

## **Movement toward IFRS: What is the potential impact on processes, systems, and controls for investment companies?\***

A transition to International Financial Reporting Standards (IFRS) from US generally accepted accounting principles (US GAAP) is inevitable for US public companies and, ultimately, investment companies. Although the time frame is uncertain, a wave of convergence that will bring an unprecedented magnitude of accounting changes in the United States is expected within the next several years. The effects of the move will reach far beyond financial reporting processes, touching every aspect of the business, including internal processes, systems, and controls. As investment companies plan for their successful implementation of IFRS, they will need to adopt new methods of generating and gathering financial data. However, it's vital that the decision makers gain an understanding of the differences between US GAAP and IFRS before they take the first steps of convergence.

### **Highlights**

- A timeline to transition has not been set, but the SEC is currently reviewing public comments from their proposed IFRS roadmap, and are expected to address this again by early 2010.
- IFRS implementation could have significant impact on investment companies' financial statements, particularly areas such as valuation, classification of capital, consolidation and risk disclosure.
- Early action will help control costs, manage the challenging scope of implementation, and allow for a smooth transition.

### **What are the significant accounting areas where investment companies will be impacted by IFRS?**

#### **Accounting policies, reporting and disclosure**

IFRS requires changes to accounting policies with new financial statement layouts and more comprehensive disclosures. This change will allow for a fresh look at accounting policies.

#### **Reporting of net asset values**

As the requirements of IFRS change the recording and valuation of certain assets and liabilities, the net asset values (NAVs) unit price may be different from the financial reporting NAV.

#### **Multi-GAAP reporting**

Under IFRS, investment companies may need to prepare comparative financial statements, under both US GAAP and IFRS.

#### **Data inputs**

IFRS may require new data for more detailed disclosures, and there may be changes with respect to data inputs required for the valuation of investments.

#### **No exceptions for investment companies regarding consolidation**

Under IFRS, consolidations apply to all investments that are controlled by an investment entity, which likely will impact many master feeder funds, fund of funds, and private equity funds.

# SEC roadmap for voluntary IFRS application

The Securities and Exchange Commission (SEC) recently proposed a roadmap for voluntary application of IFRS for certain qualifying US registrants. Before the comment period ended in April 2009, the SEC received numerous comments from a wide range of constituents. The SEC is currently analyzing these comments, and PricewaterhouseCoopers expects that the commission will address the roadmap again either later this year or early in 2010. The proposed roadmap targets potential mandatory adoption for US registrants for accelerated filers in 2014, with other companies to adopt within the following two years. Investment companies are not among those contemplated in the current proposed roadmap; they will need to be considered separately.

However, as other companies are required to move to IFRS, investment companies may be included. The firm believes that the SEC will continue to approach change with a thoughtful, measured process and ultimately will propose a revised roadmap with a possible slower timetable for change.

There are many distinctions between IFRS and US GAAP. One big distinction is that, unlike US GAAP, IFRS is not industry-specific, so there is no accounting framework designed specifically for investment companies. Therefore, investment companies should be aware of the potential impact a move to IFRS could have on their financial statements in areas such as valuation, classification of capital, consolidation, and risk disclosures.

# A movement to IFRS requires change

## What is the potential impact of IFRS on fund management, accounting, and administration?

- Fund management needs to ensure controls are placed in operation with regard to accounting policy elections, decisions made regarding consolidation, and the capturing of data for potential new disclosure requirements.
- Fund accounting may need to update systems to capture changes in data inputs, system calculations, and the generation of new reporting. Furthermore, there may be a need to perform a reconciliation between the NAV used for unit pricing and the reported NAV.
- Fund administration will need to implement or update controls to support the correct application of new accounting policies and ensure that fund reporting systems and related procedures are updated to include changes with respect to financial statement preparation, including new disclosure requirements.

It can take a substantial amount of time to change an organization's processes, systems, and controls; adopt new governance practices; and train its people accordingly. Therefore, now is the time to begin thinking about an IFRS strategy. Early action will control costs through timely and effective planning, enable staff members to understand and manage the challenging scope of an implementation, and allow for a smooth transition.

