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Harnessing the forces of change
IFRS for Investment Funds

Foreword

The forces of change continue to sweep through the industry, impacting management decisions and operational processes at every institution. Compliance requirements are shifting, with new regulations becoming law and new reporting standards being enforced. Capital demands are changing, with a new focus on liquidity and capital efficiency. Customer expectations are evolving, driving demand for new products and increasing the need for service innovation. And competition is responding, with new entrants and emerging financial centers all challenging the established order.

These forces of change can be seen at work in the area of financial reporting, where there is a renewed focus on moving towards a set of globally accepted standards. Most recently the U.S. Securities and Exchange Commission ("SEC") has establishing a 'Work Plan', which aims to provide SEC leadership with the information it needs to decide whether to adopt International Financial Reporting Standards (IFRS) for U.S. issuers. The 'Work Plan' will examine specific areas of concern raised by members of the industry.

This report outlines some of the issues the 'Work Plan' will have to address and highlights the major differences between IFRS and the existing U.S. Generally Accepted Accounting Principles ("GAAP").

As the forces of change continue to transform the industry, financial institutions have a unique opportunity to 'harness' these forces for competitive advantage. By adjusting their strategies and operations to meet the shifting challenges of compliance, capital, customers and competition, institutions can claim a leading market position and generate superior value for all their stakeholders.

Deloitte's Global Financial Services Industry ("GFSI") network is committed to providing continued thought leadership across each of these key areas and helping institutions as they focus on 'Harnessing the forces of change'.

Regards,

Stuart Opp
DTTL Investment Management Sector Leader

IFRS for Investment Funds
The journey towards global standards

As the activities of investors, companies, and markets become increasingly global, use of a single set of high-quality global standards will help provide investors with the comparable financial information they need to make informed decisions about investment opportunities around the world.

In 2008 the U.S. Securities Exchange Commission ("SEC") issued a proposed International Financial Reporting Standards ("IFRS") 'roadmap' and proposed specific rule changes that would permit the use of IFRS for certain U.S. issuers. The roadmap proposed a timetable and appropriate milestones that need to be achieved for mandatory transition to IFRS starting for fiscal years ending on or after December 15, 2014. The rule changes would give certain U.S. issuers, on the basis of specific criteria, the option to use IFRS in their financial statements filed on Form 10-K for fiscal years ending on or after December 15, 2009. The Investment Company Institute ("ICI") supported this convergence but expressed concern with the application of IFRS to investment funds; they suggested that the standards converge toward existing U.S. principles that better serve fund shareholders.

On February 24, 2010, in an open meeting, the SEC voted unanimously to issue a statement expressing its strong commitment to the development of a single set of high-quality globally accepted accounting standards. The SEC affirmed that IFRS are best positioned to be that set of standards for the U.S. market. It also outlined the next steps in its determination of whether incorporation of IFRS into the financial reporting system for U.S. issuers is in the best interests of U.S. investors and markets.

In addition to its emphasis on convergence, the statement recognizes that there are many structural, operational, and transitional issues that would result from such a significant change to the current financial reporting environment. The statement therefore directs the SEC staff to execute a "Work Plan" addressing specific areas of concern that have been highlighted in comment letters to the SEC. The purpose of the Work Plan is to provide the SEC with the information it needs to make a well-informed decision regarding the use of IFRS by U.S. issuers.

After the Work Plan is executed and the Financial Accounting Standards Board ("FASB") and International Accounting Standards Board ("IASB") current convergence projects are completed, the SEC will determine whether to incorporate IFRS into the U.S. financial reporting system. The statement indicates that this determination will be in 2011, in line with the timeline in the SEC's 2008 proposed roadmap for IFRS adoption (see discussion below). The statement notes that if in 2011 the SEC votes to incorporate IFRS into the financial reporting system for U.S. issuers, sufficient transition time would be allowed, with U.S. issuers reporting under such a system no earlier than 2015.

While the SEC did not provide a definitive date for the U.S. adoption of IFRS (as some had hoped), the statement is a step forward in the movement toward the use of one single set of high-quality globally accepted accounting standards in all major markets around the world, a goal endorsed by the leaders of the Group of Twenty nations ("G-20"). Although the SEC still has much groundwork to do to accomplish this goal, the statement and the staff's Work Plan demonstrate a level of commitment to moving forward with IFRS for U.S. issuers.

