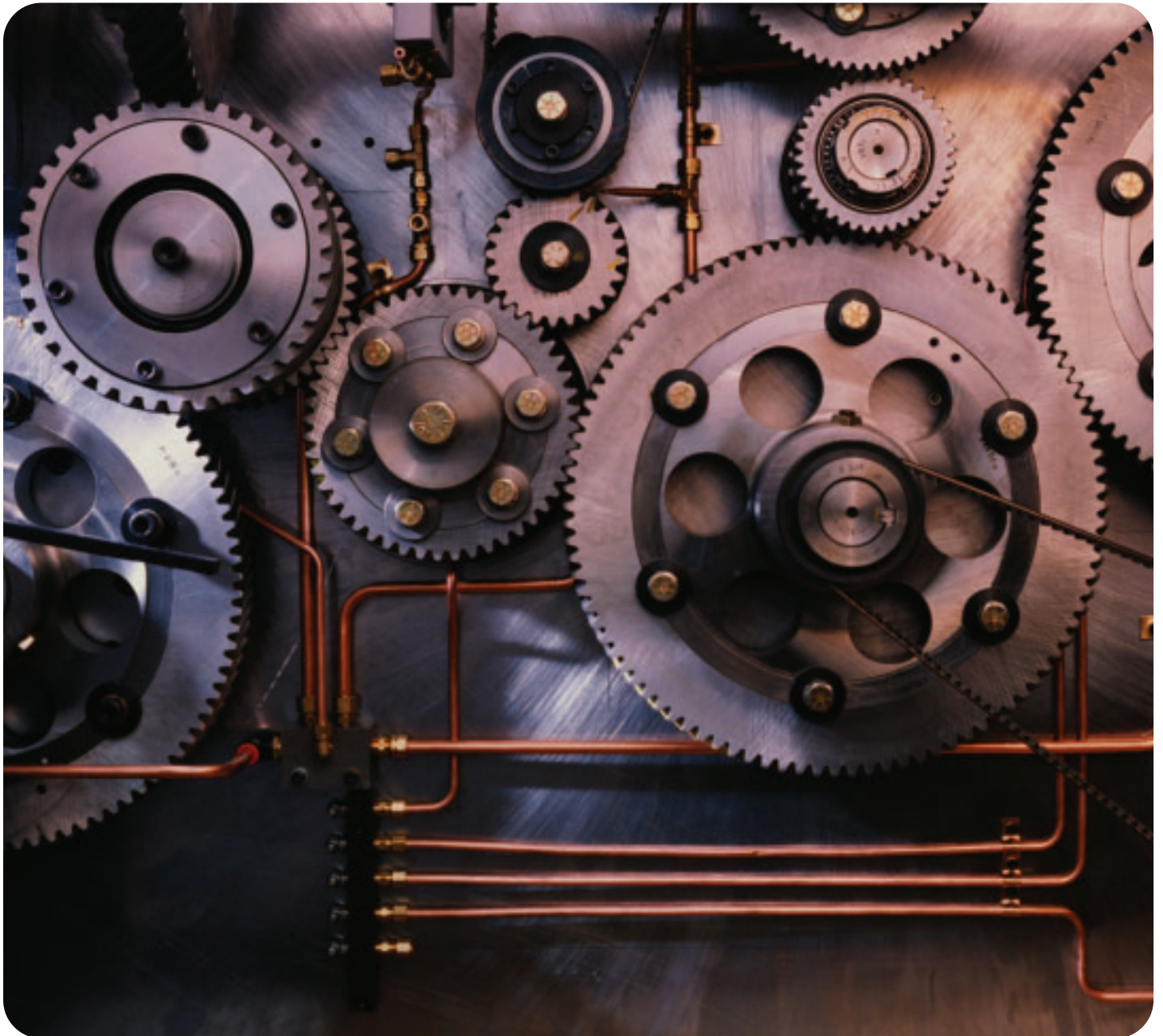


# Getting to grips with IFRS

Making sense of IFRS for the Investment Management industry\*



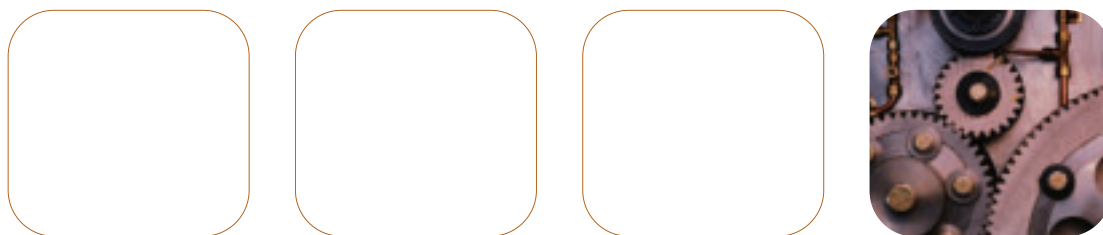
IFRS – Global Reporting Revolution  
January 2006

\*connectedthinking

## IFRS checklist

IFRS is changing the 'language' of financial disclosure and the criteria by which companies are viewed by the markets.

- Are your information and disclosure systems up to speed?
- Do you understand how IFRS could affect your reported numbers including any potential earnings volatility/surprises?
- Do you understand how IFRS could affect the valuation of your funds under management and the potential impact on your fees calculation?
- Do marketing, fund management and other frontline staff understand how IFRS could affect the valuation, consolidation and possible location/functional currency of funds?
- Do your IFRS numbers stand up to auditor, market and regulatory scrutiny?



## Introduction and Overview

International Financial Reporting Standards (IFRS) are changing the way financial statements are presented and the criteria by which companies' performance and prospects are judged by customers, analysts and investors.

In an increasingly global investment management (IM) sector and ever more competitive capital marketplace, the move to IFRS has been welcomed as an opportunity to improve the comparability of financial statements and help companies to compete for investment with businesses from other countries and industries. The move to IFRS will also lead to the development of improved management information systems which could also enhance the basis for decision-making and help meet stakeholder demands for more open and useful disclosure.

Initially, however, there may be some uncertainty as investment managers and the users of their accounts grapple with a new regime. The impact of IFRS on the IM sector is in many ways even more pervasive than almost any other commercial field, not least

