International Financial Reporting Standards for Hedge Funds

Overview

This document is intended to introduce hedge funds and hedge fund service providers to International Financial Reporting Standards (IFRS) and to help them understand major differences between them and U.S. GAAP. The information here will also educate them on potential impacts to their organization when adopting the international standard, including considerations for accounting systems. Finally, the document will educate firms about Advent's portfolio accounting system, Geneva,® and its currently available capabilities for supporting multiple accounting standards.

What is IFRS?

International Financial Reporting Standards is a set of accounting principles that is rapidly gaining acceptance on a worldwide basis. These standards, which are published by the London-based International Accounting Standards Board (IASB), are more focused on objectives and principles and less reliant on detailed rules than GAAP. While there have been convergence efforts between the Financial Accounting Standards Board (FASB) and the IASB since 2002, there are still numerous differences that exist. In this publication, we have outlined some of the differences between IFRS and GAAP that are specific to hedge funds.

IFRS is being applied today in more than 100 countries where the use of IFRS is either required or permitted. The major breakthrough occurred in 2002 when the European Union (EU) required all European-listed companies to adopt IFRS by 2005. Since then, several countries outside the EU have followed and IFRS has gained acceptance as a set of global standards specifically among multinational organizations. For example, approximately 40% of the Global Fortune 500 companies are currently using IFRS, with another 40% using GAAP, and the remaining 20% using other local GAAP. Many of the companies using local GAAP are located in countries that will be transitioning to IFRS in the near term. Examples of some of the global markets and emerging markets that are moving toward IFRS in the near term are: Chile (2009), South Korea (2009), Brazil (2010), Canada (2011), and India (2011).

What about IFRS in the U.S.?

The United States is almost the only major capital market that has not yet adopted IFRS, but it seems that this may be changing soon. In August 2007, the SEC issued a "concept release" soliciting input on whether U.S. registrants should be permitted to have the option to prepare their financial statements using IFRS or GAAP for SEC reporting purposes. The majority of comments received on the concept release expressed support for permitting IFRS for U.S. registrants. A "proposing release" and/or an IFRS roadmap are expected to be issued by the SEC during the second or third quarter of 2008, which could result in U.S. companies having the option to adopt IFRS by 2010 or 2011. We may even see IFRS as a requirement in the longer term.

But why should you, as a U.S.-based hedge fund or fund administrator, start considering IFRS? Is it only because of the appeal of principle-based accounting and the ability to apply professional judgment to how certain transactions are accounted for compared to the rule-based GAAP? One of the reasons to consider IFRS is that the standard generally focuses on the "substance" of transactions, which results in an accounting presentation reflecting the "economic reality." Another important reason to start considering IFRS today is because adoption of IFRS in the U.S. is inevitable. IFRS provides an opportunity for reduced complexity, greater transparency, increased comparability, and improved efficiency to investors, capital markets, and companies. That is why many countries including the U.S. are either considering or are in the process of adopting IFRS.

Is It Just Your Accounting Policies that Need to Change?

The adoption of IFRS affects more than a company's accounting policies and financial reporting. Many aspects of an organization's business could be affected. The adoption of IFRS may have a transformational impact on financial reporting systems, internal controls, taxes, treasury and cash management with an extended impact on employees, processes, and systems.

Accounting Differences between IFRS and U.S. GAAP

The differences outlined below are not intended to be an all-inclusive list but highlight significant differences between IFRS and GAAP relevant to hedge funds. Some of the most notable differences include:

- **Industry Specific Guide.** In contrast to GAAP, which provides industry specific guidance for investment companies,[1] IFRS does not provide industry specific guidance. In fact, hedge funds use the same financial

1 AICPA Audit and Accounting Guide, Investment Companies.

reporting standards that apply to other companies across all industries.

- **Consolidation.** Under IFRS, a fund should be consolidated by its controlling party—that is, the party that has the power to govern the financial and operating policies of the fund. The identity of the controlling party will depend on the following factors: (i) the ability of the investment manager to make real investment and other decisions; (ii) the existence of any rights to remove the investment manager; (iii) the existence of any other interest held by the investment manager or its affiliates in the investment entity; and (iv) any other statutory, contractual, legal, or regulatory constraints on the power of the investment manager. Therefore, an investment manager with real decision-making powers who cannot be removed immediately and who has a significant economic interest in a fund may have to consolidate that fund under IFRS. The consolidation model under IFRS does not provide exemptions to investment companies. For example, and unlike GAAP, when a feeder fund has control over its master fund, the master fund should be consolidated into the feeder fund.

- **Investments.** Unlike GAAP, which requires all investments to be recorded at fair value, IFRS would permit classifying investments as either (i) fair value through profit or loss (held for trading or designated under fair value option); (ii) available-for-sale; (iii) held-to-maturity or (iv) loans and receivables. The subsequent measurement attribute is based on the elected classification. Generally, held-to-maturity classification is not possible for hedge funds and in practice hedge funds typically classify their investments as fair value through profit or loss (either held for trading or designated under fair value option).