As acceptance of IFRS in the U.S. becomes imminent, more investment management firms are asking how IFRS affects them, events that would influence the pace of IFRS adoption, and obstacles to consider. As part of ongoing efforts to assist investment management industry executives with IFRS conversion, Deloitte is issuing this document to provide an update to a previous Deloitte whitepaper entitled, "IFRS for Investment Funds: More Than Just Accounting and Reporting" which was issued in December 2008.

Technical accounting issues for investment funds

The challenges highlighted within this document relate to all types of funds, whether registered mutual funds or private investment funds, that convert to IFRS either due to a SEC requirement for registered investment companies, or as a result of an election made by private funds due to investor demands. Public company investment advisors will likely need to address IFRS convergence ahead of investment funds. Registered investment companies are subject to SEC requirements.

Selected accounting differences that impact investment funds

Potential differences	IFRS	U.S. GAAP/SEC
Industry Specific Guidance	IFRS does not provide specific guidance for registered investment companies or private funds. Where specific guidance does not exist for industry specific issues, investment companies following IFRS must look to other IFRS dealing with similar issues, the Conceptual Framework, standards of other standard-setting bodies and, in certain instances, accepted industry practices.	Specific guidance is available for investment companies, principally through the FASB's Accounting Standards Codification ("ASC") Topic 946 – Financial Services – Investment Companies ("Topic 946").
Financial Instruments – Initial Recognition	Securities transactions can be recorded either on a trade date or settlement date basis. When settlement date accounting is applied, an entity recognizes any change in value between the trade date and the settlement date of the financial instruments through profit or loss for assets classified as financial assets at fair value through profit or loss ("FVTPL").	Securities transactions for investment funds must be recorded on the trade date basis.
Financial Instruments – Classification	Investments are generally classified as trading, or designated at fair value through profit and loss. Subsequent measurement depends on the classification of the investments, although it is generally at fair value through profit or loss.	For funds, all investments are accounted for at fair value pursuant to Topic 946. Subsequent measurement is recognized in the statement of operations.
Financial Instruments – Fair Value Measurements	Fair value is based on observable market prices or observable market data. If these are not available, transaction price is deemed best evidence of fair value. Investments are fair valued using bid for long positions and ask for short positions (mid can be appropriate for offsetting positions). There is a detailed guidance on inputs to valuation techniques. IAS 39, paragraph 48A and paragraph AG69-AG82 of Appendix A establishes and describes the framework for fair value measurements. IASB's Exposure Draft "ED" on Fair Value Measurement, which was issued in May 2009, proposed to establish a single source of guidance for all fair value measurements required or permitted by IFRS. This guidance will essentially converge with ASC 820. The IASB expect to issue their final Standard in Q1 2011.	Fair value is assumed to be the exit price. Investments are fair valued but methods vary and there is no specific prescription for long versus short securities. Last traded price is common or mid market as a practical expedient. There is a detailed guidance on three acceptable valuation approaches. SEC registered money market funds generally value investments at amortized cost for financial reporting purposes and disclose that amortized cost approximates fair value. Current exposure draft released May 26, 2010 proposes that money market funds report investments at fair value. ASC 820 Fair Value Measurements establishes the framework for fair value measurement.
Financial Instruments – Transaction Costs	Transaction costs that relate to investments recorded at fair value through profit and loss are expensed.	Transaction costs are recognized as part of an investment's cost.

Selected accounting differences that impact investment funds (continued)