because of the high level of financial assets on the books of investment funds. The adoption of IFRS criteria could affect the valuation of funds under management, the calculation and recognition of fees by fund managers and thus give rise to potential earnings volatility/surprises. Failure to anticipate and adequately explain these changes could lead to accounting errors and restatements and, in turn, regulatory fines and the undermining of market credibility.

Good communication is particularly important in an environment where all companies moving to IFRS are facing the enormous challenge of finding the right data for the new requirements and putting appropriate controls in place for the new information. At the same time users and regulators are not necessarily experienced at interpreting IFRS accounts.

IFRS reporters and users must also get used to ongoing change. The details of IFRS and their application are still evolving. Indeed, even companies that already published IFRS statements prior to 2005 will find that key elements have changed, including the determination of the functional currency.

Among the requirements for the valuation of investments under IFRS is the mandatory use of bid pricing as the best fair value measure of quoted securities. This is a change from the mid to last traded price favoured by many investment managers. Companies therefore need to explain and reconcile any possible discrepancies between IFRS fund valuations and the day-to-day pricing based on different measurement criteria.

However, for those investment funds based in jurisdictions where regulation or legislation does not allow different measurement criteria to be adopted, other than those prescribed by relevant accounting standards, such a reconciliation will not be required since they must comply with IFRS even for the day-to-day pricing.