Changing accounting policies will be a key element of the transition plan as it relates to funds. The policies elected will drive many of the changes required by the fund. Based on the accounting policy elections of the fund, existing processes and controls will need to be adapted to capture new data requirements and generate new financial statements and disclosures. Fund accounting and fund administration systems will need to be configurable to apply the policy elections for all the funds serviced. Convergence will offer a fresh opportunity for companies to reassess and revamp financial processes and controls, as well as the technology that supports them, including:

- Redefining training requirements for staff and management based on the skills and knowledge bases needed to generate and report accounting information under this new standard
- Making accounting policy choices with a clearer understanding of the impact on key performance measurements and indicators
- Promoting greater accountability and transparency while improving communication to relevant stakeholders

## The impact on systems and controls under IFRS

Financial reporting risks and associated control activities likely will change as a result of accounting and systems changes. Fund management should see that accounting and administration functions are taking necessary steps to ensure systems and controls are updated or upgraded to capture the fundamental accounting changes required with a conversion to IFRS. The new accounting standards will affect how data is captured, processed, reported, and how results are analyzed. As investment companies evaluate their options, it's essential to integrate IFRS into the overall IT strategy, ensuring systems can support IFRS compliance. The transition may require significant changes to the existing technology environment within accounting and administration functions. The IFRS impact on systems should be identified early so changes can be integrated into IT plans in order to minimize the cost and challenges.

Several key considerations surround choices in IT and quality standards for data accessibility, availability, and integrity. Underestimating the technological challenges involved with IFRS convergence has led some international companies to rush this complex process, leaving more room for error and driving up costs. Questions to consider include:

- Does the existing IT infrastructure permit ease of access to the information required by IFRS?
- If not, can data be obtained by reconfiguring systems appropriately, and at what cost?

- Can existing systems generate, store, and report two sets of financial data: one for IFRS and one for US GAAP?
- How capable are current systems in producing financial statements in an efficient and effective manner?

The following list includes certain controls and considerations that fund management, accounting, and administration can apply as they assess and implement IFRS reporting requirements. Although not comprehensive, this list provides examples for your consideration:

### Fund management

- Consolidation is one of the areas in which significant differences exist between the accounting framework under US GAAP and IFRS for investment companies. Management needs to review investee companies and determine whether consolidation is required. Management also should have processes and controls in place to determine whether scope exceptions for investments in associates can be applied.
- IFRS provides options relating to the format of certain financial statement reports (e.g., statement of assets and liabilities) and individual line items (e.g., expenses). From a control perspective, fund management should review and approve the formats that provide the most relevant and reliable information to users.
- The disclosure of financial highlights, including the disclosure of the entity's NAV, is not required under IFRS. However, management should have processes and controls in place to determine whether to include financial highlights, in order to present the fund's performance.
- Requirements under IFRS 7 Financial Instruments: Disclosures are more onerous than US GAAP. Management needs to have controls in place to ensure that appropriate data is identified and captured to meet these requirements. For example, qualitative and quantitative information is required for new risk disclosures.
- Management should identify, review, and approve new accounting policy elections and determine the presentation that will provide shareholders with the most insight. Compared with US GAAP, IFRS allows more judgment and options in applying accounting policies in many areas such as:
  - Accounting for regular way trade transactions; regular way trades can be accounted either on a trade date or settlement date basis
  - The calculation method to be applied to the cost of an investment (e.g., weighted average cost or FIFO) when derecognizing assets
  - Grouping of realized and unrealized gains (losses) within the income statement