- **Fair Value.** IFRS has not yet adopted fair value measurements guidance similar to SFAS 157 and as such GAAP differences still exist.[2] For example, under IFRS long positions must be valued at the bid price and short positions must be valued at the ask price, while assets and liabilities with offsetting market risks may be valued at mid-market prices for the offsetting risk positions and at bid or asking price for net position, as appropriate. Under GAAP, the use of mid-price is permitted as a practical expedient.

Transitioning to IFRS: Impact to Operations and Technology

Firms wishing to switch from GAAP to IFRS or to produce reporting under both standards may require changes to their operational and technology environments. In many cases, the requirements for IFRS are less specific than GAAP and as such, in many cases treatment under GAAP will work for IFRS. However, some differences require different accounting treatment or reporting and therefore will impact how firms operate and account for their investment activity. High level considerations include:

- **Pricing.** Firms that are currently valuing investments using only the mid-price under GAAP will need to accommodate additional prices for valuing their assets. Depending on how firms gather prices and value their investments, this may represent a technology change, as many firms are using technology to automate the process of price collection and position valuation.

- **Trade vs. Settle Date Representation.** Firms moving to IFRS who want to report initial recognition of positions as of settle date will need to ensure they are capturing settlement date information. Firms that are tracking positions for GAAP only based on trade date may not be capturing settle date information today.

- **Transaction Costs.** Under GAAP, transaction costs are often recognized as part of an investment's cost basis. As such, firms may not be tracking these separate from investment cost. Under IFRS, transaction costs may need to be expensed. Firms that are not currently differentiating transaction costs from the investment cost will need to identify transaction costs so that different treatments may be applied.

Reporting Specifics

- **Statement of Cash Flows.** This statement is required for IFRS even for firms that may be exempted under GAAP. For firms that currently provide this under GAAP, the potential exists for classification differences. In both cases, firms will need to capture cash activity with enough detail to generate the Statement of Cash Flows and classify appropriately on statements.

- **Amortization.** Premiums and discounts must be amortized under GAAP. With IFRS, there may not be a need to segregate amortization from market gain (or loss) as the investments carried at fair value will show the P&L through the fair value.

- **Classification of Investor Ownership.** GAAP classifies owner interest as equity. Under IFRS, ownership may be expresses as equity or as a liability when the interest is redeemable by the investor. In addition, IFRS requires that investor capital be split between share capital, premium, and surplus. Firms that were not previously tracking different types of ownership may need to do so to report accurately.

- **Recognition of Unrealized and Realized Price and Currency Gains.** Under GAAP, firms should distinguish between realized and unrealized gains and price and FX gains. IFRS does not require this. This is an example where GAAP is more specific, and while this may not change current operations for a GAAP firm adopting

2 The IASB issued a discussion paper on fair value measurements in November 2006 which is based on SFAS 157, Fair Value Measurements.

IFRS, it may require technology to report both ways without manual effort to combine gains for IFRS.

- **Functional Currency.** It is possible for a fund to have different functional currencies under GAAP vs. IFRS. If this is the case, firms now need to ensure that additional FX rates to and from additional functional currencies are captured and must have the ability to restate in multiple currencies.
- **Segment Reporting.** IFRS requires separate subreporting for business unit or geographic segments. Firms will need to track and associate all investment activities to the appropriate segments.
- **Risk Reporting.** IFRS requires disclosures related to the nature and extent of risk exposure of investments. The types of risk that must be reported include credit risk, liquidity risk, interest rate risk, market risk, and currency risk.

System Considerations

From a financial reporting perspective, firms wanting to provide IFRS reporting in addition to GAAP will need to leverage technology in a number of ways. Ideally, firms should be able to produce compliant statements for both standards from the same system with minimal incremental overhead.

There are three fundamental imperatives for an accounting and reporting platform to support these requirements. First, the system must allow firms to capture any additional data needed to ensure proper treatment and reporting of accounting results. Second, the system must be flexible enough to apply different sets of accounting rules to the same underlying data sets. In the case where a fund may need to report in both standards, this is critical as the alternative is tracking a second complete set of books. And third, the system must be able to present the results in ways that are compliant with both standards without ongoing manual intervention.