Potential differences	IFRS	U.S. GAAP/SEC
Financial Instruments – New Standards	The IASB published IFRS 9 Financial Instruments in November 2009 which will be updated in three phases. The first piece issued (described below) covers phase one. The IASB aims to replace IAS 39 in its entirety with all three phases of IFRS 9 by Q2 2011. The issued standard introduces new requirements for the classification and measurement of financial assets and is effective from January 1, 2013 with early adoption permitted. All recognized financial assets that are currently in the scope of IAS 39 will be measured at either amortized cost or fair value. Under IFRS 9, most financial instruments are expected to be measured at FVTPL except for debt instruments that satisfy both a "business model test" and a "contractual cash flow characteristics test", as defined by the Standard, and if an entity irrevocably designates an equity instrument as at fair value through other comprehensive income ("FVTOCI"). This new standard is not expected to have significant impact on the current measurement bases for investments held by investment funds.	On May 26, 2010, the FASB issued an exposure draft for a proposed Accounting Standards Update ("ASU") titled, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. This proposal addresses the measurement, classification, and impairment of financial instruments, as well as hedge accounting. Specific provisions which may affect investment companies include the following: • Requirement for money market funds to report investments at fair value rather than at amortized cost. • Expensing of transaction costs associated with financial instrument purchases. • Measurement of financial liabilities at fair value. Comments on the proposed ASU are due by September 30, 2010. The FASB did not propose an effective date.
Set-up costs	Set-up costs should be expensed when incurred.	Organization costs should be charged to expense as they are incurred.
Uncertain tax positions	Funds disclose any tax-related contingent liabilities and contingent assets in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.	In accordance with FASB ASC 740, *Income Taxes*, a Fund is required to determine whether a tax position within the Fund is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement.
Consolidation	Funds are required to consolidate all investments (including other funds and operating companies) over which they have 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". This definition considers two factors: governance and benefits/risks. Governance relates to the power to make decisions, and may or may not be represented by the presence of voting rights. Benefits/risks relate to consequential economic value arising from the decisions that are made. As part of its project on consolidated financial statements, IASB has announced it will propose, subject to comments received on exposure, that investment companies should be exempted from consolidation and should account for controlling interests in other entities at fair value. The exposure draft is expected to be issued in Q4 2010.	Consolidation of operating companies is not appropriate for an investment fund except in the case of operating subsidiaries providing services to the investment fund. If an investment fund is a feeder fund within a "master/feeder" structure, the master fund should not be consolidated but shown using specific presentation requirements as described in Topic 946. Additionally, if an investment fund is classified as a fund of funds, it would not consolidate investee funds but show its investments using specific presentation requirements as described in Topic 946.

Selected accounting differences that impact investment funds (continued)

Potential differences	IFRS	U.S. GAAP/SEC
Classification of Investor Ownership	Shareholder interest is currently expressed as a liability when the interest is redeemable by the investor. An amendment to IAS 32, which was effective for annual periods beginning on or after January 1, 2009 enabled some puttable financial instruments and financial instruments that impose on the issuer an obligation to deliver a pro-rata share of net assets of the entity only on liquidation to be presented as equity. This amendment resulted in certain investment companies presenting their preferred/participating shares as equity. The IASB is currently reviewing the guidance in IAS 32 to address some practice issues, including eliminating current rules-based approaches, and to achieve convergence with U.S. GAAP. This is one of the long-term projects on the IASB's agenda to address issues related to financial instruments. The publication of the exposure draft is currently planned for Q1 2011.	Shareholder interest is classified as equity.
Distributions to Fund Shareholders	Distributions are recognized as transactions in equity and shown in the statement of changes in equity. Distributions flow through the income statement as financing costs if related instruments are recognized as financial liabilities.	Distributions are recognized as transactions in equity and shown in the statement of changes in net assets.

Financial statement presentation and disclosure differences for investment funds

Potential differences	IFRS	U.S. GAAP/SEC
Titles of Financial Statements	1. Statement of financial position. 2. Statement of comprehensive income (or two statements, a separate income statement and a statement of comprehensive income). 3. Statement of changes in equity (or Statement of changes in net assets attributable to holders of redeemable shares if there is no equity). 4. Statement of cash flows.	1.Statement of assets and liabilities (or net assets), which includes a schedule or condensed schedule of investments. 2. Statement of operations. 3. Statement of changes in net assets or statement of changes of partners'/members' capital (depending on structure). 4. Statement of cash flows (may or may not be required under U.S. GAAP).
Comparatives	IFRS requires two years for statements of financial position, statement of comprehensive income, statement of changes in equity and statement of cash flows. When an accounting policy has been applied retrospectively or items in the financial statements have been restated or reclassified, an additional statement of financial position is required. (Therefore, in these limited circumstances, three statements of financial position are required.)	Comparatives are not required except for the statement of changes in net assets for SEC registered funds or funds subject to other regulatory requirements.
Financial Highlights	IFRS does not require presentation of financial highlights (per unit results, total return/internal rate of return and income/expense ratios).	Financial highlights are required for each share class for all periods presented in the financial statements for private funds and for the latest five fiscal years for SEC registered funds. The disclosure of financial highlights is required under U.S. GAAP, either as a separate schedule for each permanent class of share which is not a management class or within the notes to the financial statements.
Schedule of Investments	Disclosure of a schedule (or a condensed schedule) of investments is not required. However concentrated market and credit risk are required to be disclosed as per IFRS 7.	Disclosure of a schedule (or a condensed schedule) of investments is required. This schedule is categorized by type, country, and industry. A full schedule of investments is required for SEC registered funds. Under U.S. GAAP, a condensed schedule of investments or full schedule of investments is required for private funds. A condensed schedule of investments must detail all individual positions and investments greater than 5% of net assets and all investments in any one issuer or underlying greater than 5% of net assets.
Earnings per share ("EPS")	Required for publicly traded funds. The requirement to disclose EPS applies only to those funds whose shares qualify as equity instruments.	Not applicable, as investment funds are excluded from the scope of ASC 260 EPS.
NAV per share	Not required but it is common practice to disclose NAV per share.	NAV per share is required to be presented on the statement of assets and liabilities and per unit changes in net assets are required to be disclosed in the financial highlights for unitized funds.