Figure 1 | Impact of IFRS on asset management value chain

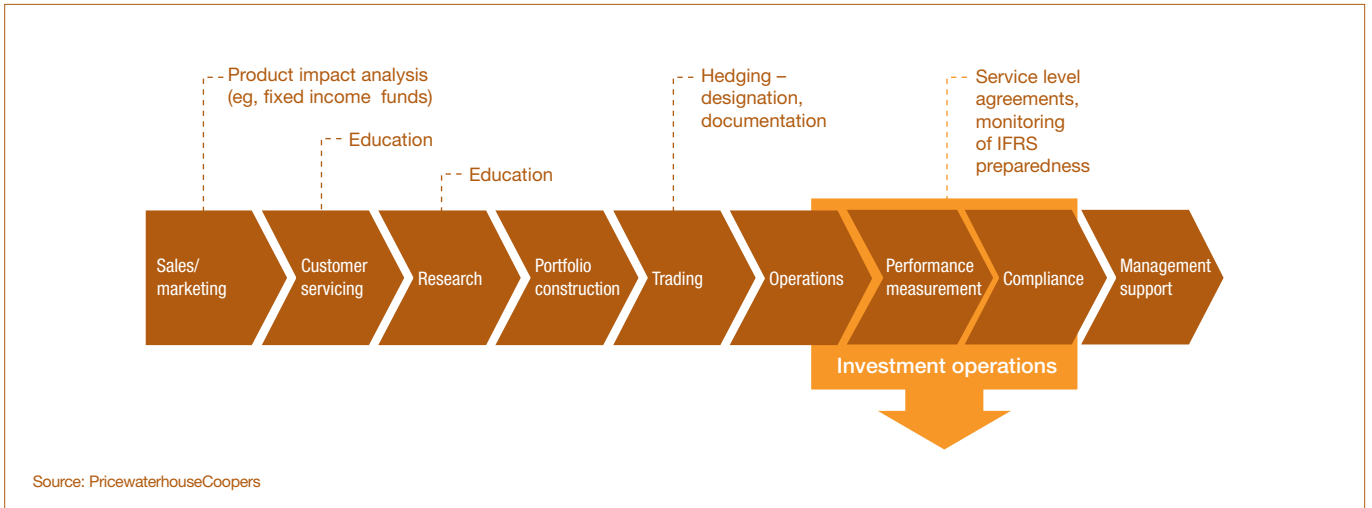
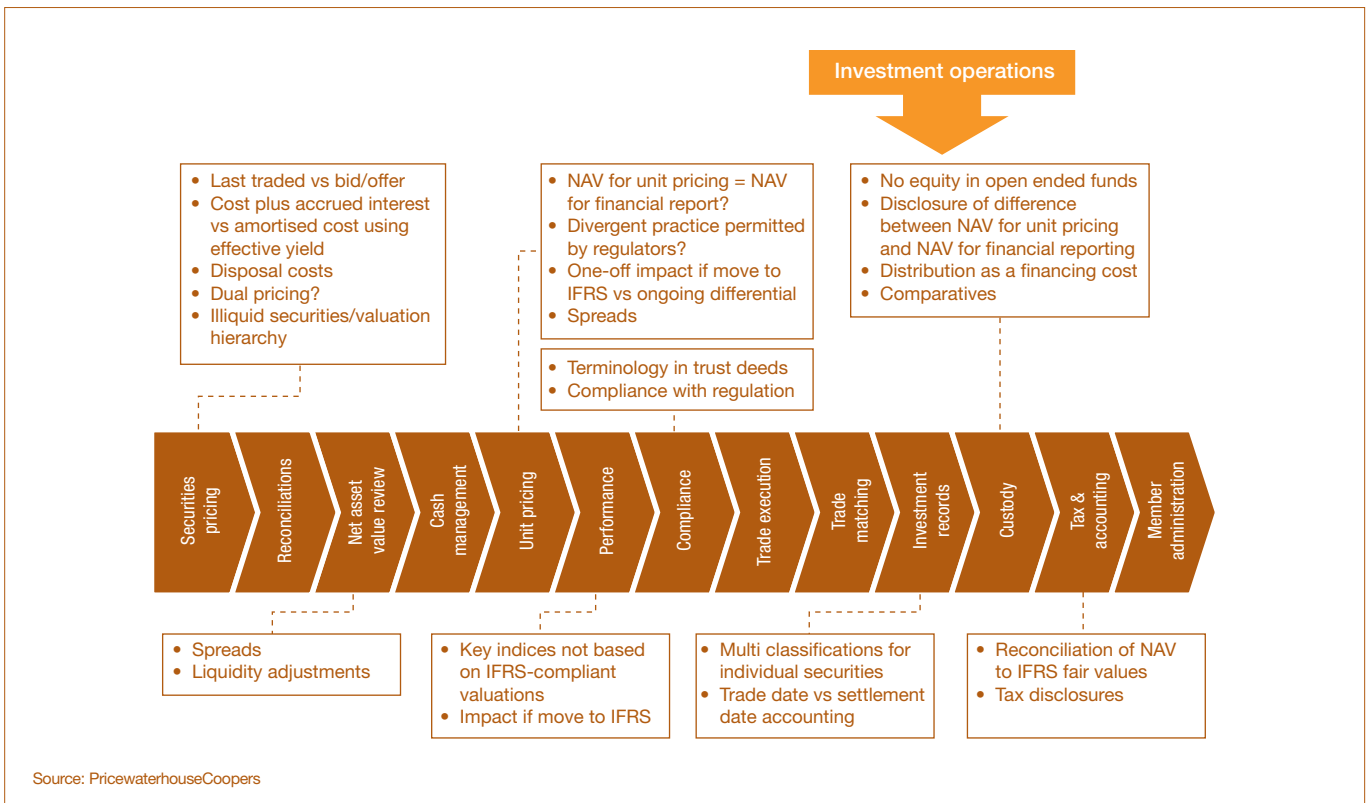
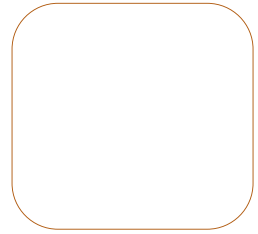
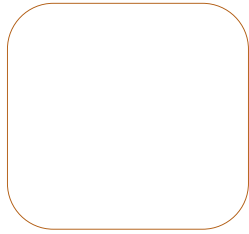
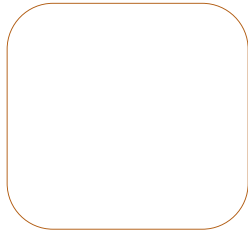