When implementing an accounting application, the following considerations must be made with respect to the operational and technology impacts identified in the previous sections:

- **Pricing.** The system must be configured to allow for multiple prices for each investment and apply different pricing rules for IFRS and GAAP.
- **Trade vs. Settle Date.** The system must track both trade and settle date information as well as support the reporting of positions from both perspectives.
- **Transaction Costs.** The system must have the ability to capture transaction costs and report positions including and excluding them.
- **Cash Flows.** The system must support the ability to apply different classification logic to the same transactions based on user-defined rules.
- **Amortization.** The system must have the ability to generate financial reports with and without the effect of amortization and accretion of premiums and discounts.
- **Investor Ownership.** The system must be able to differentiate different types of capital inflows and segregate equity vs. liabilities for IFRS reporting.
- **Gain Recognition.** The system must be able to calculate unrealized and realized gains and price and FX gains and separate or combine them as requested on financial reports.
- **Functional Currency.** The system must be able to have different reporting currencies for each fund in addition to the ability to have multiple reporting currencies for a single fund.
- **Segment Reporting.** The system must be able to support segments by business unit or geographic unit within a fund and produce financial reports for these sub accounts.
- **Risk Reporting.** The system must support the storage of sufficient investment and market data to source risk reporting.

Advent Geneva®

Geneva is Advent's global investment management and accounting solution. Geneva was designed with input from some of the world's leading investment firms with an eye toward increasing operational efficiency in operations, accounting, and financial reporting.

Geneva is a multi-tenant, multi-consumer system. Native functionality allows the system to support different workflows for the various standards with minimal duplication of effort. The system allows firms to apply different accounting rules to funds on an ad hoc basis to support different reporting perspectives on the same underlying investment data. And the system allows for any number of mapping rules to represent the accounting results on IFRS and GAAP statements.

Geneva's extendable data model allows firms to store additional information—unlimited prices, business segments, investment data, market data, transaction data, and descriptions—to support different reporting requirements. This flexible accounting model gives firms the ability to apply different accounting parameters, price hierarchies, functional currencies, general ledger maps, and accounting views. These features make reporting in two standards possible with a single system and minimize the incremental change to support IFRS reporting.

In support of IFRS and GAAP, the system should generate compliant accounting results. However, it's important to note that with IFRS, as with GAAP, certain specific reporting requirements that exist today, or may exist in the future, are not immediately available. Such examples include consolidated or comparative financial statements which require report customizations and qualitative notes and disclosures around risk.

There are several key features in Geneva which support multiple standards:

- **Pricing.** Geneva can store multiple prices per investment, including bid and ask prices, and can apply the bid/ask logic required by IFRS. Geneva also tracks additional price details to support SFAS 157 reporting.
- **Accounting Parameters.** Geneva's Accounting Parameter sets allow firms to define a number of accounting rules that can be saved and applied when generating financial reports. The settings in an Accounting Parameter set include:
- **Book Currency.** Each Accounting Parameter set may have a different functional currency.
- **Price Schedule and Bid/Ask Settings.** Each set applies a different set of pricing rules, which include a price schedule and hierarchy of different sources and rules for utilizing bid and ask vs. mid-prices for long and short positions.
- **Amortization.** Amortization settings can be alternated to enable or disable this functionality and to apply different methods for amortization.
- **Customizable Chart of Accounts and General Ledger Maps.** Firms are able to add and subtract from Geneva's chart of accounts as necessary (e.g. to create different accounts for owner interest). With the General Ledger mapping functionality, firms can define multiple sets of mapping logic that determines how the general ledger accounts flow through to different reports. For example, under GAAP realized and unrealized gains are mapped to separate classifications on the Statement of Operations. For IFRS, they may be combined.
- **Accounting View.** By default, Geneva includes all applicable transactions on reports. However, to suppress consolidation or reclassification entries on GAAP or IFRS statements, firms may want to exclude specific transactions. Special accounting views can be associated to these transactions so that they can be included on some statements but excluded from others.
- **Accounting Filters/Business Units.** Geneva supports tracking sub accounts for different business segments within a given portfolio. For IFRS reporting, firms can choose to generate statements for whole funds or for segments separately with no additional effort.
- **Inventory State.** Geneva's inventory state tracking keeps detailed records of unsettled positions and supports reporting from trade and settle date perspectives.

Conclusion

As long as there is divergence in accounting standards, firms wishing to adhere to multiple standards or switch from one to another have several things to consider. First, firms must analyze the accounting differences as they relate to them between the standards. This document attempts to identify those differences specific to hedge funds at a high level. Second, they must assess how accommodating a new standard will impact their organization, in terms of process and in terms of technology.

When technology is a major component of the firm's accounting environment, they must examine how their systems can or cannot meet their needs and what type of configuration or customization is necessary. Advent Geneva is poised to meet these varying requirements with functionality currently available and in use by many of the world's leading hedge fund and accounting firms.

For more information about Advent Geneva, please visit www.advent.com. Or to see an online demonstration of Geneva, please visit www.advent.com/about/resources/demos/genevademo.

For a more detailed analysis of IFRS vs. GAAP, consult the relevant accounting standards and your professional audit and accounting firms.

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