policy decisions. “Significant influence” is presumed to exist if it holds an interest of 20% or greater. If the interest is less than 20% other factors should be taken into consideration. Investments in associates should be accounted for under the equity method, except when the investments are associates of venture capital organizations, mutual funds, unit trusts, and similar entities. In such cases, investments in associates are classified as financial instruments at fair value through profit or loss upon initial recognition (the “fair value option”) or as held for trading. In practice, investment companies have used this exception to carry the equity method investees at fair value through profit or loss.</td>
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<td><strong>Consolidation (continued)</strong></td>
<td>Given the limited application of the consolidation model for investment companies under US GAAP, the guidance on business combinations and noncontrolling interests will generally not have significant accounting and reporting implications for an investment company. Accordingly, this publication will not expand on the requirements under US GAAP and the comparison to IFRS for this topic.</td>
<td>Under IFRS, an investment company would need to apply IFRS 3R if it acquires a business (as defined by the standard) and if, as a result of the transaction, the investment company obtains control (as defined by IAS 27R/SIC 12) over that business. In accordance with IFRS 3R, an investment company would be required to recognize and measure the identifiable assets, liabilities assumed, and any noncontrolling interest in the acquired entity as well as any goodwill or gain from a bargain purchase. Subsequently, the investment company would follow IAS 27R in determining how to account for changes in level of ownership or loss of control of the subsidiary. Disclosures around the nature and financial effects of the business combination and relationship between the investment company and its subsidiaries are also required. IFRS 3R and IAS 27R should be applied prospectively to business combinations occurring in the first accounting period beginning on or after July 1, 2009 (with early adoption permitted, although both standards should be applied at the same time). Note however, similar provisions would apply under the current IFRS 3 and IAS 27 rules prior to the adoption of these new standards.</td>
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### Financial instruments

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<td>Initial recognition</td>
<td>Securities transactions are recorded on the trade date basis.</td>
<td>A financial instrument should be recognized when an entity becomes a party to the contractual provisions of the instruments. Regular-way purchases of financial assets can be recorded based on the trade date or the settlement date. Derivatives that permit or require net settlement do not meet the definition of regular-way trades.</td>
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<td>De-recognition</td>
<td>A transfer of financial assets in which the transferor surrenders control over the financial assets shall be accounted for as a sale to the extent consideration is exchanged. Similar to initial recognition, securities transactions are recorded on the trade date basis.</td>
<td>A financial asset should be de-recognized when the contractual rights to the cash flow from the financial asset have expired or are transferred together with substantially all the risks and rewards of the asset. Upon de-recognition, regular-way sales can be recorded based on the trade date or the settlement date. Derivatives that permit or require net settlement do not meet the definition of regular-way trades. A financial liability should be de-recognized when the obligation specified in the contract is discharged, canceled, or expired.</td>
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<td><strong>Financial instruments</strong></td>
<td>There is no specific classification (i.e., trading, available for sale, etc.) guidance for investments of investment companies; all financial assets are required to be reported at fair value (See chapter Financial Instruments—5.6) as noted in ASC 946 Financial Services—Investment Companies.</td>
<td>Financial assets are classified either as (a) financial assets at fair value with changes recognized through profit or loss (held for trading or designated upon initial recognition under the fair value option); (b) held to maturity; (c) loans and receivables; or (d) available for sale.</td>
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The fair value option can be used in the following cases: (1) a financial instrument containing one or more embedded derivatives; (2) when it results in more relevant information because either it eliminates or significantly reduces a measurement or recognition inconsistency; or (3) a group of financial instruments is managed and its performance is evaluated on a fair value basis. The fair value option applies to both financial assets and liabilities.

An investment company typically classifies its investments as financial instruments at fair value through profit or loss. Additionally, it is not uncommon for investment companies to also use the available-for-sale category.

For entities that early adopt IFRS 9 (effective on or after January 1, 2013), the following apply:

An entity shall classify financial assets as either amortised cost or fair value through net income on the basis of both:

(a) the entity’s business model for managing the financial assets; and

(b) the contractual cash flow characteristics of the financial asset.

Under IFRS 9, the fair value option has been limited to accounting mismatches under that option.

Because the objective of an investment company is to manage its portfolio to realize fair value rather than to collect contractual cash flows, investment companies will generally follow a fair value driven business model, where the entire portfolio is managed and measured on a fair value basis.

The IFRS 9 classification principles also require that all derivative instruments should be carried at fair value.
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<td><strong>Financial instruments (continued)</strong></td>
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<td>Financial liabilities—classification</td>
<td>US GAAP requires that all investment liabilities (e.g., written options, securities sold short, etc.) be measured at fair value through the income statement while other liabilities (e.g., other debt, etc.) are stated at amounts payable, net of unamortized premium, unless the fair value option is elected.</td>
<td>IFRS has only two defined categories of financial liabilities: a) financial liabilities at fair value through profit or loss (held for trading or designated at inception under the fair value option); or b) other financial liabilities.</td>
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<td>In practice, the classification between US GAAP and IFRS for financial liabilities is similar (i.e., all short sales and derivatives would be carried at fair value through profit or loss).</td>
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<td>In October 2010, the requirements for classifying and measuring financial liabilities were added to IFRS 9. Most of the added requirements were carried forward unchanged from IAS 39. However, the requirements relating to the fair value option for financial liabilities were changed to address the issue of own credit risk in response to constituent feedback that the effect of changes in the liability’s own credit risk ought not to impact profit and loss unless the liability is held for trading. IFRS 9 requires that changes in the credit risk of the liability will be recognized in other comprehensive income and not recycled when the fair value option is used.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial measurement</td>
<td>Financial assets and financial liabilities are initially recorded at cost, which includes commissions and other charges that are part of the transaction.</td>
<td>Financial assets and financial liabilities are initially recorded at fair value. If the financial instrument will not be carried at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial instrument should also be included in the amount initially recorded.</td>
<td>5.5</td>
</tr>
<tr>
<td></td>
<td>If the financial instrument will be measured at fair value through profit or loss, transaction costs, including the bid/offer spreads and commissions, should be expensed through profit and loss.</td>
<td></td>
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</tr>
</tbody>
</table>
Financial instruments (continued)

Subsequent measurement

US GAAP
All investments are reported at their fair value. Unrealized gains or losses on investments are recognized in the statement of operations in addition to interest and dividend income.

Unless carried at their fair value through profit or loss, financial liabilities should be stated at their amortized cost.

IFRS
Financial assets and financial liabilities measured at fair value through profit or loss are subsequently measured at fair value, and any change in value is recognized in profit and loss.

Held-to-maturity investments and loans and receivables are subsequently measured at their amortized cost using the effective interest method.

Available-for-sale investments are subsequently measured at their fair value with changes in fair value recognized in equity (except for impairment losses and foreign exchange gains and losses for debt securities).

Financial liabilities not carried at their fair value through profit and loss are carried at their amortized cost using the effective-interest method.

For additional guidance around the effective interest method, refer to chapter Financial Statements—3.4.1.

For entities that early adopt IFRS 9, the following apply:

For financial assets (with the exception of certain equity investments as described below) classified and subsequently measured at fair value, changes in value are recognized in profit and loss.

Financial instruments classified at amortized cost will continue to utilize the effective interest rate method as under IAS 39.

IFRS 9 also allows entities to elect to recognize fair value gains and losses from investments in equity instruments not held for trading in other comprehensive income with no subsequent recycling of gains and losses.

Existing guidance for financial liabilities under IAS 39 is retained except if an entity elects fair value option for its liabilities. Any changes in fair value related to the liability’s credit risk are required to be reflected in other comprehensive income, unless doing so would create an accounting mismatch.
<table>
<thead>
<tr>
<th>Subject</th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair value</strong></td>
<td>In an active market, the fair value measurement should represent the price within the bid-ask spread at which market participants would transact on the measurement date. A “blockage factor,” which is the premium or discount based on the relative size of a position, is precluded for instruments quoted in an active market. ASC 820 <em>Fair Value Measurements and Disclosures</em> describes three main approaches to measuring the fair value of assets and liabilities: the market approach; the income approach; and the cost approach. It is unlikely that the cost approach would be appropriate when measuring the fair value of a financial asset or liability. The selection of appropriate valuation techniques may be affected by the availability of relevant inputs as well as by the relative reliability of the inputs.</td>
<td>In an active market, long positions should be valued at the bid price, and short positions should be valued at the asking price. Midmarket pricing may be used as a practical expedient under US GAAP but is not allowed under IFRS. Assets and liabilities with offsetting market risks may be valued at midmarket prices for the offsetting risk positions and at bid or asking price for net position as appropriate. Similar to US GAAP, the use of a blockage factor is precluded for instruments traded in an active market. If the market for a financial instrument is not active, an entity establishes fair value by using a valuation technique. The chosen valuation technique shall make maximum use of market inputs and rely as little as possible on entity-specific inputs.</td>
</tr>
<tr>
<td><strong>Disclosure</strong></td>
<td>Apart from the required schedule of investments, disclosure is also required around fair value measurements. Specific quantitative and qualitative disclosures are required for assets and liabilities measured at fair value on a recurring basis. The information should be presented separately for each major category of assets and liabilities. In annual periods, a reporting entity should disclose the valuation techniques used to measure fair value, including a discussion of any changes in the techniques employed.</td>
<td>Under IFRS, disclosures should be provided to enhance users’ understanding of the risk exposure and the entity’s risk management. Specifically, IFRS requires information about the significance of financial instruments for an entity’s financial position and performance as well as qualitative and quantitative disclosures about exposure to risks arising from financial instruments. Under IFRS 7, the quantitative risk disclosures should be given “through the eyes of management” (that is, based on the information provided internally to key management). In addition, certain minimum quantitative disclosures are required by IFRS 7 to the extent they are not already covered by the “through the eyes of management” disclosures, including: preparation of a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date; a maturity analysis for financial liabilities; and specific disclosures around credit risk. Similar to US GAAP, disclosures around fair value of financial instruments also should be made. The use of judgment and key assumptions around uncertainty of estimates used in determining fair value should be disclosed along with the nature and the carrying amount of assets and liabilities that typically approximate fair value, as well as transparent disclosures around the valuation techniques used to determine fair value.</td>
</tr>
<tr>
<td>Subject</td>
<td>US GAAP</td>
<td>IFRS</td>
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<td>---------</td>
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</tr>
<tr>
<td>Financial instruments (continued)</td>
<td></td>
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</tr>
</tbody>
</table>

**Offsetting**

A right of offset exists when the amounts are determinable and there is a right and intention to offset.

Without regard to the intention to offset (otherwise one of the key conditions), US GAAP specifically permits offsetting under a master netting arrangement for derivative contracts and for cash collateral arising from such derivative contracts if all other conditions are met. However, this would be a policy choice by the entity to offset under the master netting arrangement, and it must be applied consistently.

There are additional considerations for amounts recognized as payables under repurchase agreements and amounts as recognized as receivables under reverse repurchase agreements.

Similar to US GAAP, offsetting is allowed only when there is a legal enforceable right to offset and there is intention to settle on a net basis or to realize the asset and settle the liability simultaneously.

IFRS is more restrictive regarding offsetting under a master netting arrangement because all criteria must be met. There is no exception similar to that provided by US GAAP. As such, the criteria are generally not met because such arrangements commonly create a right of offset that becomes enforceable only in the event of default or circumstances outside the normal course of business.

**Other accounting and reporting topics**

<table>
<thead>
<tr>
<th>Subject</th>
<th>US GAAP</th>
<th>IFRS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Functional currency</td>
<td>An entity's functional currency is the currency of the primary economic environment in which it operates; normally, that is the currency of the environment in which it primarily generates and expends cash.</td>
<td>The definition and the determination of the functional currency are similar to US GAAP, with the exception that the IFRS determination is based on a hierarchy of primary and secondary indicators. The primary indicators are closely linked to the primary economic environment in which the entity operates, and they are given greater weight. Secondary indicators provide additional supporting evidence to determine the entity's functional currency. If the indicators are mixed and the functional currency is not obvious, management should use its judgment to determine the functional currency that most faithfully represents the economic results of the entity's operations. In practice, differences between IFRS and US GAAP are not expected in the determination of the investment company's functional currency.</td>
</tr>
<tr>
<td>Foreign currency transactions and translation of financial statements</td>
<td>Foreign currency transactions are initially recorded using the exchange rate at the date of the transactions. A change in the exchange rates between the functional currency and the currency in which a transaction is denominated would increase or decrease the expected amount of functional currency cash flows. This is a transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes. When translating the financial statements of the investment fund from the functional currency into the presentation or reporting currency, assets and liabilities shall be translated at the closing rate. Income statement items shall be translated at the dates of the transactions. The resulting exchange differences shall be recognized as a separate component of equity.</td>
<td>Similar to US GAAP.</td>
</tr>
</tbody>
</table>
### Other accounting and reporting topics (continued)

<table>
<thead>
<tr>
<th>Subject</th>
<th>US GAAP</th>
<th>IFRS</th>
<th>Chapter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax uncertainties</td>
<td>ASC 740 <em>Income Taxes</em> provides guidance for recognizing, measuring, and disclosing uncertain tax positions that are “more likely than not” to be sustained based on the technical merits of the position. ASC 740 requires that all uncertain tax positions be measured using the cumulative probability methodology.</td>
<td>IFRS does not specifically address uncertain tax positions. However, there is guidance in the IFRS tax standard that addresses the identification and measurement of “amounts expected to be paid to (recovered from) the taxing authorities.” The liability is measured using either an expected value (weighted average) or the single best estimate. The cumulative probability method is not allowed.</td>
<td>6.3</td>
</tr>
<tr>
<td>Real estate investments</td>
<td>Investments in real estate should be reported at their fair value.</td>
<td>IFRS allows an entity to choose either the fair value model with the change in fair value recorded through earnings or the cost model for all investments in real estate.</td>
<td>6.4</td>
</tr>
<tr>
<td>Share-based compensation</td>
<td>For equity-settled share-based awards, the fair value of the awards on the grant date is generally recognized over the vesting period. For cash-settled awards, the fair value of the liability incurred is generally recognized over the vesting period.</td>
<td>Similar model to US GAAP, although many differences exist in detailed application.</td>
<td>6.5</td>
</tr>
<tr>
<td>Financial highlights (including earnings per share)</td>
<td>All investment companies are exempt from the earnings per share disclosure requirement. Financial highlights are required to be presented. Unitized investment companies also would include per-share NAV information.</td>
<td>All entities with shares that are or will be traded in a public market are required to provide earnings per share. If all of the shares of an investment fund are classified as financial liabilities, there is no requirement to disclose the earnings per share information. Financial highlights are not required, but investment companies may choose to present them including per-share NAV information.</td>
<td>6.6</td>
</tr>
<tr>
<td>Related party transactions</td>
<td>Amounts and nature of transactions and balances due to or from related parties should be disclosed.</td>
<td>Similar to US GAAP.</td>
<td>6.7</td>
</tr>
<tr>
<td>Segment reporting</td>
<td>Segment reporting is applicable only to public business enterprises.</td>
<td>Segment disclosure is required unless an investment company’s shares or debt instruments are not publicly traded.</td>
<td>6.8</td>
</tr>
</tbody>
</table>
## 1.2 Summary of applicable standards under US GAAP and IFRS

Below is a summary of the applicable US GAAP and IFRS accounting literature discussed or referred to within each respective topic. This list is not intended to be a comprehensive list of all guidance applicable to these topics.