Figure 2 | Impact of IFRS on asset management value chain





These fundamental bottom-line changes are likely to be compounded by an overhaul of the rules governing consolidation and revenue recognition for asset managers. Each company will need to think through the impact and implementation issues for them and ensure that the expectations of investors and the public are carefully considered in communications strategies. This will help to avoid any erosion of market credibility.

The scale and complexity of the logistical challenges involved in moving to IFRS are becoming evident as more and more companies make the change. Many investment managers and fund administrators engaged in fund valuation have found their information and disclosure systems wanting. As a result, many have needed to invest in short-term tactical solutions to produce the initial 'numbers'. This includes the use of 'quick fix' spreadsheet reconciliations. Many have also been forced to rely on increasingly scarce and expensive contractors. Without the development of reliable and sustainable IFRS systems and the significant transfer of knowledge to staff within the business, companies may find themselves in equally challenging situations when the next set of accounts fall due.

Some still appear to view IFRS as primarily a back-office book-keeping issue with limited implications for the fundamentals of the business. It is true that IFRS need not affect the underlying economics of the entity. However, it does represent a change in the 'language' of financial disclosure and the criteria by which companies are viewed by the markets.

Investment funds are facing significant shifts in fund valuations, investment designation and currency measurement. Fund managers are facing fundamental changes in the way revenue is recognised and items such as trail commissions are accounted for and how these could impact provision for taxation. These developments could clearly affect key areas of the business ranging from product offerings and the bases for fees and bonus evaluations through to taxation, investor relations and acquisitions (see Figures 1 & 2).

This paper is designed to help you understand the potential implications of these changes for your business so that you can ensure the risks are appropriately addressed and the rewards of having improved and internationally comparable financial information are realised.

This section examines the main technical, logistical and business implications of IFRS and how investment managers can steer a safe course through the uncharted waters ahead.

## Impact on investment funds

### Fund valuation

The requirement to fair value the vast proportion of equities, bonds and other financial investments under IAS 39 might seem relatively straightforward for a sector where marking to market is routine. However, for financial instruments quoted in an active market, IAS 39 insists that companies should usually base the fair value on the current bid (for long position) or asking price (for short position), rather than on the mid to last traded price commonly used by the fund industry.

Under IFRS companies can also choose to hold appropriate assets until maturity at amortised cost ('held-to-maturity' classification). However, for investment funds that are open to

'The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price.'