Financial statement presentation and disclosure differences for investment funds (continued)

Potential differences	IFRS	U.S. GAAP/SEC
Financial Instruments – Disclosure	Separate presentation is required for certain classes of financial assets and liabilities. IFRS prescribe disclosure for financial instruments held by an entity, either individually or as a class. IFRS require significant risk management disclosure.	Like IFRS, separate presentation is required for certain classes of financial assets and liabilities for registered funds. Unlike IFRS, there are no specific presentation requirements for private funds. For derivative financial instruments in private funds, disclosure in the schedule of investments of the number of contracts, range of expiration dates, and cumulative appreciation/depreciation is required if the derivative exceeds 5% of net assets. Also, disclosure of the range of expiration dates and fair value for all other derivatives of a particular underlying which exceed 5% of net assets is required. For registered funds, disclosure is required of all details of each derivatives contract separately. On January 21, 2010, the FASB issued ASU 2010-06, which amends ASC 820 to add new requirements for disclosures about transfers into and out of Levels 1 and 2 and separate disclosures about purchases, sales, issuances, and settlements relating to Level 3 measurements. These amendments are generally consistent with IFRS 7 disclosures. The ASU is effective for the first reporting period (including interim periods) beginning after December 15, 2009, except for the requirement to provide the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis, which will be effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Early adoption is permitted.
Cash	Overdrafts may be included in cash balances. The policy should be disclosed in the footnotes, and consistency of policies across the investment complex should be considered.	Overdrafts are generally excluded from cash balances and disclosed separately.
Statement of Comprehensive Income/Statement of Operations Format	IFRS does not prescribe a standard format, although expenditure is presented in one of two formats (function or nature). Certain minimum items are presented on the face of the statement of comprehensive income. Interest income on fixed income securities not required to be separated from gains/losses.	Present as either a single-step or multiple-step format. Expenditures are presented by function. U.S.GAAP requires separate presentation of investment income (i.e., dividends and interest) for investment funds. Registered funds should follow SEC regulations.
Realized and Unrealized Gains/ (losses) on Investments	IFRS does not specifically address whether the disclosure of net realized gains (losses) and net change in unrealized appreciation (depreciation) should be presented separately for investments which are determined to be fair valued through profit and loss.	Net realized gains (losses) and net change in unrealized appreciation/depreciation should be disclosed separately. There is no requirement to separately break out derivatives on face of statement of operations (see Risk Disclosures below).

Financial statement presentation and disclosure differences for investment funds (continued)