### Fund accounting and fund administration

- Systems may need to be updated in order to generate, store, and report multi-GAAP financial information and data for each fund. This is critical for accounting periods prior to the adoption date, as under the current roadmap results will need to be disclosed using both US GAAP and IFRS.
- A reconciliation may need to be performed between the NAV used for unit pricing to the reported NAV, to explain differences to shareholders. 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 a short position. However, a fund may continue to value its investments on the last-traded or midprice on a daily basis. In other words, if a different valuation method is prescribed by an investment company's offering document, it may result in a different NAV for IFRS versus the investment company's redemption price under the offering document.
- Systems, and certain automated controls, may need to be updated to address new IFRS requirements, including the following areas:
  - Recording and classifying financial instruments appropriately. Financial instruments may be classified differently under IFRS than under US GAAP as a result of the differences in the definition of a financial liability (i.e., more instruments may be classified as liabilities under IFRS). 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.
  - Capturing relevant pricing information and applying IFRS-mandated fair value pricing techniques for certain financial instruments (e.g., under IFRS, bid prices should be applied for the pricing of long positions, and asking prices for short positions).
  - Accounting for the initial recognition of assets. Specifically, if the financial instrument qualifies as a regular way trade, then fund management is required to make an accounting policy election of accounting for the transaction, either on a trade date or settlement date basis. Most investment companies applying IFRS have been recording trades on a trade date basis for regular way sales and purchases; however, this may result in necessary system and control changes if policy changes are made in this area.
  - Under IFRS, when derecognizing assets, the cost of investments needs to be calculated based on the calculation method elected by the fund (e.g., weighted average cost or FIFO). As a consequence, certain system calculations may need to be updated, including the calculation of unrealized/realized gains and losses on investments.
  - Under US GAAP, the equity method of accounting is specifically prohibited for investment companies. But with regard to consolidation and accounting for investments in associates, it is required under IFRS in cases where the fair value may not be reliably measured (e.g., investments in emerging markets). Systems and controls may need to be updated to apply the equity method.

- US GAAP and IFRS both require the application of the effective interest method for recognizing interest income and expense. However, system and control changes may be required as differences may arise in the detailed application of the effective interest rate method because there is no requirement under IFRS to separate interest from the fair value movements for instruments carried at fair value through profit or loss.
- Capturing and applying transaction costs dependent on the measurement of assets and liabilities. Transaction costs should be expensed immediately for financial assets and financial liabilities at fair value through profit and loss (P&L); however, capitalization of such costs is required for all financial assets and liabilities that are not measured at fair value through P&L.
- Under IFRS, real estate investments need to be recorded based on the fund election of the cost model or the fair value model with the change in fair value recorded through earnings. Under US GAAP, investments in real estate should be reported at their fair value. Therefore, systems and controls may need updating to apply the cost model, if chosen by fund management.
- During initial adoption, fund administrators will need to prepare and review comparative financial statements, including a balance sheet, a statement of comprehensive income/income statement, a statement of changes in equity, a cash flow statement, and notes to the financial statements.
- Fund administration should update financial reporting checklists and prepare and review new disclosures to ensure they are complete and accurate (e.g., changes in accounting policies, IFRS 7 Financial Instruments: Disclosure Requirements, etc.).
- Fund administration should update systems and controls with regard to the preparation and review of financial statements to ensure accurate reporting of changes such as:
  - Minimum items have been captured on the income statement and have been broken out correctly by nature or function (as defined by the fund).
  - Appropriate presentation of interest income and foreign currency gains/losses are made for asset categories.
  - Withholding tax is presented as a separate component of income tax when required.
  - Bank overdrafts are classified within cash and cash equivalents if they are part of the investment company's overall cash management.
  - Under IFRS, a statement of cash flows is provided. IFRS encourages the use of the direct method, but most investment companies use the indirect method in preparing its cash flows. Fund administrators should ensure cash flows are prepared in accordance with fund management instructions.

## Conclusion

The asset management industry faces three near-term challenges:

- Unprecedented accounting transformation, driven by continued convergence of standards
- Increasing interest in IFRS accounting outcomes
- Continued focus on longer lead-time differences between IFRS and US GAAP, as the convergence projects will not address all differences

To face these challenges, investment companies should:

- **Focus on the challenge.** Stay focused on the unprecedented US financial reporting changes and the impact they will have.
- **Perform an assessment.** Identify operational, accounting, tax, investor systems, controls, and workforce-related issues.
- **Be ready to adapt to ongoing change.** Consider using scenario planning to incorporate likely convergence and IFRS adoption expectations into strategic thinking and business planning.
- **Monitor actual changes.** Consider how the actual accounting changes will influence service providers, internal processes, systems, and controls.

- **Identify what you can do now.** Stay focused on those aspects of convergence and conversion that have a long lead time and consider small one-off projects and “easy wins,” where desirable.

Although the time line to transition has not been set, forward-looking investment companies understand the importance of getting a jump on the transition to IFRS. They are already planning their IFRS strategy and taking steps to assess the impact on processes, systems, and controls, such as the multi-GAAP reporting challenge. Early action will allow proactive companies to control costs, understand and manage the challenging scope of implementation, and achieve a smooth transition to IFRS.

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