**IAS 39 AG72**

subscriptions and redemptions, it would be difficult to demonstrate that the funds have the ability to hold the investments to maturity as required under IFRS, in which case the held-to-maturity classification is unlikely to be an option for such funds.

In practice, therefore, investment managers may find they need to look at how they structure their products and overall portfolio, especially for fixed income funds which have sometimes adopted amortised cost as a basis of valuation for the investments.

Many entities in countries where the regulations do not mandate compliance with relevant accounting standards for the purpose of their funds' day-to-day pricing are continuing to use industry techniques to fair value their day-to-day pricing. They are confining the 'accounting' alternative required by IFRS to their statutory statements. Running what are in effect parallel reporting frameworks places huge demands on already hard-pressed systems, as well as giving rise to considerations about regulation, offering documents and communications with investors. In particular, any inconsistencies in the valuations are likely to confuse users of accounts already struggling to make sense of an unfamiliar new reporting regime.

### Market communications

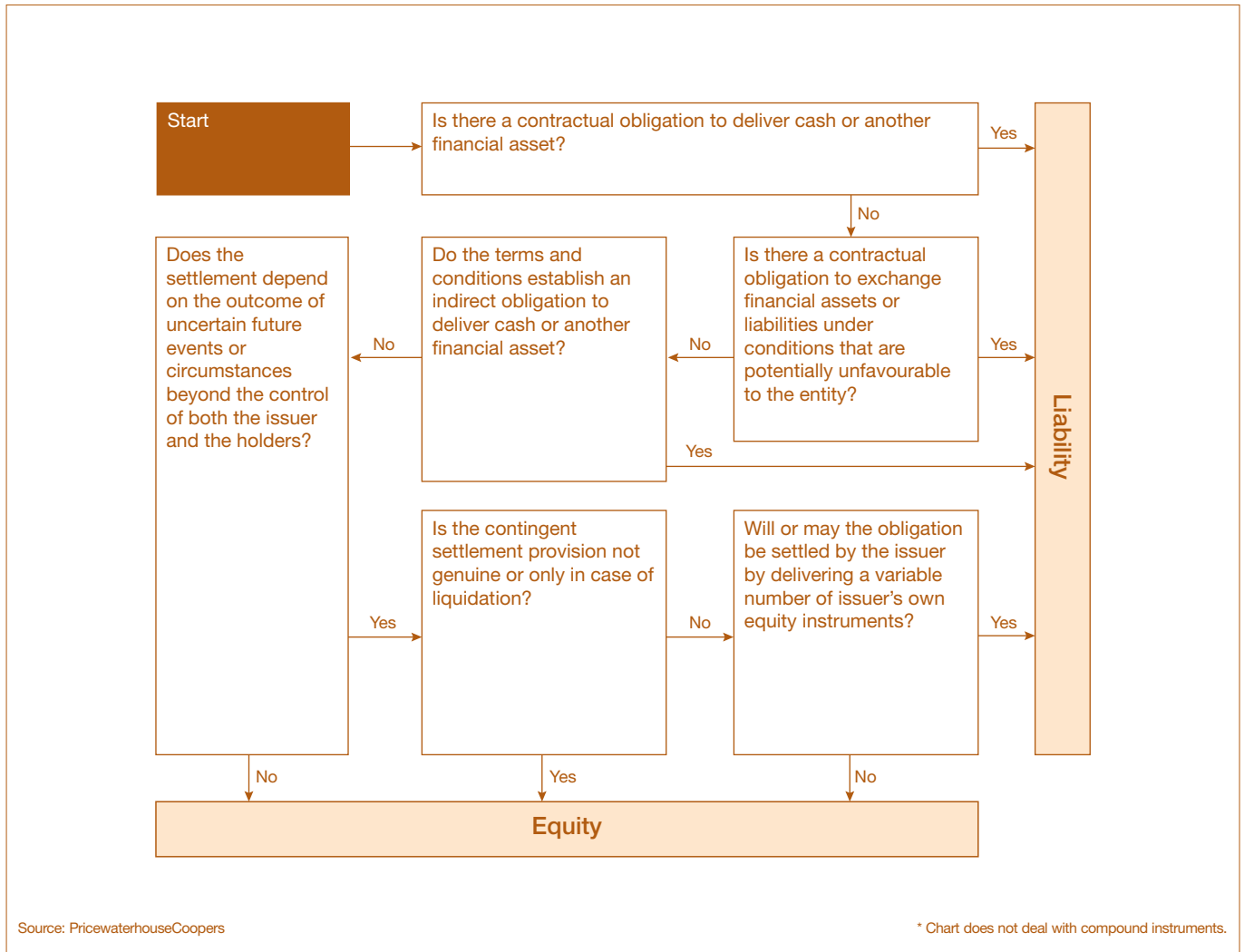
At the very least, companies need to carefully explain and reconcile any differences between their day-to-day pricing and their IFRS statutory statements to analysts, investors and customers. Business and share values may suffer if they cannot. Companies also need to decide which of the value criteria will be used as the basis for fees and whether reconciliations are reliable.