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<thead>
<tr>
<th>Subject</th>
<th>US GAAP</th>
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<tbody>
<tr>
<td>2.1 Accounting standards/industry practice</td>
<td>ASC 946 Financial Services—Investment Companies</td>
<td>Framework for the Preparation and Presentation of Financial Statements; IFRS 1, First-time Adoption of International Financial Reporting Standards; IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors</td>
</tr>
<tr>
<td>2.2 First-time adoption</td>
<td>Not Applicable</td>
<td>IFRS 1R, First-time Adoption of International Financial Reporting Standards</td>
</tr>
<tr>
<td>3.1 Components of financial statements</td>
<td>ASC 946 Financial Services—Investment Companies</td>
<td>IAS 1, Presentation of Financial Statements; IAS 10, Events after the Reporting Period</td>
</tr>
<tr>
<td>3.2 Statement of assets and liabilities</td>
<td>ASC 946 Financial Services—Investment Companies</td>
<td>IAS 1, Presentation of Financial Statements; IAS 32R, Financial Instruments: Presentation</td>
</tr>
<tr>
<td>3.2.1 Equity—classification</td>
<td>ASC 480 Distinguishing Liabilities from Equity</td>
<td>IAS 32R, Financial Instruments: Presentation</td>
</tr>
<tr>
<td>3.2.2 Net assets—measurement</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 825 Financial Instruments; ASC 820 Fair Value Measurements and Disclosures; ASC 470 Debt with Conversion and Other Options</td>
<td>IAS 39, Financial Instruments: Recognition and Measurement</td>
</tr>
<tr>
<td>3.3 Schedule of investments</td>
<td>ASC 946 Financial Services—Investment Companies</td>
<td>IFRS 7 Financial Instruments: Disclosures</td>
</tr>
<tr>
<td>3.4 (3.4.1-3.4.3) Income statement</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 450 Contingencies; ASC 310-20 Nonrefundable Fees and Other Costs</td>
<td>IAS 1, Presentation of Financial Statements; IAS 18, Revenue; IAS 39, Financial Instruments: Recognition and Measurement; IAS 21, The Effects of Changes in Foreign Exchange Rates; IAS 12, Income Taxes</td>
</tr>
<tr>
<td>3.5 Statement of changes in net assets/equity</td>
<td>ASC 946 Financial Services—Investment Companies</td>
<td>IAS 1, Presentation of Financial Statements; IAS 32, Financial Instruments: Presentation</td>
</tr>
<tr>
<td>Subject</td>
<td>US GAAP</td>
<td>IFRS</td>
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</tr>
<tr>
<td>3.6 (3.6.1) Statement of cash flows</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 230 Statement of Cash Flows</td>
<td>IAS 7, Cash Flow Statements</td>
</tr>
<tr>
<td>4.1 Overview of the consolidation model</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 810 Consolidation</td>
<td>IAS 27R, Consolidated and Separate Financial Statements(a); SIC 12, Consolidation-Special-Purpose Entities; IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations</td>
</tr>
<tr>
<td>4.2 Equity method of accounting for investments in common stock/ investment in associates</td>
<td>ASC 323 Investments—Equity Method and Joint Ventures</td>
<td>IAS 28, Investment in Associates; IAS 31, Interests in Joint Ventures</td>
</tr>
<tr>
<td>4.3 Business combinations and noncontrolling interests</td>
<td>ASC 810 Consolidation; ASC 805 Business Combinations</td>
<td>IFRS 3R, Business Combinations(a); IAS 27R, Consolidated and Separate Financial Statements(a)</td>
</tr>
<tr>
<td>5 Financial instruments</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 825 Financial Instruments; ASC 820 Fair Value Measurements and Disclosures; ASC 815 Derivatives and Hedging; ASC 325 Financial Instruments; ASC 275 Risks and Uncertainties</td>
<td>IAS 21, The Effects of Changes in Foreign Exchange Rates</td>
</tr>
<tr>
<td>6.1 Functional currency and translation of financial statements</td>
<td>ASC 830 Foreign Currency Matters</td>
<td>IAS 21, The Effects of Changes in Foreign Exchange Rates</td>
</tr>
<tr>
<td>6.2 Foreign currency transactions</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 830 Foreign Currency Matters</td>
<td>IAS 21, The Effects of Changes in Foreign Exchange Rates</td>
</tr>
<tr>
<td>6.3 Tax uncertainties</td>
<td>ASC 740 Income Taxes</td>
<td>IAS 12, Income Taxes</td>
</tr>
<tr>
<td>6.4 Real estate investments</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 820 Fair Value Measurements and Disclosures</td>
<td>IAS 40, Investment Property</td>
</tr>
<tr>
<td>6.5 Share-based compensation</td>
<td>ASC 718 Compensation-Stock Compensation; ASC 850 Related Party Disclosures</td>
<td>IFRS 2, Share Based Payment; IFRS 8, Operating Segments (b)</td>
</tr>
<tr>
<td>6.6 Financial highlights (including earnings per share)</td>
<td>ASC 946 Financial Services—Investment Companies; ASC 260 Earnings per Share</td>
<td>IAS 33, Earnings per Share</td>
</tr>
<tr>
<td>6.7 Related party transactions</td>
<td>ASC 850 Related Party Disclosures</td>
<td>IAS 24, Related-Party Disclosures</td>
</tr>
<tr>
<td>6.8 Segment reporting</td>
<td>ASC 280 Segments Reporting</td>
<td>IFRS 8, Operating Segments (b)</td>
</tr>
</tbody>
</table>

(a) Applicable for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after July 1, 2009 (early adoption is permitted). Note: IFRS 3R and IAS 27R should be applied at the same time.

(b) Applicable for annual periods beginning on or after January 1, 2009 (early adoption is permitted).

(c) Applicable for annual periods beginning on or after January 1, 2013 (early adoption is permitted; however, the standard has not yet been endorsed by the European Union).
1.3 Practical considerations for the implementation of IFRS

This publication focuses primarily on the accounting-related differences between US GAAP and IFRS for nonregistered investment companies. However, the switch to IFRS is not simply an accounting exercise that can be tackled at the relevant financial year-end.

The list of considerations when converting to IFRS can include design and marketing of the fund, reviewing valuation policies, determining the impact of IFRS on the net asset value and contractual arrangements with investors, assessing the impact of consolidation, and ensuring that all the information required for disclosure purposes is provided. In some cases, opening balance sheets may need to be restated. Adopting IFRS may also affect important performance metrics, requiring thoughtful communications plans for management and investors. Many of these effects will require attention; others can be addressed at the discretion of the company. In both cases, companies that identify these effects early will be in a better position to take appropriate action. No company will want to embrace every available change in connection with adopting IFRS, but insightful companies will want to understand their options so that they are aware of the possible changes, which options are most appealing, and how best to pursue them.

When negotiating contracts, it is important to consider both the current US GAAP implications and the IFRS implications that may arise a few years down the road. Consolidating additional entities under IFRS is a prime example of how other contracts may need to be modified to maintain financial reporting objectives under IFRS. Existing debt covenants may no longer be relevant or appropriate if additional entities are scoped under the consolidation umbrella. Renegotiation of the covenants may be needed and may take longer than usual depending on the availability and quality of financial information from the newly consolidated entities. To ensure balanced negotiations, companies should begin discussions with lenders and borrowers early.

An effective strategy for communicating with key stakeholders generates necessary familiarity with and acceptance of the conversion. Delivering key messages in an appropriate style is important to gain buy-in from both internal and external stakeholders for upcoming changes. Moreover, these actions cannot be taken in a piecemeal manner because, to be sustainable, they must be embedded into the underlying decision-making processes. The bottom line is that IFRS must become as pervasive throughout operations as US GAAP is today.

The complexity and effort required of an investment company to convert to IFRS will vary depending on the size and complexity of the company. Regardless of the length of the conversion process, it is manageable if properly planned with sufficient lead time. Investment companies have time on their side until the SEC formally mandates adoption of IFRS (and this decision flows down to nonregistered companies). Companies should take advantage of this time to become more knowledgeable/educated about IFRS, participate in the standard setting and industry debates on IFRS, analyze what IFRS would mean for their business, and take the plunge to convert ahead of their industry peers.
In June 2010, the IASB and the FASB announced their intention to prioritize the major convergence projects to permit a sharper focus on issues and projects that they believe will bring about significant improvement and convergence between IFRS and US GAAP. The major convergence projects are in the areas of fair valuation and disclosure, consolidation, financial statement presentation, revenue recognition, and leases. With the modified strategy, the boards have been focused on execution of the new work plan, with mid-2011 being targeted for the completion of a number of significant projects, including consolidation and financial instruments. More recently, in their November updated progress report, the boards retained the target completion date of June 2011 or earlier for the convergence projects they consider most urgent (i.e., financial instruments, revenue recognition, leases, statement of comprehensive income, and fair value measurement) and changed the timeline on lower-priority projects.

The boards’ current projects will affect the financial reporting of most companies, so you are already in the game whether or not you are actively participating. If you have a point of view, the boards are eager to get your feedback. Whether you choose to comment on an entire project or only certain key components, your opinion matters. Understanding the projects and strategizing your approach for evaluating and responding is more important than ever.
Executive takeaways

• IFRS is different from US GAAP in certain areas because it relies more on broad accounting principles, rather than US GAAP's bright-line rules adopted through the years. One of the primary differences in the application of US GAAP is the investment company-specific provisions versus the general (i.e., non-industry specific) accounting principles under IFRS.

• The areas that typically will be affected the most include valuation, consolidation, equity presentation, and risk disclosure.

• IFRS has one standard that addresses the requirements of adopting IFRS for the first time including required reconciliations from previous GAAP to IFRS, the requirement to present an opening balance sheet, as well as the optional exemptions and mandatory exceptions from full retrospective application. Investment companies should consider these requirements prior to the date of transition to IFRS in order to begin collecting relevant data and to appropriately apply the exemptions and exceptions available.
2.1 Accounting standards/industry practice

**US GAAP**
The objective of financial statements, including financial highlights, for investment companies is to present information about their financial position including net assets, results of operations, changes in net assets and financial highlights resulting from investment activities and, if applicable, from capital transactions (ASC 946-205-45) so that users of financial statements can make informed decisions.

In June 2009, the FASB issued *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*, which was codified in ASC 105-10. It establishes the FASB Accounting Standards Codification as the single source of authoritative accounting principles to be applied in the preparation of financial statements in conformity with US GAAP. The industry-specific guidance noted in AAG-Inv was codified primarily into ASC 946 Financial Services—Investment Companies.

**IFRS**
The objective of general-purpose financial statements for investment companies is similar to that under US GAAP, which is to provide information about a company’s financial position, financial performance and cash flows so that users of the financial statements can make informed decisions. Financial statements also show the results of management’s stewardship of the resources entrusted to it (IAS 1).

IFRS, as a set of principle-based accounting standards, does not provide accounting standards or guidance specific to investment companies. Accordingly, investment companies follow the same financial reporting standards as general entities.

IFRS embodies not only the standards themselves but also the International Accounting Standards (IAS) and interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or its former Standing Interpretations Committee (SIC) (IAS 1R.7). Investment companies are required to follow all such standards and interpretations in order to be in compliance with IFRS; an explicit and unreserved statement of such compliance also should be made in the notes to the financial statements (IAS 1.16).

IFRS (IAS 8) articulates a hierarchy of guidance that management would follow in the absence of a standard that specifically applies to a transaction. In such cases, management uses its judgment in developing and applying an accounting policy. In making that judgment, management considers first the requirement of other IFRS standards dealing with similar issues, and then the concepts in the IASB’s framework. It also may consider the accounting standards of other standard-setting bodies, but there is no automatic default to US GAAP in the absence of specific guidance under IFRS.

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**Highlights**

Though the common objective of US GAAP and IFRS is to present high-quality financial information to users to enable them to make informed decisions, the two accounting frameworks employ different means to achieve that objective. While US GAAP has industry-specific standards (i.e., ASC 946 Financial Services—Investment Companies), which contain authoritative accounting and reporting guidance specific to investment companies, no such industry-specific guidance exists under IFRS. Accordingly, investment companies using IFRS have to apply the accounting framework that is applicable to all entities.

In the absence of IFRS guidance that specifically applies to a transaction, IFRS requires that the investment company follow a hierarchy of steps to account for the transaction.

As a result, the investment company cannot default to US GAAP for applicable guidance.
2.2 First-time adoption of IFRS

**US GAAP**

US GAAP does not provide specific guidance for first-time adoption of its accounting framework, similar to that of IFRS 1, described below. However, first-time adoption of US GAAP does require full retrospective application unless some standards specify a different transitional treatment for first-time application. US GAAP has no requirement to present reconciliations of equity or income statement upon first-time adoption; however, the first-time adopter also needs to consider the requirements of the exchange where the company is listed and the legal or state jurisdiction where the company is based.

**IFRS**

IFRS 1, *First-time Adoption of International Financial Reporting Standards*, provides specific guidance on applying IFRS for the first time. First-time adoption of IFRS as a primary accounting basis generally requires full retrospective application of the standards, effective at the reporting date for the entity's first IFRS financial statements. However, IFRS 1 establishes optional exceptions (e.g., business combinations, employee benefits) and mandatory exceptions (e.g., hedge accounting, estimates) from retrospective application.

An entity's first IFRS financial statements must present reconciliations of profit or loss in respect of the last period reported under previous GAAP, of equity at the end of the last period reported under previous GAAP and of equity at the start of the earliest period presented in the financial statements. These reconciliations should be presented in sufficient detail to enable users to understand the material adjustments made in the conversion to IFRS.

If the entity presented a statement of cash flows under its previous GAAP, it should explain the material adjustments required for it to comply with IFRS.

For annual periods beginning on or after January 1, 2009, a first-time adopter is required to disclose its opening balance sheet on the date of transition to IFRS.

**Highlights**

When converting to IFRS, investment companies should ensure they plan for the conversion with sufficient lead time to manage both the financial and operating changes of reporting under IFRS. The conversion process will be smoother if properly planned.

Although both US GAAP and IFRS require full retrospective adoption for the periods presented, IFRS requires reconciliations of the income statement and equity from previous GAAP to IFRS for specified periods, an opening balance sheet and the material adjustments to the statement of cash flows (only if previously prepared under US GAAP). IFRS also introduces a number of optional exemptions and mandatory exceptions to full retrospective application upon first-time adoption. The guidance contained within IFRS 1 will be new to US GAAP reporters as there are no similar requirements upon first time adoption of US GAAP.

Please also see the PwC publication, Preparing your first IFRS financial statements, for additional guidance.
Executive takeaways

At a high level, the financial statement models are generally consistent between US GAAP and IFRS. However, there are significant exceptions.

- While the primary statement requirements between US GAAP and IFRS are similar, US GAAP does provide a possible exception to presenting the statement of cash flows. This exception does not exist under IFRS, where all entities are required to present a statement of cash flows.

- The schedule of investments is required to be presented as a primary statement under US GAAP with investments constituting more than 5% of net assets individually disclosed. IFRS requires disclosure in the notes to the financial statements that allow users of the statements to understand the nature and significance of the investments held by the company. Consequently, the schedule of investments may be used to provide a meaningful analysis of the portfolio but is not required.

- More instruments may be classified as liabilities under IFRS than under US GAAP. As a result, investment companies may have their puttable shares classified as liabilities and hence minimal or no equity and therefore not required to present a statement of changes in equity. In such cases, it is best practice to provide a statement of changes in net assets attributable to holders of redeemable shares. Additionally, if the net asset value for subscriptions and redemptions is different from the net asset value calculated using bid/ask prices (for example, because it is based on the last traded price), an adjustment to net asset value is recorded so that the net asset value attributable to the holders of redeemable shares represents the redemption amount.

- Because IFRS does not have industry-specific guidance, it allows more flexibility in the presentation of line items in the primary financial statements as compared with the more prescriptive requirements under US GAAP. However, in practice, the presentation may be similar due to the significance of certain activities of the investment company.

- IFRS requires comparative information, which will result in additional work upon first-time adoption of IFRS because companies will need to present two years of financial information on an IFRS basis rather than only one year, which is required under US GAAP.

- In certain circumstances IFRS requires earnings per share disclosures, but it does not require the more extensive US GAAP “financial highlights.”

