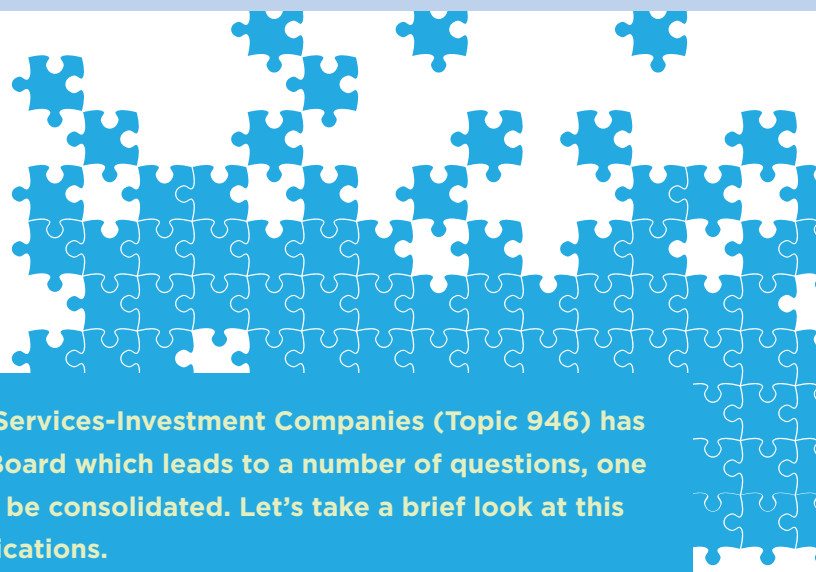


By Leonard Hecht, CPA and Frank R. Boutillette, CPA

DO HEDGE FUNDS NEED TO BE CONSOLIDATED?



A proposed accounting standards update, **Financial Services-Investment Companies (Topic 946)** has been issued by the **Financial Accounting Standards Board** which leads to a number of questions, one of which is to consider whether hedge funds need to be consolidated. Let's take a brief look at this proposed accounting standards update and its ramifications.

WHO IS AFFECTED?

The amendments in this proposed update would affect entities currently within the scope of Topic 946 that do not meet the revised definition of an investment company. Several kinds of investment companies exist, including: management investment companies, unit investment trusts, common (collective) trust funds, investment partnerships, certain separate accounts of life insurance companies and offshore funds.

In addition, an entity that invests in real estate properties and meets the criteria of an investment property entity under the proposed Accounting Standards Update *Real Estate-Investment Property Entities (Topic 973)*, would be deemed to not be an investment company.

Investment companies that have controlling financial interests in other investment companies (Fund of Funds) would also be affected by the proposed amendments because they would be required to consolidate their investment company (hedge fund) subsidiaries.

HOW DOES THIS CHANGE CURRENT STANDARDS?

1. Amends the investment company definition in Topic 946 and provides implementation guidance for assessing whether an entity is an investment company and improves comparability with the definition included in International Financial Reporting Standards (IFRS). An investment company, as used in Topic 946, generally is an entity that pools investors' funds to provide

the investors with professional investment management. Investments typically consist of securities of other entities, but may also include commodities, securities based on indexes, securities sold short, derivative instruments, and other forms of investments

2. Requires an investment company to consolidate another investment company or an investment property entity if it holds a controlling financial interest in the entity in a fund of funds structure.
3. Amends the financial statements and financial highlights presentation requirements for situations in which an investment company consolidates a less than wholly owned investment company or a less than wholly owned investment property entity.
4. Prohibits an investment company that is able to exercise significant influence over another investment company or an investment property entity from accounting for its interest using the equity method of accounting; fair value is used instead.
5. Requires additional disclosures including changes in an entity's status as an investment company, whether the investment company has provided support to any of its investees, and any significant restrictions on an investees ability to transfer funds to the investment company.

WHEN WILL THIS BECOME EFFECTIVE?

The proposed amendments would be effective for an entities interim and annual reporting periods in fiscal years that begin after the effective date.