The alternative would be for entities to switch to a consistent IFRS fair value approach for both the purpose of financial reporting and for day-to-day pricing. These anomalies will be ironed out in time. However, they leave companies with difficult choices about exactly how to apply IFRS and sustain stakeholder confidence.

Another anomaly with market practice is in respect of the treatment of redeemable share capital. IFRS may require redeemable share capital to be treated as a liability rather than equity. In general, if there is an obligation to pay cash, the instrument is likely to be deemed a liability (see Figure 3). Where a fund is established as an open-ended fund allowing the stakeholders to redeem their shares at their option, this will currently result in such shares being treated as liabilities instead of equity. While this may not necessarily



Figure 3 | Redeemable Participating Shares Fund Share – Equity or liability under IAS 32?



affect the way the fund operates, companies need to consider whether their current documentation in the relevant constitutive documents is still appropriate as fund documentation often defines 'Net Asset Value' (NAV) as assets minus liabilities.

With the change in classification and presentation of the 'Net Asset Value' as a liability required by IAS 32 the definition of Net Asset Value in fund documentation may need to be changed to reflect the change in the treatment required by accounting standards.

However, dual net asset valuations will disappear from funds that include puttable shares classified as liabilities, as IAS 39 currently requires that such shares are fair valued and this will generally be represented by the price at which the investors in the fund can redeem their shares from the fund. Funds may still need to value the portfolio on both bases to determine the difference. Effectively funds are expected to revalue their investment portfolio under IFRS bases and thereafter as their redeemable shares are treated as liabilities requiring fair valuation under IFRS, the net assets attributable to redeemable shares will be valued at their original day-to-day pricing basis.

It should also be noted that the treatment of redeemable shares being treated as liabilities may change in future as the International Accounting Standards Board ('IASB') is considering revisiting this treatment.

Investment managers need to take account of the direct and cumulative impact of these and other detailed changes on the way their balance sheets and results for the period are measured and disclosed.

### Functional currency

IAS 21 replaces the 'measurement currency' with a more rigid and precisely determined 'functional currency' (FC).

Entities are required to maintain their accounting books and records in their functional currencies. The FC is the denomination of the 'primary economic environment in which the entity operates'. As the panel below highlights, the identification of the FC is not a free choice and the rules and guidance are extensive. In effect, the FC places more emphasis on where the fund's primarily operates and less on the denomination of the transactions. Once established, the FC cannot change unless the primary

economic environment also alters. Shifts in FC are therefore likely to be rare.

### How to identify a functional currency

(a) Primary indicators;

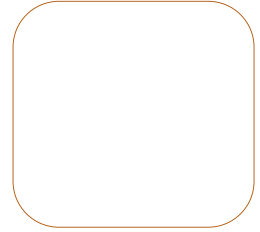
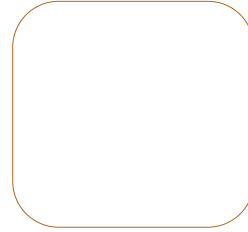
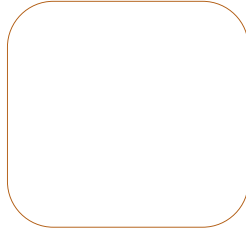
'...functional currency is the currency of the primary economic environment in which the entity operates...'  
IAS 21, para 8

'The primary economic environment in which an entity operates is normally the one in which it primarily generates and expends cash.'