- FASB-IFRS project update—financial statement presentation: The IASB and the FASB initiated a joint project on financial statement presentation to address users’ concerns that existing requirements permit too many alternative types of presentations and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to understand fully the relationship between an entity’s financial statements and its financial results. The proposals in this project would establish common structures for the statements of financial position, comprehensive income, and cash flows in the form of required sections, categories, or subcategory and related subtotals. This project recently was deferred until after June 2011.
## 3.1 Components of financial statements

**US GAAP** Comparative financial statements are not required. ASC 946-205-45 specifies the requirements for financial statements, which should include:

1. A statement of assets and liabilities with a schedule of investments or a statement of net assets, which includes a schedule of investments therein as of the close of the latest period. At a minimum, a condensed schedule of investments should be provided for each statement of assets and liabilities.
   (balance sheet)
2. A statement of operations (income statement)
3. A statement of changes in net assets
4. A statement of cash flows (unless the exemption is met)
5. Notes to the financial statements, including the summary of accounting policies
6. Financial highlights, either presented as a separate schedule or disclosed in the notes to the financial statements

The date of authorization to issue financial statements and the name and title of the person who authorizes them for issue should be provided if required by local laws and regulations but is not a requirement under US GAAP.

**IFRS** Comparative financial statements are required (IAS 1R.36) and include (IAS 1R.10):

1. A balance sheet
2. An income statement (or a statement of comprehensive income, as applicable)
3. A statement of changes in equity
4. A cash flow statement
5. Notes to financial statements, comprising a summary of significant accounting policies and other explanatory notes

An investment company, whose redeemable shares are classified as a financial liability and which does not have any other transaction classified under equity, is not required to present a statement of changes in equity because it does not have equity. Although, for those shares classified as liabilities, a statement of changes in net assets attributable to holders of redeemable shares provides relevant and useful information and it is therefore best practice to provide this statement.

The date of authorization to issue financial statements and the name of the person who authorizes them for issue are required under IFRS (IAS 10.17).

Investment companies that have comprehensive income may either present a single statement of comprehensive income or two statements—an income statement and a statement of comprehensive income. References to the income statement in subsequent sections of this publication should be read as reference to the statement of comprehensive income if the investment company has comprehensive income.
3.2 Statement of assets and liabilities

US GAAP
For an investment company, a balance sheet is called a statement of assets and liabilities when there is a separate schedule of investments or a statement of net assets, which includes a schedule of investments therein (ASC 946-205-45).

The financial statements format is well-developed, and most investment companies follow the format as an industry practice. Major categories of assets and liabilities generally reported on the face of the balance sheet include:

1) Investment in securities
2) Cash
3) Receivables
4) Other assets
5) Accounts payable
6) Call or put options written, futures contracts sold, and securities sold short
7) Accrued liabilities
8) Notes payable and other debt
9) Other liabilities
10) Net assets

Additional line items may be presented, as appropriate.

Under US GAAP, the statement of assets and liabilities is nonclassified because all assets and liabilities of an investment company are presumed current. Furthermore, the general practice is to present investments as the first asset because of their relative importance to total assets.
**IFRS**

IFRS does not prescribe a specific format for an investment company’s balance sheet. At a minimum, the face of the balance sheet shall include line items that present the following amounts (note: only those minimum line items that might apply to an investment company are identified—please see IAS 1R.54 for the complete list):

1. Investment property
2. Financial assets
3. Trade and other receivables
4. Cash and cash equivalents
5. Trade and other payables
6. Financial liabilities
8. Issued capital and other components of shareholders’ equity (unless shares are classified as financial liabilities)

A company may present additional line items, headings, and subtotals on the face of the statement of financial position when the presentation is relevant to an understanding of its financial position (IAS 1R.55).

Both current and noncurrent assets and current and noncurrent liabilities should be reported on the face of the balance sheet except when the presentation is based on a liquidity, in which assets and liabilities are presented in the order of liquidity and provides information that is reliable and more relevant (IAS 1R.60). Whichever method of presentation is adopted, assets and liabilities with maturities greater than 12 months should be identified in the notes.

A typical investment company whose shares are redeemable at the discretion of its holders or in a limited life entity where the shares are redeemable at liquidation may have no shareholders’ equity at all or only a nominal amount representing its voting, nonparticipating shares (please see “Equity—Classification” for detailed discussion on classification of these shares and the impact of the new IAS 32 amendment on these shares). Although there is no specific format, illustrative examples (IE) 32 and IE 33 of IAS 32, *Financial Instruments: Presentation* provide models of presentation for balance sheets and income statements for entities with no equity or some equity but explicitly state that other formats are possible. PwC’s publication, *International Financial Reporting Standards: Illustrative Financial Statements—Investment Fund*, also provides an example for reference.

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**Highlights**

An investment company presents a nonclassified statement of assets and liabilities when the financial statements are prepared under US GAAP; financial statements prepared under IFRS may be either classified or nonclassified. When preparing financial statements under IFRS, management should assess which format will provide more relevant and reliable information to the users of the financial statements. Due to the nature of an investment company, where typically all or substantially all of its assets and liabilities are current, the liquidity presentation may be more relevant and is generally followed in practice under IFRS (IAS 1R.60).

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**Similarities & differences: A comparison of US GAAP and IFRS for investment companies**
3.2.1 Equity—classification

**US GAAP**

All financial instruments, including equity, are first evaluated under ASC 480 *Distinguishing Liabilities from Equity* for potential liability classification. ASC 480 establishes the framework for evaluating whether a financial instrument, such as the issued equity, should be classified as a liability.

ASC 480 defines a mandatorily redeemable financial instrument as any financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

ASC 480-10-65-1 defers the effective date of ASC 480 for mandatorily redeemable financial instruments issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants. It requires that only financial instruments mandatorily redeemable on fixed dates for amounts that are either fixed or are determined by reference to an interest rate index, currency index, or another external index, be classified as a liability. For all other financial instruments that are mandatorily redeemable, the classification, measurement, and disclosure provisions of ASC 480 are deferred indefinitely pending further action by the FASB.

Shares or interests of an investment company are generally subject to redemption at the option of the holders, but because the amounts to be paid are not fixed or determinable, such shares would meet the deferral criteria noted above; therefore, such interests do not meet the scope under ASC 480. As a result, these shares or interests would be classified as equity.

However, shares or interests to be redeemed due to an irrevocable redemption request made prior to a reporting period end for a redemption effective immediately after period end and to be paid after period end either for a fixed amount or at an amount determined based on the NAV at period end are considered financial liabilities under ASC 480 and classified as redemptions payable.

**Highlights**

As a result of the differences in the definition of a financial liability, financial instruments may be classified differently under IFRS than under US GAAP (i.e., more instruments would be classified as liabilities under IFRS).

Classification of shares or interests as financial liabilities may result in an investment company having no equity or minimal equity (typically in the form of voting nonparticipating shares, in the case of an offshore fund). The biggest impact from this change in classification for investment companies is that changes in the fair value for those liabilities are recorded directly in the income statement.

Under US GAAP, the redeemable equity generally meets the criterion under ASC 480 to be classified as equity—except when the fund has redemptions payable. Redemptions payable are generally classified as liability because the payment dates and amounts are fixed or determinable.

The amendment to IAS 32 was limited in scope, and a number of investment companies applying IFRS continued to have their shares or interests classified as liabilities. For example, an investment company may have more than one class of issued shares; however, only the most subordinate class may qualify for equity classification if all other criteria are met. Another criterion that is often problematic for an investment company is that all features within that class of instruments must be identical (e.g., identical voting rights, currency, administrative fees).
The definition of a liability under IFRS is different from that under US GAAP. The definition of a financial liability includes a contractual obligation to deliver cash or another financial asset to another entity (IAS 32.11). A financial instrument that gives the holder the right to put it back to the issuer for cash or another financial asset (a “puttable instrument”) is a financial liability, regardless of whether the amount of cash or another financial asset is determined based on an index or other item that has the potential to increase or decrease. IAS 32 specifically cites, as examples of puttable instruments, interests issued by open-ended mutual funds, unit trusts, partnerships, etc. (IAS 32.18), that would be classified as liabilities.

However, in February 2008, the IASB issued an amendment to IAS 32 and IAS 1—*Puttable financial instruments and obligations arising on liquidation* (IAS 32 amendment), which is effective for annual periods beginning on or after January 1, 2009 (with earlier adoption permitted). The amendment provides an exception to the definition of a financial liability to require certain puttable instruments and instruments with obligations that arise upon liquidation to be classified as equity if strict criteria are met. The scope of the amendment is intended to be narrow, and unless all criteria are met, the instrument would continue to be classified as a liability. The specific criteria are as follows:

1) The instrument is the most subordinate class of instruments

2) All financial instruments in the class of instruments that is subordinate to all other classes have identical features (e.g., the formula to calculate the redemption price is the same for all instruments in that class)

3) The holder is entitled to a pro rata share of net assets (i.e., the assets remaining after deducting all other claims on its assets)

4) The total expected cash flows to the holder are substantially based on profit and loss, change in net assets, or change in the fair value of the net assets*

5) No other instrument is tied to the same measures as in #4 above and has the effect of fixing or restricting the residual return to the puttable instrument holder

6) The instrument has no other liability feature apart from the obligation to redeem the instrument*

*A criterion only for puttable instruments

Given the restrictive criteria above, redeemable shares of investment companies will rarely qualify for equity classification under the IAS 32 amendment.

Apart from redeemable shares that may be classified as liabilities, an investment company may have activity in equity (e.g., shares meeting the definition of equity, or available-for-sale securities, in which changes in fair value would be recorded through other comprehensive income). In such cases, the investment company is required to present a statement of changes in equity.

Changes in the liability, which includes related dividends or distribution of income to holders of redeemable shares and subsequent measurement of the liability, should be recognized in the income statement. Refer to the “Net assets—Measurement” section below. Subscriptions and redemptions should be recorded directly as a change in the liability and not flow through the income statement.
### 3.2.2 Net assets—measurement

#### US GAAP
Net assets represent the residual interests in the assets of an investment company, which generally corresponds to the carrying amount of the net asset at initial and subsequent measurement. Because US GAAP allows more discretion in the fair valuation of investments (i.e., the price within the bid-ask spread that is most representative of fair value), most investment companies’ offering memoranda prescribe one of the bases allowed under US GAAP (such as the bid price or the last price). Accordingly, there is usually no difference in net asset value for financial statement purposes and net assets attributable to holders of redeemable shares for subscription or redemption purposes.

#### IFRS
As discussed in section 3.2.1 above, net assets attributable to holders of redeemable shares will generally be classified as a liability on the balance sheet, carried at the redemption amount that would be payable at the balance sheet date if the holders exercised the right to put the shares back to the investment company. Changes in this redemption amount each period should be recorded through the income statement.

If the net asset value for subscriptions and redemptions is different from the net asset value calculated using bid/ask prices (for example, because NAV as prescribed by the offering memorandum is based on the last traded price), an adjustment to net asset value is recorded so that the NAV attributable to the holders of redeemable shares represents the redemption amount.

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**Highlights**

Because US GAAP (ASC 820) is less prescriptive than IFRS when it comes to the use of the bid or asking price, the differences, if any, between the financial statements NAV and the NAV attributable to holders of redeemable shares are more likely to exist in financial statements prepared under IFRS than under US GAAP.
3.3 Schedule of investments

**US GAAP**

At a minimum, a condensed schedule of investments is required (ASC 946-205-45). An investment company may alternatively present a full schedule of investments that details all its individual positions and investments.

The format and minimum disclosure requirements of the condensed schedule of investments and the schedule of investments are specified in ASC 946. Investment partnerships that are exempt from SEC registration under the Investment Company Act of 1940 (the 1940 Act) should report the following (ASC 946-210-50-6):

- Categorize the investments by (1) type; (2) country or geographic region; and (3) industry.
- Disclose the name, shares, or principal amount, value, and type for each investment constituting more than 5% of net assets and for investments from the same issuer if their aggregate is more than 5% of net assets.
- For derivatives whose fair value exceeds 5% of net assets, the range of expiration dates and fair value of a particular underlying asset should be disclosed.
- For investment in another investment company whose fair value exceeds 5% of net assets, the investment objective and restrictions on redemptions should be disclosed.

For nonregistered investment companies that are not “investment partnerships,” the above criteria are measured at a 1% level rather than a 5% level. At least the 50 largest investments must be identified even if certain investments do not exceed 1% of net assets (ASC 946-210-50-1).

Furthermore, if a reporting investment company’s proportionate share of any security owned by an investee investment company exceeds 5% of the reporting investment company’s net assets, such security should be disclosed. This is known as the “look-through” provision (ASC 946-210-50-9).

**IFRS**

A condensed schedule of investments is not required to be presented under IFRS. However, IFRS 7 requires an entity to disclose information that enables users of its financial statements to evaluate the significance of financial instruments for its financial position and performance (IFRS 7.7). In particular, IFRS 7 requires quantitative disclosures about concentrations of risk (IFRS 7.34c). As such, an analysis of the investments similar to the one provided through the schedule of investments may be used as part of the IFRS 7 disclosures.

**Highlights**

IFRS does not require a schedule of investments to be presented. However, a similar analysis of the investments provided through the schedule of investments is generally provided as part of the IFRS 7 disclosures.
3.4 Income statement

**US GAAP** An income statement is usually called a statement of operations. The objective of the statement of operations is to present the increase or decrease in net assets resulting from all of an investment company’s investment activities. This includes, but is not limited to, reporting investment income from dividends, interest, and other income less expenses; the amounts of realized gains or losses from investment and foreign currency transactions; and changes in unrealized appreciation or depreciation of investments and foreign currency denominated assets and liabilities for the period.

The format, as illustrated below, helps the user understand the contribution of each aspect of investment activity to the company’s overall operations (ASC 946-225-45):

1) Investment income  
   a. Dividend income  
   b. Interest income  
   c. Other income  

2) Expenses (the following expenses are commonly reported separately)  
   a. Investment advisory fees  
   b. Administration fees  
   c. Shareholder service costs  
   d. Distribution expenses  
   e. Custodial fees  
   f. Federal and state income taxes  
   g. Other taxes  
   h. Interest  
   i. Dividends on securities sold short  
   j. Professional fees  
   k. Directors’ or trustees’ fees  
   l. Registration fees and expenses  

3) Net investment income (total of No. 1 and 2 above)  

4) Net realized gain or loss from investments and net realized gains or losses from foreign currency transactions (Please see “Foreign currency transactions,” section 7.2 of this publication.)  

5) Net increase (decrease) in unrealized appreciation or depreciation on investments and net unrealized gains (losses) on foreign exchange (Please see “Realized and Unrealized Gains (Losses) on Investments—Presentation,” section 3.4.2 of this publication.)  

6) Net realized and unrealized gain or loss from investments and foreign currency (total of No. 4 and 5 above)  

7) Net increase or decrease in net assets/partners’ capital from operations (net income)
**US GAAP** (continued) Other common and major specific format or presentation requirements included under ASC 946 and applicable to nonregistered investment companies are:

1) Incentive allocation: If organized as a limited partnership, an investment company’s incentive allocation (i.e., an allocation from limited partners to the general partner) should be presented in the statement of changes in partners’ capital, or as an expense item in the statement of operations as described in the partnership agreement.

2) Fees and expenses waived or reimbursed: Fees and expenses waived and reimbursed, both voluntarily and involuntarily, should be disclosed on the face of the income statement as a reduction of total expenses (ASC 946-20-50-7).

If there is noncontrolling interest, ASC 810 Consolidation requires the noncontrolling interest to be reported as part of equity in the consolidated financial statements.

**IFRS**

IFRS does not prescribe a specific format. Similar to the balance sheet, IAS 1R.82 requires that certain minimum line items be presented on the face of the income statement. Expenses should be classified according to nature or function (IAS 1R.99). If the classification by function is used, additional information on the nature of expenses should be disclosed.