Potential differences	IFRS	U.S. GAAP/SEC
Statement of Cash Flows – Exemptions, Format and Method	Required for all funds. Direct or indirect method is permitted. Specific differences in presentation exist versus requirements of U.S. GAAP. For example, interest and dividend income/expense and interest and dividends received/paid are broken out separately on the statement of cash flows.	If certain conditions are met, an investment company may be exempted from presenting a statement of cash flows. The direct or indirect method is permitted.
Authorization of Financial Statements	Disclosure is required on who approved the financial statements and on what date.	In accordance with ASC 855 Subsequent Events, management must disclose the date through which subsequent events have been evaluated and whether that is the date on which the financial statements were issued or were available to be issued.
Risk Disclosures	IFRS 7 has robust and specific quantitative and qualitative risk disclosure requirements. IFRS 7 requires disclosures related to the nature and extent of risk exposure of investments including credit risk, liquidity risk, interest rate risk, market risk, and currency risk. For market risks, sensitivity analyses must also be disclosed, either for each market risk or in the aggregate.	ASC 815 – Derivatives and Hedging requires qualitative and quantitative disclosure regarding the investment company's objectives for holding and using derivative instruments. Tabular disclosure of the location by line item of gross fair value amounts in the statement of assets and liabilities and the location by line item, of amounts of gains and losses reported in the statement of operations by underlying risk exposure (e.g., interest rate risk, credit risk, foreign exchange risk or equity risk). The level of derivative activity during the period also needs to be disclosed.
Segment Reporting	Segment Reporting is required for all entities whose debt or equity instruments are traded in a public market. Only funds that traded in a public market are under the scope of IFRS 8. Public market under IFRS 8 does not only include domestic and foreign stock exchanges but also OTC markets and local and regional markets. Open-ended investment funds that are offered and redeemed only in private transactions between the fund and the shareholders are not considered to be "traded in a public market".	Not required for funds.

IFRS for Investment Funds: Next steps

Above highlighted are the main technical areas where IFRS and U.S. GAAP are comparable and divergent. Pending confirmation from the SEC of the possibility of U.S. adoption of IFRS, investment fund industry groups from both the U.S. and elsewhere are currently asking the IASB to reconsider the accounting standards which are in place for investment funds and rather than the "one fits all" approach to standard setting, to consider the issue of a prescriptive set of standards for application by investment funds.

There are a number of key issues for investment funds when applying full IFRS:

- Significant inconsistencies in information that U.S. investors expect as opposed to what is actually disclosed, for example, as stated above, IFRS does not require the disclosure of a schedule of investments.
- Different measurement basis for financial assets and liabilities under IFRS and per the offering memorandum which leads to a different NAV per share in the financial statements to investor statements issued.
- Increasing and sometimes irrelevant disclosure regarding the investment funds risks and sensitivity analysis to these risks which may be misleading to investors.

A number of international bodies who represent the interest of the investment fund industry have expressed similar sentiment to the above and believe that future consideration is necessary on the future of IFRS for Investment Funds. The U.S. Investment Company Institute ("ICI"), a national association of U.S. investment companies, issued a letter to the SEC recommending that the SEC ensure that there was substantial convergence relating specifically to investment company financial reporting before providing investment companies with the option to produce IFRS financial statements. The European Funds and Asset Management Association ("EFAMA") released a discussion paper on discussing the application of IFRS to investment funds. The EFAMA paper describes a number of significant issues in IFRS that must be addressed before IFRS can be meaningfully applied to investment funds.

In February 2010, the Irish Funds Industry Association ("IFIA") responded to a policy proposal from the U.K. Accounting Standards Board ("ASB") on The Future of U.K. and Irish GAAP. Within this response the IFIA proposed the development of a separate framework for IFRS for investment companies. They stated that this could be carried out in a similar fashion to the IFRS for SME project. The IFIA proposed that an IFRS for investment companies have the following basic features:

- Measurement principles consistent with full IFRS (though removing some of the options available for different measurement basis in full IFRS).
- Primary statement presentation that more clearly reflects the nature of investment funds with a focus on the key metrics of net asset value and net asset value per share.
- Meaningful disclosure requirements that focus on the key risk and uncertainties within investment funds.

The IFIA believe that the development of an IFRS for investment companies is the viable route to full convergence, given that U.S. GAAP explicitly recognizes investment companies as a separate class of entities.

The ASB has issued tentative decisions in its redeliberations of its policy proposal issued in August 2009. One of these is to retain a number of Statements of Recommended Practice ("SORP") for Authorized Funds and the SORP issued by the Association of Investment Companies ("AIC"), however these will be additional guidance for the industry for use in conjunction with full IFRS. The ASB's next steps include developing and drafting a Financial Reporting Exposure Draft ("FRED") for consultation which they hope to issue by the end of 2010. The IASB has not yet recognized the need for such a framework within IFRS and therefore it does not form part of the IASB Work Plan in the foreseeable future, an outcome which may disappoint many in the investment management industry.

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Designed and produced by The Creative Studio at Deloitte, London. 7607A

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Item# 100175