An entity considers the following factors in determining its functional currency:

(a) the currency:

- (i) 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
- (ii) of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services...'  
IAS 21, para 9



(b) Secondary indicators

‘The following factors may also provide evidence of an entity’s functional currency:

- (a) the currency in which funds from financing activities (ie ,issuing debt and equity instruments) are generated;
- (b) the currency in which receipts from operating activities are usually retained).’  
IAS 21, para 10

In practice, the guidance on the designation of the FC tends to be more applicable to operational entities such as banks or industrial groups than funds whose primary objective is to provide a competitive return to investors. Achieving this objective can be influenced by a multitude of factors including:

- The primary economic environment(s) in which the assets are invested;
- The primary economic environment(s) of the investors;
- The competitive environment;
- The regulatory environment;
- The structure of the fees; and
- Performance reporting.

When the above indicators are mixed and the FC is not obvious, IFRS states that management should use their judgement to determine the FC that most faithfully represents the economic effects of the underlying transactions, events and conditions. To make its decision, management may consider the currency in which the performance of the funds will be reported to investors.

An entity should record all its transactions and balances in its FC. Where other currencies are used, they are deemed to be ‘foreign’ and need to be translated into the FC, initially at the spot rate and subsequently at the closing rate. Retrospective translation in the opening statements is likely to entail a significant amount of identification, re-calculation and accounting reconciliation.

The impact of IAS 21 on increasingly international funds is likely to be far-reaching. Considering the FC issues when the fund’s financial year end arrives may leave too little time for what could be taxing deliberations.

## Impact on Investment Managers

### Control and consolidation

A parent is expected to consolidate any entity that it controls. Control is defined as having the power to govern the financial and operating policies of an entity so as to gain benefits from its activities. In practice, however, the rules can be difficult to apply, reflecting the often complex terms of incorporation, relationships and tiers of ownership seen within the investment management sector.

**'Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.'**  
**IAS 27.4**

For example, while in most cases control would mean majority voting rights, it could also apply to a lower shareholding in subsidiaries. As such,

control could exist even if an entity holds less than 50% of the shares in an entity. If the substance of the relationship with an entity indicates control then the entity needs to be consolidated. On the other side of the coin, an investment manager or other party could conceivably control an entity even if the actual majority ownership rests with another entity. Investment managers may find that they may be deemed to control the investment funds they manage even they do not hold the majority of the equity investments in the underlying investment funds.

Companies need to look at each case on its merits. This includes examining:

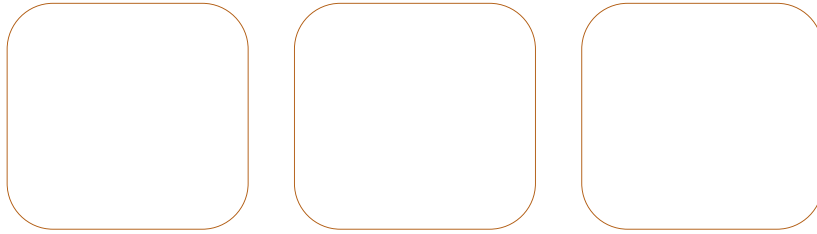
- The extent of an ownership stake;
- The circumstances that give rise to and the nature of the control;
- The limitations and the possible removal of such control;
- The legal or contractual relationships; and
- The benefits derived from the relationship.

Having carried out this exercise, companies may find that they need to reconstitute arrangements that may no longer have the desired tax, arbitrage or other advantages.

### Charges and commissions

**'Financial services fees are earned as services are provided'**  
**IAS 18 Appendix 14b**

Under IFRS, revenue recognised by asset managers could be significantly affected. Typically, investors in a fund would pay an up-front fees to fund managers, which is also used to defray initial commission costs to independent financial advisers. Under IFRS, such initial service charge could be regarded as the fees earned to provide management services to the client and would form part of the management fee, be initially deferred as a liability and recognised as revenue over the lifetime of the contract. A phenomenal difficulty which fund managers face is over the estimation of the duration over which



investors will continue to hold the shares/units in the underlying investment funds, i.e. lifetime of the contract.