Carried interest is a common feature of private investment vehicles, many of which are structured as limited partnerships. It is the mechanism by which the fund’s manager and its principals and staff earn a share of the fund’s profits. A service is rendered by the general partner, which gives rise to a financial liability (with a corresponding expense) as soon as the service is rendered as the obligation to pay meets the definition of a financial liability in IAS 39 (obligation to deliver cash arising under a contractual arrangement) and such obligation being recorded in income statement. Thus, unlike US GAAP where a carried interest may be presented as an allocation, a carried interest under IFRS will always be reflected as an expense (when the appropriate thresholds have been met).

The portion of the profit and loss attributable to the minority interest is disclosed separately in the income statement (IAS 1R.83). The minority portion of net income is presented after the “net income” line as an allocation of “net income.”

**Highlights**

US GAAP identifies a number of income statement line items, some of which are required while others are generally disclosed based on their individual significance to the income statement (e.g., if a line item represents greater than 5% of total net income). IFRS also requires that certain minimum line items be disclosed on the face of the income statement; however, that list is not as exhaustive as the requirements under US GAAP. With regard to presentation, most investment companies present their income statement by nature of expense under IFRS.

Unlike US GAAP, where a carried interest may be presented as an allocation, a carried interest under IFRS will be reflected as an expense (when the appropriate thresholds have been met).

Similar to US GAAP, an investment company may present additional line items, headings, and subtotals on the face of the income statement when it is relevant to an understanding of its financial performance (IAS 1R.85).

In addition, in an instance in which the entity has little or no equity, IAS 32.IE 32, 33 provides examples of income statements for such entities. PwC’s publication, *IFRS Illustrative Financial Statements—Investment Funds*, also provides an example for reference.
### 3.4.1 Interest and dividend income—recognition

**US GAAP**

Interest income and expense should be accrued and recognized using the effective interest method (i.e., discounts and premiums, if any, should be amortized) (ASC 946-320-35-20). Dividends should be accrued on the ex-dividend date (ASC 946-320-35-5). Generally, the effective interest rate used to calculate amortization under the effective interest method discounts contractual cash flows through the contractual life of the instrument with exceptions for certain types of instruments (e.g., for puttable instruments, the first put date is used instead of the contractual life of the instrument).

ASC 310-20 *Nonrefundable Fees and Other Costs* notes that the objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable. That is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount.

An investment company should consider the collectability of interest in making accruals. In accordance with the guidance provided by ASC 450 Contingencies, accrued interest should be written off when it becomes probable that the interest will not be collected and the amount of uncollectible interest can be reasonably estimated.

**IFRS**

Interest should be accrued and recognized using the effective interest method (IAS 18.30) from the date of purchase (IAS 18.32), and dividends should be recognized when the right to receive payment is established (IAS 18.30), typically the ex-dividend date. As such, the discount and premium of fixed-income securities should be included in the calculation of interest income under the effective interest method.

The effective interest method is based on the estimated future cash flows through the expected life of the instrument without considering future credit losses (IAS 39.9). However, in some cases, investments are acquired at a deep discount, which reflects incurred credit losses, and such incurred credit losses should be reflected in the estimated cash flows (IAS 39.AG5). If the investment company subsequently revises its estimates of future cash flow, it shall adjust the carrying amount of the financial asset or financial liability (or group of financial instruments) to reflect actual and revised estimated cash flows using the original effective interest rate and record this adjustment through the income statement (IAS 39.AG8).

**Highlights**

US GAAP and IFRS both require application of the effective interest method for recognizing interest income and expense. However, differences may arise in the detailed application of the effective interest rate method.

IFRS requires separate presentation of interest income and foreign currency exchange gains and loss except when the financial assets and liabilities are carried at fair value through profit or loss. For example, exchange differences arising on translating an available-for-sale debt security as well as the current period amortization on the security would need to be presented separately in the income statement.
3.4.2 Realized and unrealized gains (losses) on investments—presentation

**US GAAP**
Realized gains or losses and changes in unrealized appreciation or depreciation on investments should be disclosed separately (ASC 946-225-45-6) in the statement of operations.

US GAAP presents two alternatives for disclosing realized and unrealized foreign currency gains or losses: either as separate line items or combined with the realized or unrealized gain loss line item. Investment companies generally do not disclose foreign currency gains or losses arising from investments separately, and such foreign currency gains or losses are generally combined with the realized or unrealized gains or losses line item.

**IFRS**
Although not a minimum required item to be presented under IAS 1R, net gains or losses on investments are typically presented on the face of the income statement, given their importance to an investment company’s financial performance. There is no requirement to separate realized and unrealized gains or losses.

As noted above in section 3.4.1, because interest income and foreign exchange gains/loss do not need to be disclosed separately for financial instruments at fair value through profit or loss, they may be included in the gains or losses on investments.

**Highlights**
US GAAP requires separate disclosure of realized gains and losses and changes in unrealized appreciation or depreciation. When applying IFRS, the realized gains and losses and changes in unrealized appreciation or depreciation may be combined in a single line item in the income statement. Although not required under IFRS, realized gains and losses and changes in unrealized appreciation or depreciation are generally disclosed separately in the notes.
### 3.4.3 Withholding taxes—presentation

<table>
<thead>
<tr>
<th><strong>US GAAP</strong></th>
<th>Withholding taxes should be deducted from the relevant income item (e.g., dividends) and disclosed parenthetically or shown as a separate contra item in the income section (ASC 946-225-45-3).</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>IFRS</strong></td>
<td>Income should be included gross in the income statement. The withholding taxes should be presented as a separate component of income tax for the period.</td>
</tr>
</tbody>
</table>

**Highlights**
Under IFRS, presentation of withholding tax should be presented gross; however, this would not have any impact on net profit or loss for the period as compared with US GAAP, under which the withholding taxes are netted with the relevant income item. Refer to section “Tax uncertainties” in this document for possible measurement differences related to income taxes.
3.5 Statement of changes in net assets/equity

**US GAAP**

A statement of changes in net assets summarizes results from operations, net equalization credits or debits, dividends or distributions to shareholders, capital share transactions, and capital contributions (ASC 946-205-45-3).

In addition to beginning and ending net assets, ASC 946 specifies the items to present as the increase and decrease in net assets (ASC 946-205-45-3):

1) Net change in net assets resulting from operations—Net investment income or loss, net realized gains or losses from investments and foreign currency transactions, and changes in unrealized appreciation or depreciation on investments and foreign exchange as shown in the statement of operations should be presented separately to arrive at the net change in net assets resulting from operations

2) Net equalization debits or credits

3) Distributions to shareholders

4) Capital share transactions (issuance, redemption, and repurchase) for each class of shares or series, which can be presented either in the statement or in the notes.

5) Capital contributions

For investment partnerships, the statement of changes in net assets may be combined with the statement of changes in partners’ capital (ASC 946-205-45-5).

**IFRS**

IFRS does not prescribe a specific format. The general presentation and disclosure requirements are detailed in IAS 1R.106 through 1R.110.

For an investment company with no equity (i.e., all the shares are classified as liability under IAS 32 and the investment company does not have any other equity reserves), the statement of changes in equity is not required. PwC’s publication *IFRS Illustrative Financial Statements—Investment Funds* also provides an example for reference.

**Highlights**

Under IFRS, a statement of changes in equity is required if the investment company has equity. If the investment company does not have equity, while not required, a best practice is to present a statement of changes in net assets attributable to holders of redeemable shares.
3.6 Statement of cash flows

**US GAAP** ASC 230, *Statement of Cash Flows*, is the primary source of cash flow guidance under US GAAP. The statement classifies cash receipts and cash payments as resulting from operating, investing, and financing activities.

The cash flows from operating activities can be presented using either the direct or indirect method, although the latter is more commonly used. If the direct method is used, the net cash provided by and used for operating activities must be reconciled with the net increase or decrease in net assets from operating activities.

Purchases and sales of investments should be included in operating activities. As such, an investment company typically does not have cash flows from investing activities in its statement of cash flows. Also, purchases and sales of investments generally should be presented on a gross basis, rather than on a net basis.

ASC 230 specifies the items to be included for each type of activity.

1) Operating activities that represent the reconciliation of the net cash provided or used for operating activities with the net increase or decrease in net assets from operating activities
   a. Purchases and sales of investments
   b. Changes in noninvestment asset and liability accounts
   c. Noncash income and expense items
   d. Realized and unrealized gains on investments

2) Financing activities
   a. Issuance and redemption of fund shares
   b. Proceeds from and repayment of debt
   c. Dividends and distributions to shareholders
   d. Bank overdrafts

Information about noncash investing and financing activities should be disclosed (ASC 946-230-55-1). If the indirect method is used, interest paid and income taxes paid should be included in a supplemental disclosure (ASC 230-10-50-2).

As noted in ASC 230-10-15-4 a statement of cash flows is required unless all of the following conditions are met:

1) Substantially all investments are liquid
2) Substantially all investments are carried at their fair value
3) There is little or no debt, based on average debt outstanding during the period in relation to average total assets
4) A statement of changes in net assets is presented
**IFRS** Unlike US GAAP, a statement of cash flows is required.

The classification of cash receipts and payments is similar to that under US GAAP, wherein the statement of cash flows should report cash flows classified by operating, investing, and financing activities (IAS 7.10). The cash flows from operating activities can be presented using either the direct or indirect method (IAS 7.18), although IFRS encourages the use of the direct method (IAS 7.19).

Unlike US GAAP, regardless whether the direct and indirect method is used, cash flows from interest and dividends received and paid should be disclosed separately within the statement of cash flows and classified consistently as either operating, investing, or financing activities (IAS 7.31). Cash flows from taxes should also be disclosed separately and classified as operating activities unless specifically identified with financing or investing activities (IAS 7.35).

In accordance with IAS 7.15, purchases and sales of investments for investment companies are generally considered operating activities as they relate to the main revenue-producing activity of the investment company. In addition, purchases and sales may either be shown on a gross basis or on a net basis (IAS 7.22, 24) if the turnover is rapid, the amounts are large, and the maturities are short.

Similar to their treatment under US GAAP, noncash transactions should be excluded from the statement of cash flows and should be disclosed in the notes to the financial statements (IAS 7.43).

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**Highlights**

Under IFRS, a statement of changes in equity is required if the investment company has equity. If the investment company does not have equity, while not required, a best practice is to present a statement of changes in net assets attributable to holders of redeemable shares.
3.6.1 Definition of cash and cash equivalents

**US GAAP**

Cash comprises cash on hand and demand deposits (ASC 230-10-20). Cash equivalents are defined as short-term (usually three months or less), highly liquid investments that are both readily convertible to known amounts of cash and so near maturity that they represent an insignificant risk of changes in value. Generally, only investments with original maturities of three months or less qualify as cash equivalents (ASC 230-10-20).

The definition of cash and cash equivalents under ASC 230-10 does not include bank overdrafts. Furthermore, US GAAP specifically requires that bank overdrafts be included in financing activities. Accordingly, bank overdrafts should not be included as a component of cash and cash equivalents.

The effect of foreign exchange fluctuations on cash balances must be disclosed as a separate line item (ASC 830-230-45-1).

**IFRS**

Similar to US GAAP, cash comprises cash on hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible into known amounts of cash and subject to an insignificant risk of change in value (IAS 7.6). Usually, an investment qualifies as a cash equivalent when it has a maturity of three months or less from the date of acquisition (IAS 7.7).

Unlike US GAAP, bank overdrafts can be included as a component of cash and cash equivalents if they are repayable on demand and form an integral part of a company’s overall cash management (IAS 7.8).

Similar to US GAAP, the effect of exchange rate changes on cash and cash equivalents held or due in foreign currency should be presented on the face of the cash flow statement, although separately from cash flows from operating, investing, or financing activities, in order to reconcile the cash and cash equivalents at the beginning and end of the period (IAS 7.28).

Cash and cash equivalents that are not available for use by the fund should be disclosed. Similar to US GAAP, cash and cash equivalents subject to withdrawal or use restrictions should be disclosed separately from other cash amounts (IAS 7.48).

**Highlights**

The definition of cash and cash equivalents is broadly similar under US GAAP and IFRS. However, there are exceptions, such as bank overdrafts being classified as cash equivalent if they are part of the company’s overall cash management under IFRS. By contrast, under US GAAP bank overdrafts would have to be disclosed separately and not be combined with cash and cash equivalents.
Chapter 4: Consolidation

Executive takeaways

• The IFRS consolidation model is based on control. Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. Control may exist even when the investment company holds less than 50% of the voting power of the underlying investee. There are no specific exceptions from consolidation under IFRS, which is a significant change for companies that utilized the special provisions available for the investment management industry under US GAAP.

• Under IFRS, investment companies are required to consolidate all operating companies that they control. Under US GAAP, investment companies are not required to consolidate other investment companies even when there is control if the master-feeder or fund of fund presentation is considered more appropriate. Additionally, under US GAAP, investment companies are precluded from consolidating noninvestment companies (i.e., operating companies) except when the non-investment company provides services to the investment company.

• Under IFRS, more investments will need to be assessed under the consolidation model. Investment companies will need to apply the business combination standards if they acquire a business that they will control.

• FASB-IFRS project update—consolidation: The IASB’s staff draft of the proposed new consolidation standard changes the definition of control so that the same criteria are applied to all entities to determine control. The new standard proposes additional guidance in the area of principal versus agent, which might need to be considered and when issued will replace IAS 27 and SIC 12.

• FASB-IFRS project update—Proposed changes to the definition of an investment company: The FASB and the IASB intend to issue proposals to introduce a new definition of investment companies. This proposal would require entities that meet the revised definition to measure the investments they control at fair value, with changes in the fair value recognized in net income. The proposed changes will not have any significant effect on US investment companies but will have an impact on investment companies applying IFRS because these entities will be required to measure their investments at fair value rather than doing a line-by-line consolidation.

• FASB-IFRS project update—Retaining investment company specialized accounting upon consolidation: The FASB has tentatively agreed that entities consolidating investment companies will be allowed to retain the “specialized accounting” (i.e., fair value accounting), even if they do not meet the revised definition of an investment company. The IASB has tentatively decided not to retain this specialized accounting, but stay tuned for further developments in this area.

• The boards plan to issue an exposure draft in early 2011 of proposed changes to investment companies, with the final standard expected in late 2011. The IASB plans to issue final guidance on consolidation in early 2011.
4.1 Overview of the consolidation model

**US GAAP**  Investment companies may offer investors the opportunity to invest in a master-feeder structure or a fund of funds. Master-feeder structures involve the allocation of the master portfolio’s income, expenses, and realized and unrealized gains and losses among its feeder funds. Funds of funds are investment companies that invest in other investment companies. Master-feeder structures can be viewed as funds of funds, but usually only with one top-tier (portfolio) fund; a more typical fund of funds structure has more than one top-tier fund. Master-feeder and fund of funds are fund structures used by investment companies, and the accounting and disclosure requirements discussed herein are a combination of the requirements under US GAAP and investment company industry practices.

Because the master-feeder is a capital structure applied by investment companies, a feeder fund within a master/feeder structure will not consolidate its master fund even if it has a majority voting control over the master fund if the master-feeder presentation is considered to be more appropriate than consolidation. The feeder fund should either present the master fund’s financial statements together with its own, or report on the investment in the master fund as indirect portfolio investments (ASC 946-205-45, ASC 946-210-50).

Additionally, if an investment company is a fund of funds, it would not consolidate the underlying investee companies but instead show its investments in the underlying investee companies using the guidance for a required schedule of investments (ASC 946-210-50-8) if the fund of funds presentation is considered to be more appropriate than consolidation.

Thus, if either the master-feeder or fund of fund presentation is considered more appropriate after considering any entity-specific facts, the consolidation of an underlying investee investment company is not required.

Consolidation or use of the equity method of accounting by an investment company of a noninvestment company investee is generally not appropriate. An exception to this general principal occurs if the investment company has an investment in an operating company that provides services to the investment company. Examples would include an investment advisor or transfer agent (ASC 946-810-45-3 and 946-323-45-2).

If the consolidation model is considered appropriate (i.e., if the investment company has an investment in an operating company that provides services to the investment company), an investment company would apply the guidance under ASC 810-10 Consolidation. Entities that meet the definition of “investment companies” set forth in ASC 946 are per ASC 810-10-15 scoped out from application of the accounting guidance relating to consolidation of variable interest entities.
The accounting standards on consolidation are set forth in IAS 27R, *Consolidated and Separate Financial Statements*, which does not provide a scope exception for an investment company.

An investment company should consolidate all its investments in which it has control. Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefit from its activities:

1) Control is presumed to exist if an investment company owns more than half of the voting power of another entity.

2) If an investment company owns half or less than half of voting power, control also exists if it has:
   a. Power over more than half of voting rights by virtue of an agreement with other investors
   b. Power to govern the financial and operating policies of the entity under a statute or an agreement
   c. Power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body
   d. Power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body

The existence of currently exercisable potential rights, such as warrants, call options or convertible instruments, also should be taken into consideration under the consolidation model.

An investment company should consolidate any investments that are deemed to be subsidiaries under IAS 27R. A subsidiary is defined as an entity, including an unincorporated entity such as a partnership that is controlled by another entity (IAS 27R.4). A feeder fund that has the majority of voting shares of the master fund in a master-feeder structure will need to consolidate the master fund. In cases in which the feeder fund owns only nonvoting participating shares of a master fund, other criteria should also be considered, including whether the feeder fund has the power to govern by virtue of laws or an agreement such as a control agreement between the feeder fund and the master fund, and whether the master is in fact an SPE of the feeder fund.

In some circumstances, in which a feeder fund invests in only one particular master fund, the feeder and master funds may represent an integrated entity. In such cases, the integrated entity could be considered the reporting entity and only one set of financial statements may be prepared for the integrated reporting entity (i.e., by combining the master and feeder financial statements).

Furthermore, a fund of funds or a private equity fund may need to consolidate the investments in other investment companies or investee companies for which it has control as defined in IAS 27R. However, if the fund of funds holds only nonvoting shares and the holders of the voting shares have the ability to direct the financial and operating policies of the investment company, then the fund of funds should not consolidate the investee company.
A private equity fund typically purchases investments, including controlling interests, in investee companies with a view to resale. However, unless qualified as a disposal group held for sale at acquisition under the criteria in IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*, the investee companies should be consolidated. The criteria include that the assets should be available for immediate sale and that such a sale should be highly probable, including completion the sale within one year (IFRS 5.7 and 5.8).

**Special-purpose entities**

An investment company should consolidate any special-purpose entity (SPE), defined as an entity created to accomplish a narrow and well-defined objective (SIC 12.1), when the substance of the relationship indicates that the SPE is controlled by the investment company (SIC 12.8).

To establish control, the criteria under IAS 27R discussed above should be considered. Furthermore, the following circumstances may indicate control (SIC 12):

1. The activities of the SPE are being conducted on behalf of an entity according to its business need so that the entity obtains benefits from the SPE’s operations
2. The entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an “autopilot” mechanism, the entity has delegated these decision-making powers
3. The entity has the rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE
4. The entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities

As a result of the provisions under SIC 12, an investment company should consolidate an investee entity, which is qualified as an SPE in which the substance of the relationship indicates control by the investment company. All the factors identified in SIC 12 should be evaluated equally in assessing the substance of control.

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**Highlights**

Consolidation is one of the significant areas in which differences exist between the accounting model under US GAAP and IFRS for investment companies.

US GAAP states that consolidation or use of equity method accounting by an investment company of a noninvestment company investee is appropriate only if that investee is providing services to the investment company. US GAAP is silent on whether an investment company may consolidate another investment company. The practice has evolved whereby an investment company may consolidate another investee investment company if the investment company controls the underlying investee company unless the master-feeder or fund of funds presentation is considered more appropriate. In practice, the consolidation model is rarely applied except in the case of special-purpose vehicles, blocker entities, etc.

IFRS exclusively focuses on the concept of control in determining whether a parent-subsidiary relationship exists. Though the primary guidance for consolidation under IFRS is IAS 27, SIC 12 guidance is also applied to identify and assess whether control exists when the investee fund is considered an SPE.

As a result of these differences, investment companies that have or purchase controlling financial interests in investee companies may see considerable changes in their financial reporting. This could have significant reporting implications for funds such as private equity funds that purchase controlling financial interests in investee companies.

Given that the FASB and the IASB are working on revisions to the consolidation standard, this is an evolving area, and the consolidation guidance is expected to change.
## 4.2 Equity method of accounting for investments in common stock/investment in associates

| US GAAP | ASC 323 *Investments-Equity Method and Joint Ventures*, which is the principal guidance for equity method investments, does not apply to investment companies (ASC 323-10-15-4). ASC 946 states that the use of the equity method of accounting by an investment company of a noninvestment company investee is not appropriate (ASC 946-810-45-2 and 946-323-45-1).

However, investment in an operating company that provides services to the investment company should be accounted for under the equity method where the criteria for equity method of accounting are met (unless the fair value option is elected).

| IFRS | An associate is an entity over which an investment company has significant influence and is neither a subsidiary nor an interest in a joint venture (IAS 28.2). The definition of significant influence is similar to the definition under US GAAP. An investment company is presumed to have significant influence over an entity when it has more than 20% of the voting power of that entity. If it possesses less than 20%, other factors should be taken into consideration to determine the existence of significant influence. IAS 28.7 provides certain examples of such factors.

Investments in associates should be accounted for using the equity method of accounting. However, IAS 28 provides an exception when the investment is held by a venture capital organization, mutual fund, unit trust or similar entity; is designated as a financial instrument at fair value through profit or loss (the fair value option); or is classified as held for trading (IAS 28.1). The same exception applies to joint venture investments held by an investment company as defined by IAS 31. In practice, investment companies have used this exception to carry the investment at fair value through profit or loss.

### Highlights

The equity method of accounting is specifically prohibited under US GAAP for investment companies while it is required under IFRS unless investment companies qualify for the scope exception to use the fair value option or classify the investment as held for trading, which is generally the case in practice. However, in cases where the fair value may not be reliably measured (e.g. investments in emerging markets), the equity method may be applied.
4.3 Business combinations and noncontrolling interests

US GAAP
Accounting for business combinations is not a significant consideration for investment companies under US GAAP. This is because investment companies may generally consolidate only other investment companies or an operating company that provides services to the investment company such as transfer agents. See “Overview of the Consolidation Model” above.

IFRS
Under IFRS, an investment company needs to first assess whether or not it acquires a business. A business is defined as an integrated set of activities and assets that is capable of being conducted and managed for purposes of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants (IFRS 3R. App A—definition of a business). If, as a result of the transaction, an investment company obtains control over a business, IFRS 3R would apply. As defined in the “Overview of the Consolidation Model” section above, control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefit from activities.

At a high level, IFRS 3R requires investment companies to:

• Recognize and measure the identifiable assets acquired and the liabilities assumed at their fair value on their acquisition date with limited exceptions

• Record any noncontrolling interest in the acquiree at:

  a. Its fair value, resulting in the measurement of the goodwill relating to the controlling and noncontrolling interest

  b. The noncontrolling interest’s proportionate share of the acquiree’s identifiable net assets resulting in the measurement of goodwill only for the controlling interest

• Recognize and measure the goodwill acquired in a business combination or a gain from a bargain purchase
Gains or losses may be recognized in the income statement when control is obtained or lost. Any equity interest that is currently held as a result of a previous transaction is remeasured at fair value, and any resulting gain or loss is recognized in the income statement when an acquirer gains control. Any gain or loss on the interest sold and on any retained noncontrolling investment (remeasured at fair value) is recognized in the income statement when an acquirer loses control.

Additional acquisitions of ownership interests after control is obtained and disposals of an ownership interest that do not result in a company losing control are treated as equity transactions.

IFRS 3R and IAS 27R also require disclosure to enable users of the financial statements to evaluate the nature and the financial effects of a business combination and the relationship between the investment company and its subsidiaries.

IFRS 3R is to be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after July 1, 2009 (earlier adoption is permitted). IAS 27R should be adopted at the same time.

**Highlights**

Investment companies would not generally need to assess the impact of the new business combination standards under US GAAP because entities generally are not consolidated by investment companies; however, understanding the accounting under IFRS may become more relevant because of the requirement to consolidate entities that are controlled by the investment company.

Please see the PwC’s publication, A Global Guide to Accounting for Business Combinations and Non-controlling Interests—Application of the US GAAP and IFRS Standards, for additional guidance.
Chapter 5: Financial instruments

Executive takeaways

• US GAAP requires that all securities be reported at fair value with changes recognized in earnings. ASC 825, Financial Instruments, permits an entity to elect the fair value option for certain eligible items. This option permits an investment company applying US GAAP to apply fair value to its own debt with changes recognized in earnings.

• Currently (i.e., prior to the adoption of IFRS 9, which is effective for annual periods beginning on or after January 1, 2013), IAS 39 requires an entity to measure its trading assets and trading liabilities at fair value, with changes recognized in the income statement; it also provides an option to apply the fair value model to other financial assets and liabilities if certain criteria are met. Unlike US GAAP for investment companies, IFRS allows for the classification of investments as available for sale. In such cases, changes in fair value are recognized (net of tax effects) directly in other comprehensive income (OCI) as a component of equity.

• The IASB is dramatically changing the accounting model for financial instruments provided by IAS 39. The IASB has divided its project to replace IAS 39 into three main phases. For Phase 1, the IASB issued IFRS 9, Financial Instruments, in November 2009. IFRS 9 addresses the classification and measurement of financial assets. Similar to IAS 39, IFRS 9 requires financial assets to be measured initially at fair value (i.e., the transaction price or the fair value of the consideration given); however, IFRS 9 requires all financial assets to be measured subsequently at either amortized cost or fair value after considering (a) the business model of the entity for managing the financial asset and (b) the contractual cash flow characteristics of the financial asset.

• In October 2010, the requirements for classifying and measuring financial liabilities were added to IFRS 9. Most of the added requirements were carried forward unchanged from IAS 39. However, the requirements relating to the fair value option for financial liabilities were changed to address the issue of own credit risk in response to constituent feedback that the effect of changes in the credit risk of a liability ought not to impact the profit and loss unless the liability is held for trading. IFRS 9 requires that changes in the liability’s credit risk will be recognized in other comprehensive income and not recycled. This completes the first phase of the IASB’s project to replace IAS 39. As the IASB completes the remaining two phases, it will delete the relevant sections in IAS 39, and new chapters in IFRS 9 will replace the associated requirements of IAS 39.
Executive takeaways (continued)

- IFRS defines fair value for quoted investments in an active market as the bid price of the investment in the case of a long position and offer price in the case of short position. Use of the bid-ask price would be required under IFRS even if the relevant constitutional documents require the net asset value for subscriptions and redemptions from the fund to be based on the last-traded or midprice. However, under US GAAP, ASC 820 does not necessarily require the use of bid or asking prices. Rather, for level 1 inputs, ASC 820 calls for the use of the price within the bid-ask spread most representative of fair value under the circumstances.

- Financial assets and liabilities can be offset under IFRS and US GAAP only if all the required conditions for offsetting are met. Under master netting arrangements, these conditions are generally not met under IFRS because the right of offset becomes enforceable only in the event of default or circumstances outside the normal course of business. Whereas, US GAAP specifically permits offsetting under master netting agreements for derivative contracts even if the reporting entity does intend to offset. As such, investment companies may have to present their assets and liabilities on a gross basis under IFRS rather than on a net basis like US GAAP.

- IFRS requires disclosures around the significance of financial instruments and nature and extent of risks arising from those financial instruments and how the entity manages those risks. The investment company must provide these disclosures through the eyes of management along with additional minimum quantitative disclosures (e.g., a sensitivity analysis). These disclosures are part of the audited footnotes and are much more extensive than those provided in the US GAAP financial statements. Proper planning will be necessary to ensure the information is available to prepare the disclosures.

- FASB-IFRS project update—Fair value: Both the FASB and the IASB have proposed amendments to their fair value standards. The amendments include a consistent definition of fair value, which will eliminate the bid price valuation requirement under IFRS and will result in similar disclosure requirements including the disclosures of measurement uncertainty categorized within level 3 of the fair value hierarchy (such as the current disclosures in IFRS 7). The boards believe that the proposed amendments would achieve the objective of developing common fair value measurement and disclosure requirements between US GAAP and IFRS. There will continue to be differences such as the standards in US GAAP and IFRS that require or permit fair value measurements and the practical expedient, which is available only in US GAAP. The boards are redeliberating based on the feedback received on their respective exposure drafts and planning to issue final guidance in early 2011.

- FASB-IFRS project update—Balance sheet offsetting: The objective is to provide guidance on the criteria that would determine when offsetting within the balance sheet line items is appropriate. To date, the boards have decided to require an entity to offset a recognized financial asset with a financial liability only if the entity has the unconditional right of offset and intends to settle net or intends to settle simultaneously those assets and liabilities. Simultaneous settlement refers to transactions that settle at the same moment. The boards have also decided that an entity cannot offset a recognized financial asset with a financial liability if the entity has a conditional right of offset. The boards also expect to publish an exposure draft in early 2011 and target issuing a final standard by late 2011.
5.1 Initial recognition

**US GAAP**

The established practice in accounting for purchases and sales is to record transactions as of the trade date, the date on which the company agrees to purchase or sell the securities. This ensures that the effects of all securities trades entered into, by or for the account of the investment company to the date of a financial report are included in the report.

Transactions for private placements or other securities purchased and sold outside of conventional channels, such as stock exchanges, should be recorded as of the date the investment company obtained a right to demand the securities purchased and incurred the obligation to pay the price for the securities purchased (ASC 946-320-25-2).

**IFRS**

Investment companies follow the general recognition principle noted in IAS 39, *Financial Instruments: Recognition and Measurement*, which states that a financial asset or a financial liability should be recognized only when an entity becomes a party to the contractual provisions of the instrument, subject to the provisions governing regular-way purchases and sales of financial assets (IAS 39.14).

A regular-way purchase or sale is the acquisition of a financial asset under a contract whose terms require delivery of the asset within the time frame established generally by regulation or convention in the relevant market (IAS 39.9). Examples of regular-way purchases and sales include securities traded on an exchange or an over-the-counter market. Regular-way purchases of financial assets should be recognized using either trade date accounting or settlement date accounting (IAS 39.38). The choice of method is an accounting policy decision and should be disclosed. The method used should be applied consistently for purchases and sales of investments that belong to the same category (IAS 39-AG53). Derivatives that require or permit net settlement do not meet the definition of regular way trades (IAS 39 AG54).

**Highlights**

Under US GAAP, an investment company records all transactions on a trade date basis. IFRS requires that financial instruments be recognized when an entity becomes a party to the contractual provisions of the instrument. If the financial instrument qualifies as a regular-way trade, then the entity is required to make an accounting policy election of accounting for the transaction based on either a trade date or settlement date.

Most investment companies applying IFRS have been recording trades on a trade date basis for regular-way sales and purchases.
### 5.2 De-recognition

**US GAAP**
As discussed in 5.1 above, investment companies are required to account for all transactions on a trade date basis. Therefore, de-recognition of a financial asset is also recorded on a trade date basis.

Upon de-recognition, the difference between the consideration received or paid and the cost should be recognized as realized gains or losses. The cost is determined based on either a specific identification method or an average cost method (ASC 946-320-40-1).

**IFRS**
As discussed in 5.1 above, regular-way sales of financial assets should be recognized using either trade-date accounting or settlement-date accounting (IAS 39.38). The method used should be applied consistently for purchases and sales of investments that belong to the same category (IAS 39-AG53).