**Incremental costs that are directly attributable to securing an investment management contract are recognised as an asset if they can be identified separately and measured reliably and if it is probable that they will be recovered. IAS 18 Appendix 14b iii**

Under IFRS, commissions payable to brokers upon securing an investment contract would be seen as an incremental cost and recognised as an asset that represents the entity's contractual right to benefit from providing investment management services. This asset would then be amortised as the entity recognises the related revenue. Companies need to consider how these changes might affect their cost and incentive structures, including the level, timing and breakdown of the fees paid to IFAs.

## Taxation

Tax liabilities are generally calculated on an entity-level basis, so the impact of IFRS depends on the country's approach to tax and IFRS. If the use of IFRS is confined to consolidated financial statements, then there will be no direct effect on taxation. However, in some countries where entities are taxed based on their accounting profits, the adoption of IFRS could change the timing of net profit and therefore the starting point of the calculation of taxable income, including any deferred liabilities. There is a particular complication if IFRS is permitted but not required, as different companies will have different measures of profit.

The tax authorities could also choose to ignore the accounting treatment and seek to tax the revenue when billed/received and accept an expense as a deduction when paid. This 'interpretation' could actually generate more accounting entries for tax deferral accounting to further cloud the issue and reduce the transparency of the financial statements.

## Meeting the challenges ahead

Producing IFRS statements is proving tougher than many had imagined. *Fresh changes are just around the corner. If you need advice on your next step, PricewaterhouseCoopers can help.*

This paper has touched on some of the complexities and ambiguities that are likely to compound what is already a challenging logistical exercise. Companies need to be able to assess and respond to the impact of the new regime on their funds, systems and stakeholder relations/communications.

Some companies may find themselves cutting corners in a bid to meet the initial presentation deadlines. However, these fixes can be needlessly costly, potentially unreliable and ultimately unsustainable. A lack of training and knowledge transfer also means that they may find themselves back to square one when the next set of accounts fall due.

Looking ahead, the goals posts are far from fixed, with companies facing a number of continuing changes including a revamped IAS 39. We are also likely

to see increasing convergence between IFRS and US accounting principles. The immediate challenge is therefore how to develop a flexible and sustainable approach to market disclosure capable of embedding IFRS in 'business as usual' and adjusting to the evolving requirements with minimum cost and disruption. While this will clearly be a difficult exercise, it could also open up opportunities to enhance the quality, clarity and credibility of financial reporting. This could prove crucial at a time when effective market communication is becoming an imperative.

PricewaterhouseCoopers has a proven track record of assisting investment managers in the implementation and embedding of IFRS. Our *TransitionIFRS* methodology is designed to guide an entity through the operational, process, organisational and reporting issues associated with moving to IFRS. PricewaterhouseCoopers brings together technical expertise, training and communication specialists and project management resources. Our emphasis is on knowledge transfer to ensure lasting, long-term benefits for an organisation.

We have developed a range of useful practical aids to help companies understand the requirements and embrace the change to IFRS. These include P2P IFRS – from principle to practice – an electronic learning solution; illustrative IFRS financial statements for investment funds and 'Applying IFRS for Investment Management Entities', PricewaterhouseCoopers electronic guide on practical applications of IFRS with over 1,000 links to PricewaterhouseCoopers best practices examples, many examples addressing specific areas relevant to the investment fund industry when applying IFRS.

For more information about how we can help your company make the change to IFRS or make your IFRS reporting easier to sustain, please contact your local PricewaterhouseCoopers office or Marie-Anne Kong (email: [marie-anne.kong@hk.pwc.com](mailto:marie-anne.kong@hk.pwc.com); Tel: (852) 2289 2707).



We would like to highlight that IFRS is currently being applied in many countries for the first time and contains many new and revised standards. Therefore practice on which to draw in applying the standards may develop. In this booklet we are drawing attention to the current interpretation of IFRS as at 31 December 2005, it should be noted that this could be subject to change in the future.

This publication is not intended as a study of all aspects of IFRS or as a substitute for reading the actual Standards and Interpretations when dealing with specific issues. No responsibility for loss to any person acting or refraining from acting as a result of any material in this publication can be accepted by PricewaterhouseCoopers. Recipients should not act on the basis of this publication without seeking professional advice.

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