A financial asset (or part) should be de-recognized, when (IAS 39.17-19):

1) The cash flows from the financial asset expire

2) The right to the financial asset’s cash flows and substantially all risks and rewards of ownership are transferred

3) An obligation to transfer the asset’s cash flows is assumed, substantially all risks and rewards are transferred, and the following conditions are met:
   a. No obligation to pay cash flows unless equivalent cash flows from the transferred asset are collected
   b. Prohibition from selling or pledging the asset other than as security to the eventual recipient for the obligation to pass through cash flow
   c. Obligation to remit any cash flows without material delay

4) The rights to the cash flows are transferred (or an obligation to transfer the cash flows is assumed) and the additional conditions above in 3) are met. However, substantially all the risks and rewards are neither transferred nor retained, but control of the asset is transferred as follows:
   a. The transferee has the practical ability to sell the asset in its entirety (e.g., the asset is traded in an active market)
   b. The transferee is able to exercise this right unilaterally to an unrelated third party
   c. There are no further restrictions imposed on the transferee’s sale (e.g., no “strings” attached).

A financial liability should be de-recognized when the obligation specified in the contract is discharged or canceled or expired. A financial liability is also considered extinguished if there is a substantial modification in the terms of the instrument (IAS 39.39 and 39.40). Upon de-recognition, the difference between the carrying amount of the financial instruments and the consideration paid should be recognized as gain or loss in the profit and loss (IAS 39.41).

First-in first-out (FIFO) or weighted average costs are the methods generally applied for calculating the cost basis of a portfolio of investments under IFRS.

**Highlights**
Investment companies applying US GAAP generally use the specific identification method when calculating the cost of an investment for the purposes of calculating the realized and unrealized gains. Under IFRS, investment companies use either weighted average cost or FIFO when calculating the cost of an investment, which is consistent with the guidance/principles under IFRS.
5.3 Financial assets—classification

**US GAAP**  
Investment companies are required to report their securities in financial statements at fair value (ASC 946-10-15-2). The term “securities,” as defined by industry practice, is interpreted broadly to cover all of the investment company’s investments.

**IFRS**  
Under IAS 39, financial assets are classified as follows:

1) Financial instruments at fair value through profit or loss
2) Held-to-maturity investments
3) Loans and receivables
4) Available-for-sale financial assets

Financial assets should be classified into the above four categories. Financial assets measured at fair value through profit or loss (i.e., the changes in fair value are recorded as gains or losses on the income statement) are further divided into two sub-categories: Financial assets measured at fair value through profit or loss upon initial recognition (i.e., the fair value option, subject to the conditions below) or held for trading.

A financial asset is classified as held for trading if it meets either one of the following:

1) Acquired or incurred principally for the purpose of selling or repurchasing in the near term
2) Part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking
3) A derivative (except for a derivative that is a financial guarantee contract or designated and effective hedging instrument)

Financial asset (at fair value through profit or loss): The standard also allows an entity to designate a financial asset, a financial liability or a group of financial instruments (financial assets, financial liabilities, or both) as at fair value through profit and loss, provided it meets one of the following criteria (IAS 39.9 and 39.11):

1) A contract contains one or more embedded derivatives and, in that case, the entire hybrid can be designated as a financial asset or financial liability at fair value through profit or loss
2) Such use results in more relevant information because: a) it eliminates or significantly reduces a measurement or recognition inconsistency that otherwise would arise from measuring assets and liabilities or recognizing the gains and losses on them on a different basis; or b) a group of financial assets, financial liabilities, or both is managed, and its performance is evaluated on a fair-value basis, in accordance with documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's management personnel.
Note that the fair value option applies only to contracts within the scope of IAS 39 or equity method investments qualifying for the fair value option in accordance with IAS 28.1/IAS 31.1. An investment that needs to be consolidated under IAS 27/SIC 12 cannot be designated at fair value through profit or loss in the consolidated financial statements.

Caution should be taken in the classification of financial instruments under the fair value option. Once financial instruments are so designated, an investment company will not be able to reclassify them into or out of at fair value through profit or loss category (IAS 39.50).

**Held-to-maturity investments:** Held-to-maturity investments are nonderivative financial assets with fixed or determinable payments and fixed maturity that the investment company has the positive intention and ability to hold to maturity other than:

1. Those that upon initial recognition are designated as at fair value through profit or loss
2. Those that are designated as available for sale
3. Those that meet the definition of loans and receivables

**Loans and receivables:** Loans and receivables are nonderivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

1. Those that the entity intends to sell immediately or in the near term, which shall be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss
2. Those that upon initial recognition are designated as available for sale
3. Those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which shall be classified as available for sale

**Available-for-sale financial assets:** Available-for-sale financial assets are nonderivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables; (b) held-to-maturity investments; or (c) financial assets at fair value through profit or loss. However, available-for-sale investments are required to be measured at fair value unless there is no reliable fair value, in which case an unquoted equity security is valued at cost (only in rare circumstances because it is presumed that fair value can be reliably determined) and would need to be assessed for impairment, which would require an estimate of the present value of the future cash flows (IAS 39.66). Changes in fair value are recognized net of tax effects in equity (i.e., presented in the statement of changes in equity and recycled to the income statement when sold, impaired, or collected). Please see “Subsequent measurement” below for the further discussion of the result of different classification.

For entities early adopting IFRS 9 (effective on or after January 1, 2013) the following apply with respect to the classification of financial assets:

IFRS 9 replaces the above described multiple classification and measurement models governed by IAS 39 with a single model that has only two classification categories: amortized cost and fair value (IFRS 9.4.1).
IFRS (continued)  Financial assets may, notwithstanding the above, at initial recognition, be designated as measured at fair value through profit or loss if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an accounting mismatch) that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases (IAS 39 AG4D-AG4G; IFRS 9.4.5).

The objective of an investment company is to manage its portfolio to realize fair value rather than to collect contractual cash flows. Financial assets held for trading are not considered to be held for collecting contractual cash flows. Investment companies will generally follow a fair value-driven business model, where the entire portfolio is managed and measured on a fair-value basis.

Investment companies applying IFRS will continue to apply the fair value model to most of their financial assets because either the assets are held for trading or the portfolio is managed and evaluated on a fair-value basis. The criteria for measuring financial assets at amortized cost are therefore less relevant for investment companies (unless the investment companies hold loans or other financial instruments for collection of contractual cash flow purposes that could meet the IFRS 9 criteria for amortized cost classification).

The IFRS 9 classification principles also indicate that all derivative instruments should be carried at fair value.

The IFRS 9 classification principles further provide that all investments in equity instruments should be measured at fair value. However, management has an option to present unrealized and realized fair value gains and losses on investments in equity instruments that are not held for trading (e.g., shares held by private equity funds in portfolio companies) in “other comprehensive income” (as opposed to being presented as a component of “net income”). Such designation is available on initial recognition on an instrument-by-instrument basis and is irrevocable. There is no subsequent recycling of fair value gains and losses to profit or loss; however, dividends from such investments representing return on investments will continue to be recognized in profit or loss. (IFRS 9.5.4 and IFRS 9.5.5).

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**Highlights**

US GAAP does not provide for additional classification of financial assets because all financial assets of an investment company are required to be measured at fair value with changes recorded in earnings. Under IFRS, an investment company is not required to measure at fair value all of its financial assets through earnings. For example, it may choose to classify certain assets as available for sale.

However, the classification for investments under IFRS may, in practice, be similar to that under US GAAP because investment companies applying IFRS could apply either the fair value option (if the investment company manages investments on that basis—meeting one of the criteria to apply the fair value option) or trading category (for example, if the investment has been acquired for the purpose of selling in the short term). However, some investment companies, in practice, also use the available-for-sale category and the loans and receivables category (held-to-maturity is rarely seen in practice).

Upon adoption of IFRS 9, because the objective of an investment company is to manage its portfolio to realize fair value rather than to collect contractual cash flows, investment companies generally will follow a fair value-driven business model, where their portfolios are managed and measured on a fair-value basis.
5.4 Financial liabilities—classification

**US GAAP**

As an industry practice, the following categories of liabilities are reported separately

- Accounts payable
- Written options, futures contracts, and securities sold short
- Accrued liabilities
- Notes payable or other debt
- Other liabilities

**IFRS**

IAS 39 has two defined categories of financial liabilities:

- Financial liabilities “at fair value through profit or loss”
- Other financial liabilities

A financial liability is at fair value through profit and loss if it is either held for trading, a derivative not designated as a hedging instrument, or an instrument that elected the fair value option at initial recognition (provided specific criteria described above for financial assets are met).

Financial liabilities that are not classified as at fair value through profit or loss would automatically fall into the second category of “other financial liabilities” and are measured at amortized cost. Common examples are trade payables and borrowings.

For entities early adopting IFRS 9 (effective on or after January 1, 2013) the following apply with respect to the classification of financial liabilities:

Most of the added requirements were carried forward unchanged from IAS 39. However, the requirements related to the fair value option for financial liabilities were changed to address the issue of own credit risk in response to constituent feedback that the effect of changes in the credit risk of a liability ought not to impact the profit and loss unless the liability is held for trading. IFRS 9 requires that changes in the credit risk of a liability will be recognized in other comprehensive income and not recycled.

**Highlights**

Unlike its treatment of financial assets, US GAAP requires that only certain financial liabilities be measured at fair value through the income statement and requires that other financial liabilities be stated at amounts payable, unless an entity elects the fair value option under ASC 825 Financial Instruments. The classification model under IFRS to classify the instrument either at fair value through profit or loss (as trading or by use of the fair value option) or other liabilities is broadly comparable with that under US GAAP. For both US GAAP and IFRS, classification drives the measurement of the instrument.
5.5 Initial measurement of financial assets and financial liabilities

**US GAAP**
All investment securities are initially recorded at cost. The cost should be disclosed parenthetically on the face of the statement of assets and liabilities. Cost includes commissions or other charges related to the acquisition of investments (ASC 946-320-40-1).

Generally, all other financial assets and financial liabilities are also initially recorded at cost.

**IFRS**
IFRS requires that a financial asset and financial liability be initially measured and recorded at fair value or fair value plus/minus transaction costs where the financial asset or financial liability will not be carried at fair value through profit and loss (IAS 39.43). The fair value is typically the amount paid or received at the time of the transaction.

Transaction costs, including the “bid-ask spread,” directly attributable to the acquisition or issue of financial instruments at fair value through profit or loss should be expensed through profit and loss. On other hand, as noted above for instruments not carried at fair value through profit and loss, transaction costs should be included in the amount initially measured.

Because investments held by an investment company are typically financial instruments carried at fair value through profit or loss, the company should follow the IFRS requirement to expense the transaction costs, including the “bid-ask spread,” and such spread may be included as part of the change in fair value of the securities in the income statement from a practical standpoint or as a separate expense similar to other transaction costs, such as borrowing costs.

**Highlights**

US GAAP requires that costs incurred as part of the securities purchase transaction initially be included as part of the costs of that investment security. Because such costs are not a part of the instrument’s fair value, it generally will result in an unrealized loss for the investment company on subsequent measurement.

IFRS requires that such transaction costs be expensed immediately for financial assets and financial liabilities at fair value through profit and loss but require capitalization of such costs for all financial assets and liabilities that are not measured at fair value through profit and loss.
5.6 Subsequent measurement of financial assets and financial liabilities

**US GAAP**
All investment securities should be reported at fair value in the statement of assets and liabilities (ASC 946-10-15-2).

Receivables are usually listed separately at their realizable value. Receivables include, among others, dividend and interest, investment securities sold, capital stock sold, and other accounts receivable (ASC 946-310-45). In ASC 820, the FASB noted that the measurement for receivables determined using a value technique in APB 21 is a fair value measurement. For short-term receivables, a common practice of investment companies is to disclose that the carrying values of receivables approximate fair value. However, the investment company will need to consider the definition of fair value to reflect how an exit price could affect the fair value. Refer to section 5.7, “Fair value,” for further discussion.

Notes payable and other debt should be stated at the amounts payable, net of unamortized premium, or discount and are, according to industry practice, reported separately, unless the fair value option is elected under ASC 825.

Investment liabilities such as written options or securities sold short should be presented separately at fair value in the statement of assets and liabilities, with premiums or other proceeds received disclosed parenthetically as an industry practice.

**IFRS**
Subsequent measurement depends on the initial classification of the financial instrument. The general principles for subsequent measurement:

1) Financial instruments carried at fair value through profit or loss subsequently should be measured at fair value without any deduction of transaction costs that may be incurred on disposal (IAS 39.46 and 39.47). Changes in value should be recognized as gains or losses in profit and loss (IAS 39.55).

2) Financial assets designated as available-for-sale instruments subsequently should be measured at fair value (IAS 39.46) or at cost for an unquoted equity security if the fair value cannot be reliably determined (IAS 39.46). Changes in value should be recognized directly in equity, through the statement of changes in equity, except for impairment charges and the impact of movements in foreign currency exchange rates on amortized cost of available-for-sale debt instruments. Furthermore, related interest income should be recorded in profit and loss (IAS 39.55).

3) Financial assets designated as held-to-maturity and other financial assets (such as loans and receivables) subsequently should be measured at amortized cost.

4) Financial liabilities not carried at fair value through profit or loss should be measured at amortized cost, which is calculated using the effective interest method. Refer also to section 3.2.2 “Net assets—measurement” for measurement of units or shares classified as financial liabilities.
For all financial assets that are not measured at fair value through profit or loss, any impairment should be assessed at each balance sheet date. Any such impairment, if identified, should be recorded as a loss in the income statement. A financial asset is impaired, and impairment losses are incurred, only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset. The standard provides guidance on objective evidence of impairment, which varies depending on whether the investment is a debt or equity security. An impairment loss can be reversed for debt instruments if there is objective evidence that the decrease in impairment loss is related to an event that occurred after the impairment charge was recorded.

Upon adoption of IFRS 9, the following apply with respect to subsequent measurement of financial assets:

All financial assets are to be measured subsequently at either amortized cost or fair value after considering (a) the business model of the entity for managing the financial asset and (b) the contractual cash flow characteristics of the financial asset (IFRS 9.4.1).

The evaluation of an entity’s business model is not dependent on management’s intentions for individual instruments, and such determination should not be made using an instrument-by-instrument approach; rather, it is determined on a higher level of asset aggregation (e.g., portfolio of investments).

A financial asset shall be measured at amortized cost if both of the following conditions are met (IFRS 9.4.2):

(a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

(b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A financial asset shall be measured at fair value unless it is measured at amortized cost (IFRS 9.4.4). Investment companies generally would not satisfy the criteria noted above (IFRS 9.4.2) and would account for their investments at fair value.

**Highlights**

While US GAAP requires that all investment securities be measured at fair value through the income statement, IFRS currently provides alternative accounting models under which subsequent changes in fair value may not flow through the income statement, depending on the classification of the investment.

Currently under IFRS, an investment company may for various reasons choose to classify some of its investments as available for sale. Even if the investment company does not have any equity (i.e., it has issued redeemable shares that are classified as liabilities), the change in value of available-for-sale securities should continue be reported as available-for-sale reserve in equity. Additionally, if the investment company elects the available-for-sale classification model, it also needs to consider whether there is objective evidence of impairment of such financial assets.

Upon adoption of IFRS 9, however, the multiple classification and measurement models provided by IAS 39 will be replaced with a single model that has only two classification categories: amortized cost and fair value. The adoption of IFRS 9 is not expected to have any material impact to investment companies currently measuring their portfolio at fair value through the income statement.
5.7 Fair value

**US GAAP**

ASC 820, *Fair Value Measurement and Disclosures*, defines how fair value should be determined for financial reporting purposes by establishing a framework applicable to all fair value measurements under US GAAP. 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.

Some of the important characteristics of the fair value standard include:

i. Fair value is based on the price to sell an asset or transfer a liability
ii. Focus on market participant assumptions
iii. The highest and best use provides the basis for valuation of an asset
iv. Determining the market and the market participants
v. Incorporation of standard valuation techniques
vi. Fair value hierarchy

The notion of exit price does not necessarily require the use of bid or asking prices. Rather, for level 1 inputs, ASC 820 calls for the use of “the price within the bid-ask spread that is most representative of fair value in the circumstances,” and “does not preclude” the use of midmarket prices or other “conventions as a practical expedient” for fair value measurement within a bid-ask spread.

Blockage factor is the premium or discount based on the relative size of positions, such as holding a large portion of the total trading units of an investment. ASC 820 specifically precludes application of a blockage factor to a single financial instrument traded in an active market (i.e., level 1 inputs). For level 2 and level 3 inputs, specific facts and circumstances should be considered. For example, a blockage factor may be appropriate for a holding that is thinly traded and for which a market participant would be willing to transact only in a block. In other cases, a blockage factor may not be appropriate if the discount introduces an element of management intent in terms of planned disposition.

If a reporting entity holds an asset that has restrictions on its sale or transferability (i.e., a restricted asset), then the fair value measurement should be adjusted to reflect the discount, if any, that a market participant would require as a result of the restriction. A market participant generally would require a discount if the restriction is specific to the asset (e.g., a security purchased under a Rule 144A “private offering” generally would be restricted to the asset for a period). However, a discount would not be required if the restriction is specific to the entity or the holder of the instrument.
US GAAP (continued) ASC 820 does not prescribe which valuation technique(s) should be used when measuring fair value and does not prioritize among the valuation techniques discussed (i.e., the market approach, income approach, and cost approach). In some cases, one valuation technique may provide the best indication of fair value (e.g., the use of the market approach in the valuation of an actively traded equity security); however, in other circumstances, the use of multiple valuation techniques may be appropriate.

ASC 860 Transfers and Servicing; ASC 825 Financial Instruments; ASC 820 Fair Value Measurements and ASC 815 Derivatives and Hedging together provide reporting entities with an option to measure many financial instruments, selected hybrid financial instruments and separately recognized servicing assets and servicing liabilities at fair value.

Please see the PwC’s publication, Guide to Fair Value Measurements, for additional guidance on fair value.

IFRS

Financial instruments quoted in an active market should be valued at bid price for long positions and asking price for short positions.

When an investment company has financial assets and liabilities with offsetting market risks, it may use midmarket prices to determine fair value for the offsetting risk positions and apply bid or asking prices to the net open position, as appropriate.

Similar to US GAAP, the use of a blockage factor is not appropriate in the determination of fair value for instruments traded in an active market (IAS 39 AG71). IFRS also is similar to US GAAP in that a restriction on the securities that is specific to the asset would generally require a discount to be applied in determination of fair value.

For financial instruments without an active market, the fair value should be determined based on a valuation technique. The valuation technique should be based on market transactions of substantially similar securities, discounted cash flow analysis, an option pricing model or another valuation technique commonly used by market participants and proved to be reliable (IAS 39, AG 74).

Highlights

For financial instruments quoted in active market, US GAAP defines the fair value as the price within the bid-ask spread that is most representative of fair value while IFRS mandates bid prices for long positions and asking prices for short positions. This might result in fair values for similar instruments being different under US GAAP and IFRS.

Because IFRS mandates bid prices for long positions and asking prices for short positions, if a different valuation method is prescribed by an investment company’s offering document, it may result in different net asset values for IFRS and the investment company’s redemption price under the offering document.
5.5 Initial measurement of financial assets and financial liabilities

**US GAAP**

The disclosure requirements are primarily included in ASC 946 Financial Services—Investment Companies and the following pronouncements:

1) ASC 820 Fair Value Measurements and Disclosures
2) ASC 815 Derivatives and Hedging
3) ASC 825 Financial Instruments
4) ASC 275 Risks and Uncertainties

ASC 820 establishes a fair value hierarchy, which has three levels of input:

1) Level 1 consists of quoted prices in active markets for identical assets and liabilities
2) Level 2 consists of either quoted prices for similar assets or liabilities in active markets; or, quoted prices for identical or similar assets or liabilities in markets that are not active; or, the use of inputs other than quoted prices included within level 1 that are observable directly or indirectly.
3) Level 3 consists of “unobservable inputs,” which represent the entity’s own assumptions of inputs that approximate those market participants would use.

ASC 820 provides guidance on fair value disclosures and requires the disclosure of valuation techniques and inputs used to measure fair value. The guidance requires the disclosure of fair value measurements; fair value measurements segregated among the appropriate levels within the fair value hierarchy; a reconciliation of fair value measurements using level 3 inputs, including the beginning and ending balances and gains and losses (realized and unrealized) for the period; concentration of credit risk, market risk, off-balance sheet risk, significant estimates, and their uncertainty; and key assumptions used in the determination of fair value. It also requires disclosure of fair valued assets and liabilities transferred between various fair value hierarchy levels and the reasons for such transfer.

**IFRS**

Similar to US GAAP, IFRS establishes a three-level fair value hierarchy that reflects the significance of the inputs used in making the measurements. The fair value hierarchy is the same as the one set forth in US GAAP above. IFRS also requires the disclosure of fair value measurements segregated among the appropriate levels within the fair value hierarchy; a reconciliation of fair value measurements using level 3 inputs, including the beginning and ending balances and gains and losses (realized and unrealized) for the period; disclosure of fair valued assets and liabilities transferred between various fair value hierarchy levels; and the reasons for such transfer (IFRS 7.27).

In addition, IFRS 7 (IFRS 7.27B(e)) requires that for fair value measurements in level 3, if changing one or more of the inputs to reasonably possible alternative assumptions would change fair value significantly, the entity should state that fact and disclose the effect of those changes.

Disclosures related to financial instruments are driven primarily by IFRS 7. The objective of IFRS 7 is to provide disclosures “through the eyes of management” and encompass both qualitative narrative descriptions and specific quantitative data such that users are able to evaluate the nature and extent of risks arising from financial instruments to which an investment company is exposed at the reporting date and how the risks are managed.
IFRS 7 requires that certain disclosures be provided by class of financial instruments. Although IFRS 7 does not provide a prescriptive list of classes, it states that a class shall contain financial instruments of the same nature and characteristics. An instrument class is not the same as an instrument category as classes should be determined at a lower level than the categories and reconciled back to the balance sheet (IFRS 7.6). For example, instruments within the category of fair value through profit or loss might be disaggregated into different types of investments held by a fund (i.e., different classes).

Balance sheet disclosure
IFRS 7 requires disclosure of the carrying values of each of the following categories either on the face of the balance sheet or in the notes (IFRS 7.8):

1) Financial assets at fair value through profit or loss, showing separately those designated upon initial recognition and those classified as held for trading
2) Financial assets designated as available for sale
3) Financial assets designated as held to maturity
4) Loans and receivables
5) Financial liabilities at fair value through profit or loss, showing separately those designated upon initial recognition and those classified as held for trading
6) Financial liabilities measured at amortized cost

Fair value of each of the categories of financial assets and liabilities, including the assumptions and estimations used in the determination of fair value, should be disclosed. If fair value cannot be determined, that fact should be disclosed (IFRS 7.30). For an investment company, because investments generally are carried at fair value and other financial assets and liabilities are short-term in nature, the carrying amounts of other financial assets and liabilities typically approximate the fair value. This should be stated in the notes to the financial statements (IFRS 7.29).

Collateral pledged, including carrying amounts and terms and conditions, should be disclosed (IFRS 7.14). Collateral held including the fair value, the fair value of any such collateral sold or re-pledged whether the entity has an obligation to return it, and terms and conditions all should be disclosed (IFRS 7.15).

Income statement disclosure
IFRS 7 requires the disclosure of net gains or losses on each of the categories of financial assets and liabilities. Total interest income and interest expense should be disclosed for financial assets and financial liabilities that are not at fair value through profit or loss. Any impairment loss for each category also should be disclosed.

Nature and extent of risks arising from financial instruments
To help users understand the nature and extent of risks arising from financial instruments, both qualitative and quantitative disclosures should be made. The risks for an investment company usually include credit risk, liquidity risk, and market risk (including interest rate risk, price risk and currency risk). Disclosures around the nature and extent of risks should be tailored to reflect the financial instruments held by the investment company. Additional risks also may be identified and disclosed based on the company's specific investment objectives and activities.
With regard to qualitative disclosures for each type of risk resulting from financial instruments, the investment company should disclose exposures to risk and how they arise; the company’s objectives, policies, and processes for managing and measuring risk; and any changes during the period related to risk and risk management.

Investment companies are also required to disclose summary quantitative data about their exposure to each type of risk arising from financial instruments based on information provided internally to key management. At a minimum, these disclosures should include:

- **Credit risk**, including:
  - The amount that best represents the maximum exposure to credit risk at the reporting date without consideration of collateral held or other credit enhancements
  - Disclosure around collateral held or other credit enhancements for that instrument in the above bullet point
  - Analysis of financial assets that are neither past due nor impaired
- **For financial assets that are either past due or impaired**, an entity shall disclose by class of financial asset:
  - An analysis of the age of financial assets that are past due as at the end of the reporting period but not impaired
  - An analysis of financial assets that are individually determined to be impaired as at the end of the reporting period, including the factors the entity considered in determining that they are impaired
  - For the amounts disclosed in the first two points, a description of collateral held by the entity as security and other credit enhancements and, unless impracticable, an estimate of their fair value
- **For collateral and other credit enhancements obtained**
  - When an entity obtains financial or nonfinancial assets during the period by taking possession of collateral it holds as security or calling on other credit enhancements (e.g., guarantees), and such assets meet the recognition criteria in other IFRS, an entity shall disclose for such assets held at the reporting date.
- **Liquidity risk**, including a maturity analysis for financial liabilities that shows the remaining contractual maturities and a description of how the company manages the liquidity risk inherent in the maturity analysis.
Market risk, including a sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date. The disclosures for the sensitivity analysis should also include the methods and assumptions used in preparing the sensitivity analysis and any changes from the previous period to these methods and assumptions. This disclosure is one of the most challenging areas for investment companies due to the judgment and analysis involved as well as the need to accumulate data that the investment company may not immediately be able to access. As part of the process, management should identify the relevant risk variables that reflect best the exposure of the entity to market risk. For example, for a fund with a long/short debt strategy, the relevant risk variables would be interest and foreign currency rates. When preparing the sensitivity analysis, the quantitative impacts of the interest and foreign currency rate sensitivities of the fund need to be determined and disclosed.

The investment company also should provide information about concentration of risk to the extent that this information is not apparent through the disclosure discussed above. PwC’s IFRS Illustrative Financial Statements—Investment Funds provides examples of disclosure in accordance with IFRS 7.

In addition to IFRS 7, IAS 1 also requires:

- The disclosure of the use of judgment that management has made in the application of accounting policies and that have the most significant effect on the amounts recognized in the financial statements (IAS 1R.122)
- The key assumptions used and sources of estimation of uncertainty also should be disclosed, together with the nature and carrying amounts of the affected assets and liabilities (IAS 1R.125)
- The qualitative and quantitative information about the investment company’s objectives, policies, and processes for managing capital (IAS 1R.136)

**Highlights**

The approach and the level of investment-related disclosures under US GAAP differ from those under IFRS. The disclosure requirements under US GAAP are more specific and customized to industry practice, while the IFRS approach is to provide disclosure through the eyes of management, including substantial minimum disclosures.

IFRS 7 requirements may be considered to be more onerous than the current requirements under US GAAP. The required risk disclosures include not only qualitative but also certain minimum quantitative information, which can be challenging for companies both in the judgment, analysis, and preparation of the disclosure as well as the access and accumulating the data. For example, one of the most challenging areas for investment companies is the preparation of the sensitivity analysis.
5.9 Financial instruments—offsetting

**US GAAP**

ASC 210-20-45 *Offsetting* provides the guidance related to offsetting positions. The right to offset exists when all of the following conditions are met:

1. Each of two parties owes the other determinable amounts
2. The reporting party has the right to offset the amount owed with the amount owed by the other party
3. The reporting party intends to offset
4. The right of offset is enforceable at law

However, US GAAP specifically allows that fair value amounts recognized for derivative contracts executed with the same counterparty and the fair value amounts for cash collateral arising from such derivative contracts under a master netting arrangement to be offset if the three conditions apart from intent (condition 3 above) are met. This is because there is an exception from meeting the intent criterion under master netting arrangements. However, this is a policy choice to offset amounts under a master netting arrangement, and the investment company must apply it consistently (ASC 815-10-45-5).

ASC 210-20-45 provides for additional considerations for amounts recognized as payables under repurchase agreements and amounts recognized as receivables under reverse repurchase agreements.

Investment companies may choose to offset assets and liabilities if the conditions noted above are satisfied. Legal constraints such as state laws, common law, etc., also need to be considered to determine whether the right to offset is enforceable.

**IFRS**

A financial asset and a financial liability should be offset and the net amount presented on the balance sheet when an investment company (IAS 32.42):

1. Has a legal enforceable right to offset the recognized amounts
2. Intends to settle on a net basis, or to realize the asset and settle the liability simultaneously

In order to offset financial assets and liabilities, an investment company must have a currently enforceable legal right to do so. Conditional rights do not meet this criterion. For instance, an investment company may have a conditional right to set off recognized amounts, such as in a master netting agreement, but such rights are enforceable only on the occurrence of some future event, usually a default of the counterparty. Consequently, IFRS does not consider such an agreement as meeting the conditions for offset (IAS 32, AG 38). As a result, because there is no equivalent exception as under US GAAP, positive and negative fair value of derivatives under a master netting arrangement should not be offset even if such derivatives have the same counterparty. The amounts should be presented as financial assets and financial liabilities on the balance sheet, respectively.

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**Highlights**

The exception to offset derivatives in a master netting arrangement under US GAAP could lead to a large presentation difference in the IFRS financial statements because IFRS has no such exception. However, there will not be any differences if the investment company elects the policy choice not to offset amounts under a master netting arrangement for US GAAP purposes. This policy choice must be applied consistently.
Chapter 6: Other accounting and reporting topics

Executive takeaways

• Under US GAAP, ASC 740 Income Taxes is applied to all income tax uncertainties. The unit of account is the individual tax uncertainty measured based on the cumulative probability model. With respect to IFRS, IAS 12 does not explicitly address uncertain tax positions, but the general principle is similar to that under US GAAP. However, differences can arise in the identification of the unit of account (which may/may not be the individual tax uncertainty) and the measurement of the liability because IFRS does not permit the cumulative probability method. Instead, the liability under IFRS must be measured using the weighted average probability or best estimate.

• Industry-specific standards govern the disclosure of financial highlights under US GAAP; for example, investment companies are specifically exempt from presenting earnings per share under US GAAP. In contrast, IFRS does not require disclosure of financial highlights, but investment companies with publicly traded equity securities are required to disclose earnings per share. However, as discussed in Chapter 3, it is likely that the shares will be classified as liabilities under IFRS, in which case earnings per share information would not be applicable.

• Under US GAAP ASC 946 requires that all investments be reported at fair value, including investments in real estate. IFRS provides the choice between a fair value model with changes recognized in profit and loss and a cost model for investment property (i.e., property that is held to earn rentals, for capital appreciation, or both).

• The related party definition and disclosure is broadly similar between US GAAP and IFRS except that IFRS requires that certain additional disclosures related to key management personnel compensation (e.g., compensation to directors) be included in the footnotes.

• IFRS 8 is closely aligned with ASC 280 under US GAAP, and their application would generally result in similar conclusions under both US GAAP and IFRS.
### 6.1 Functional currency

#### US GAAP

The functional currency is the currency of the primary economic environment in which an investment company operates. Factors for consideration of functional currency are listed in ASC 830 *Foreign Currency Matters*, and include indicators such as cash flow, sales price, sales market, expenses, financing, and intercompany transactions.

If an entity’s functional currency is a foreign currency, translation adjustments may result from the process of translating that entity’s financial statements into the reporting currency.

#### IFRS

Similar to US GAAP, functional currency is the currency of the primary economic environment in which an investment company operates (IAS 21.9).

An entity considers the following primary indicators in the determination of its functional currency:

1. It is the currency: a) that mainly influences sales prices for goods and services (this will often be the currency in which sales prices for its goods and services are denominated and settled); and b) of the country whose competitive forces and regulations mainly determine the sales prices of the company’s goods and services.
2. It is the currency that mainly influences labor, material and other costs of providing goods or services; this will often be the currency in which such costs are denominated and settled.

Secondary indicators include the currency in which funds from financing activities are generated and the currency in which receipts from operating activities are usually retained (IAS 21.10). An example for financing is the currency in which the investment company’s shares are issued and redeemed. As a result, determining the functional currency of an investment company is not straightforward and depends on multiple factors, including but not limited to:

1. The economic environment(s) in which the financial assets are invested
2. The economic environment(s) of the investors
3. The regulatory environment
4. The competitive environment
5. The fee structure
6. The denomination of subscriptions and redemptions

Similar to US GAAP, when the factors are mixed and the functional currency is not obvious, management should use its judgment to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events, and conditions that affect the company (IAS 21.12).

When the presentation currency is different from the functional currency, disclosure should be made for the investment company’s functional currency and the presentation currency, which is the currency used in the presentation of financial statements. The reason for using a different presentation currency should also be disclosed (IAS 21.53).
6.2 Foreign currency transactions and translation of financial statements

**US GAAP**
At initial recognition, a foreign currency transaction (transaction in a currency other than the functional currency) is recorded and translated at the spot exchange rate on the transaction date. A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the expected amount of functional currency cash flows, and this is a transaction gain or loss that generally shall be included in determining net income for the period in which the exchange rate changes (ASC 830-20-35-1). Net gains or losses from assets or liabilities denominated in foreign currencies during the period should be reported separately (ASC 946-225-45-6, ASC 946-225-50-2).

If an investment company’s functional currency is a foreign currency, translation adjustments may result from the process of translating its financial statements into the reporting currency. All elements of financial statements shall be translated using a current exchange rate except for certain nonmonetary balance sheet items and related revenue, expense, gain, and loss accounts that should be remeasured using historical rates (ASC 830-10-45-18). Translation adjustments shall not be included in determining net income but shall be reported in other comprehensive income (ASC 830-30-45-12).

**IFRS**
Similar to US GAAP, a foreign currency transaction should be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate at the transaction date (IAS 21.21).

When a debt security is classified as available for sale, any foreign currency gains and losses are recognized in the income and not included as a part of other comprehensive income.

**Highlights**
The foreign currency guidance for initial and subsequent measurement under US GAAP and IFRS is similar and will generally not result in any differences.

In practice, it is rare for an investment fund that prepares its financial statements under US GAAP to translate its financial statements into a presentation currency other than its functional currency or consolidate another entity with a different functional currency that would require the translation of the financial statements. The key consideration for investment companies moving to IFRS will be around investee funds that need to be consolidated but have a different functional currency than the investor fund. Foreign currency translation gains/losses would arise in the consolidated accounts; whereas, that same investment may not be currently consolidated under US GAAP (and hence not have the translation gains/losses).

At subsequent balance sheet dates, monetary assets and liabilities denominated in a foreign currency are translated using the closing rates (IAS 21.23). Non-monetary balance sheet items that are measured at historical cost in a foreign currency should be translated using the exchange rate at the date of the transaction (IAS 21.23). Non-monetary balance sheet items that are measured at fair value in a foreign currency should be translated at the exchange rate on the date the fair value is determined (IAS 21.23).

When translating the financial statements from the functional currency into the presentation currency, assets and liabilities shall be translated at the closing rate, and income statement items shall be translated at the exchange rates on the dates of the transactions (or an average rate as a practical alternative, provided that the exchange rate does not fluctuate significantly).
### 6.3 Tax Uncertainties

**US GAAP**
Under ASC 740, Income Taxes, a model is established for how an entity recognizes, measures, presents, and discloses in its financial statements uncertain tax positions that it has taken or expects to take on a tax return of positions that are “more likely than not” to be sustained based on the technical merits of the position. ASC 740 is applied to all income tax uncertainties, so the unit of account is the individual tax uncertainty.

The amount of the tax benefit recognized in accordance with ASC 740 is the largest amount that is greater than 50% likely of being realized upon ultimate settlement, the cumulative probability model. Tax benefits are recognized or de-recognized in the period in which the tax position meets or fails to meet the recognition threshold. This may occur prior to final resolution of the uncertainty.

ASC 740 is prescriptive and requires all uncertain tax positions to be measured using the cumulative probability methodology. It requires tax benefits using the cumulative probability model, so the resulting tax liability may not be the amount that management expects to pay.

Qualitative and quantitative disclosures are required, including discussions of reasonably possible changes that might occur in the recognized tax benefits over the next 12 months, a description of open tax years by major jurisdictions and a roll-forward of all unrecognized tax benefits.

**IFRS**
Although IAS 12 does not specifically address uncertain tax positions, the general measurement guidance in IAS 12.46 should be applied: “Current tax liabilities (assets) for the current and prior periods shall be measured at the amount expected to be paid to (recovered from) the taxation authorities using the tax rates (and tax laws) that have been enacted or substantively enacted at the balance sheet date.” The unit of account and measurement method is not specified in IAS 12.

An investment company may choose to consider uncertain tax positions at the level of the individual uncertainty or group of related uncertainties. It also may choose to consider tax uncertainties at the level of its total tax liability to each taxing authority.

When an investment company elects to consider uncertain tax positions at the level of each uncertainty, it should first consider whether each position taken in the tax return is probable of being sustained on examination by the taxing authority. A liability should be recognized in connection with each item that is not probable of being sustained. The liability is measured using either an expected value (weighted-average probability) approach or a single best estimate of the most likely outcome. The current tax liability would be the aggregate liability in connection with uncertain tax positions.
When an entity elects to consider uncertain tax positions at the level of its relationship with the taxing authority, the key issue is the measurement of the tax liability. If it is probable that the investment company will pay tax, the recognition threshold has been met. The investment company should then determine the amount of tax it expects to pay, taking into account all the tax uncertainties, using either an expected value (weighted-average probability) approach or a single best estimate of the most likely outcome.

IAS 37, Provisions, Contingent Liabilities and Contingent Assets, excludes income taxes from its scope and is not used to account for uncertain tax positions.

### 6.4 Real estate investments

**US GAAP**

A common nonfinancial asset held by an investment company is real estate. ASC 946-10-15-2 notes that investment companies report all securities at fair value. Industry practice has defined a general list of what the term “securities” refers to. Because an investment company may invest in real estate for current income, appreciation, or both, such real estate investment, which is a nonfinancial asset, is required to be reported at its fair value.

**IFRS**

IAS 40 Investment Property requires an investment property to be measured initially at cost. For measurement subsequent to the initial recognition, IAS 40.32A permits an entity to choose either the fair value model, with changes in fair value recognized in earnings, or the cost model for all investment property. IAS 40.5 defines an investment property as a land and/or a building, held to earn rentals or for capital appreciation or both. An investment property does not include property held for use in production or supply of goods or services or for administrative purposes; or for sale in the ordinary course of business.

**Key notes**

Investment companies apply fair value to all their investments including non-financial assets such as real estate in accordance with the US GAAP. Under IFRS, the real estate property has to meet the definition of an investment property to be eligible for electing the fair value model. The fair value model is an accounting policy election under IFRS.

For further guidance and illustrative disclosures for investments in real estate under IFRS, refer to the IFRS Illustrative Consolidated Financial Statements—Investment Property.
6.5 Share-based compensation

**US GAAP**

**Recognition**
The fair value of stock-based compensation is recognized over the requisite service period, which may be explicit, implicit, or derived, depending on the terms of the awards (service condition, market condition, performance condition, or a combination of conditions).

**Measurement**
For equity-settled, share-based payment awards issued to employees, the awards should be measured by reference to the fair value of the equity instruments granted and recognized as compensation expense and a corresponding increase to equity over the requisite service period. For cash-settled, share-based payment transactions, the goods or services acquired and the liability incurred are measured at the fair value of the liability that is marked to market at each balance sheet date. Extensive disclosures are also required.

**Employer’s payroll tax payable on exercise of share options by employees**
Employer payroll taxes due on employee stock-based compensation are recognized as an expense on the date of the event triggering the measurement and payment of the tax to the taxing authority (generally the exercise date and the vesting date for options and restricted stock, respectively).

**IFRS**

**Recognition**
The fair value of shares and options awarded to employees is recognized over the period to which the employees’ services relate. The award is presumed to be for past services if it is unconditional without any performance criteria.

**Measurement**
While the general principles for measurement are similar, detailed differences in the model between IFRS and US GAAP exist such as the definition of the grant date, classification of awards between equity-settled and cash-settled, measurement of awards to employees or nonemployees, and measurement of awards based on service, market, or performance conditions (including the attribution of expense over a graded vesting period), and differences in award classification as a result of tax withholding arrangements.

**Highlights**
Even if investment companies do not have employees, it is not uncommon for such entities to issue options/restricted stock to its directors for services provided to the investment company in which case the investment company will need to account for those shares as share based compensation. The models are broadly comparable between IFRS and US GAAP, although detailed differences arise in the application of the models.

**Employer’s payroll tax payable on exercise of share options by employees**
Employers’ Social Security liability arising from share-based payment transactions is recognized over the same period or periods as the share-based payment charge.
6.6 Financial highlights (including earnings per share)

US GAAP

The disclosure of financial highlights is required under US GAAP, either as a separate schedule or within the notes to the financial statements (ASC 946-205-50) and should be provided for each permanent class of shares outstanding related to the nonmanaging investors (ASC 946-205-50-4).

For unitized funds, financial highlights should include per share information (ASC 946-205-50-7), ratios of expenses (before and after incentive fees), investment income or loss to weighted average net assets (ASC 946-205-50-7) and total return (based on net asset value per share, before and after incentive fees) (ASC 946-205-50-18). The required disclosure of per share information is composed of net asset value at the beginning of the period, net investment income or loss, realized and unrealized gains and losses, distributions, and net asset value at the end of the period.

For nonunitized funds, in addition to ratios of expenses (before and after incentive allocation) and investment income or loss, total return should be presented based on the change in value during the period of a theoretical investment made at the beginning of the period (ASC 946-205-50-5).

For funds of funds, the expense ratios should not include the proportionate share of expenses of underlying investee companies (ASC 946-205-50).

For private equity funds (and certain other limited life entities) which invest substantially in non-marketable securities, the internal rate of return, net of all incentive fees or allocations for each investor class (ASC 946-205-50-23), is presented as of the beginning and end of the fiscal year instead of the annual total return. Additionally, such investment companies also disclose total committed capital, the year of formation, and the ratio of total contributed capital to total committed capital in the financial highlights or elsewhere in the notes to the financial statements (ASC 946-205-50-25).

ASC 260, Earnings per Share, scopes out all investment companies from the requirements to disclose EPS (ASC 260-10-15-3).
**IFRS**  

The disclosure of financial highlights, including the disclosure of the entity’s net asset value, is not required under IFRS.

If an investment company provides an alternative performance measure (such as financial highlights), the entity should ensure that it addresses the four qualitative characteristics that make the information provided in financial statements useful to readers: comprehensibility; relevance; reliability; and comparability. Therefore, investment companies should consider the following guidelines if alternative performance measures are disclosed:

a) Define the terminology used and the basis of calculation adopted.

b) Where possible, present alternative performance measures only in combination with measures defined under IFRS.

c) Alternative performance measures should be presented consistently over time.

d) To ensure that investors are not misled, alternative performance measures should not be presented with greater prominence than defined IFRS measures. Where alternative performance measures are derived from audited financial statements and resemble defined performance measures but do not actually have the characteristics of the defined measures, then the defined measures should be given greater prominence than the alternative performance measures.

e) Generally, explain the reason for presenting alternative performance measures to investors (i.e., may be used internally).

If an investment company has equity instruments that are publicly traded, earnings per share should be disclosed in accordance with IAS 33, *Earnings Per Share*.

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**Highlights**

Although IFRS does not require the disclosure of financial highlights, a number of investment companies choose to do so in order to present the fund’s performance. IFRS requires earnings per share to be disclosed only if the equity instruments of the company are publicly traded or the company is in the process of issuing shares in the public market. If the investment company’s shares are classified as liabilities, the earnings per share information is not applicable.

Because financial highlights are a tailored disclosure for investment companies, US GAAP requires investment companies to present financial highlights and explicitly scopes out all investment companies from the requirement to present earnings per share.
6.7 Related party transactions

US GAAP Related parties are defined in ASC 850, Related Party Disclosures. They include affiliates of the enterprise; entities for which investments in their equity securities would, without the election of the fair value option, be required to be accounted for by the equity method by the enterprise; trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management; principal owners of the enterprise; its management; members of the immediate families of principal owners of the enterprise and its management; and other parties with which the enterprise may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

In accordance with ASC 850, the following should be disclosed for related party transactions (ASC 850-10-50-1):

1) The nature of such relationships*
2) A description of the transactions, including transactions to which no amounts or nominal amounts were ascribed
3) The dollar amounts of the transactions
4) Amounts due from and to related parties

* Sometimes, the effect of the relationship between the parties may be so pervasive that disclosure of the relationship alone will be sufficient. If necessary to the understanding of the relationship, the name of the related party should be disclosed.

Furthermore, if an investment company and one or more other parties are under common ownership or management control and the existence of that control could result in operating results or financial positions of the investment company that are significantly different from those that would be obtained if the investment company were autonomous, the nature of the relationship should be disclosed even though there are no transactions between the parties (ASC 850-10-50-6).

For an investment company, the major related transactions are management fees, incentive fees (or allocations), and administration fees. US GAAP requires that all amounts paid to affiliated or related parties be disclosed in accordance with ASC 850. It further specifically states that significant provisions of related party agreements, including the basis of determining management, advisory, administration, or distribution fees and other amounts paid to affiliates or related parties, should be described in a note to the financial statements (ASC 850).
**IFRS**

The term “related party” is defined in paragraph 9 of IAS 24, *Related Party Disclosures*, and is similar to the definition of related party under US GAAP.

The disclosures required for related party transactions, typically applicable to an investment company, are as follows (IAS 24.17):

1. The amount of transactions
2. The amount of outstanding balances
   a. Their terms and conditions
   b. Details of any guarantee received or given
3. Provisions for doubtful debts related to the amounts of outstanding balances
4. The expense recognized in respect of bad or doubtful debts due from related parties
5. The identity of the controlling party

Additionally, under IFRS an investment company is also required to disclose key management personnel compensation in total and for each of the following categories:

a) Short-term employee benefits
b) Post-employment benefits
c) Other long-term benefits
d) Termination benefits
e) Share-based payment

**Highlights**

The objective of the disclosures required by US GAAP and IFRS with regard to related party relationships and transactions is to ensure that the users of financial statements are aware of the extent to which the financial position and results of the operations may have been influenced by the existence of related parties.

The two standards have similar definitions and disclosure requirements for related parties. IFRS, however, requires that additional disclosures related to key management personnel compensation be included as part of the footnotes (for example, where the fund has issued options or restricted stock to directors of the fund).
6.8 Segment reporting

**US GAAP** ASC 280 *Segment Reporting*, is applicable only to public business enterprises and requires an entity to report separately information about each reporting segment.

**IFRS** Similar to US GAAP, segment reporting is required for entities whose debt or equity instruments are traded in a public market.

IFRS 8 *Operating Segments*, which is effective for the year beginning on or after January 1, 2009, is a convergence standard with ASC 280. Under IFRS 8, a segment is an operating segment, which is identified on the basis of internal reports that are regularly reviewed by an entity’s chief operating decision-makers in order to allocate resources to the segment and assess its performance. Measurement and disclosure requirements have also been amended. The segment reporting under IFRS 8 is to disclose an entity’s segment through the eyes of management.

**Highlights**

The application of converged standards for segment reporting has generally resulted in similar conclusions under both US GAAP and IFRS.
Appendix A: PwC asset management industry IFRS champions

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