

IFRS

Highlighting the value of system future proofing

WHITEPAPER

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This is a landmark event for financial services organizations. IFRS 9 supersedes all previous versions to become the new standard for financial instruments accounting. And its introduction marks a major change to the International Accounting Standards Board's (IASB) accounting principles, which have become widely used by firms around the world.

Global adoption...almost

A big part of the International Financial Reporting Standards' (IFRS) appeal is that they are more focused on objectives and principles, as opposed to the detailed rules-based methodology favored by the Generally Accepted Accounting Principles (GAAP).

By focusing on the 'substance' of transactions, IFRS allows for a professional judgment on how certain transactions are accounted for, resulting in accounting presentations that reflect 'economic reality.' IFRS also provides opportunities for reduced complexity, greater transparency, increased comparability, and improved efficiency to investors, capital markets and companies—hence the reason many countries are either considering or are in the process of adopting IFRS.

The most notable exception though is the United States.

The IFRS Foundation notes that the SEC permits, but does not require, its foreign private issuers to use IFRS Standards in preparing their financial statements¹. At present, more than 500 foreign SEC registrants use IFRS standards in their US filings. However, under SEC rules domestic issuers must continue to use US GAAP.

Convergence and divergence

Significant differences exist between IFRS and US GAAP. The long-term goal had been to achieve convergence between the two standards, with the IASB and FASB agreeing in September 2002 to work together to remove the areas of disparity. This decision resulted in a Memorandum of Understanding (MoU) known as the "Norwalk Agreement."

The aspiration, notes accounting and advisory firm Baker Tilly, was "to improve the consistency and comparability of financial statements worldwide" by developing "high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting."²

Work on the MoU project finished in 2016, when the boards issued their standards on lease accounting. Overall though, the various projects covered by the MoU have seen mixed results.

There have been notable accomplishments. For example, the converged revenue recognition standard, issued in May 2014, "provides a comprehensive, industry-neutral revenue recognition model intended to increase financial statement comparability across companies and industries," notes PwC³.

Fair value is another. The IASB's IFRS 13 "defines fair value, sets out a framework for measuring fair value, and requires disclosures about fair value measurements."⁴ With its emphasis on a fair value hierarchy and enhanced disclosures for how fair value is measured, the rule shares many characteristics with the FASB's Fair Value Measurement Topic 820 (formerly known as FAS 157). The result is a consistent set of accounting standards to determine the fair value of entities' assets and liabilities.

¹ *United States*, The IFRS Foundation, <http://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/united-states/#commitment>

² *Progress report: International convergence of accounting standards*, Baker Tilly, 31 October 2014, <http://bakertilly.com/insights/progress-report-international-convergence-of-accounting-standards/>

³ *Revenue Recognition Issues*, PwC, <https://www.pwc.com/us/en/cfoirect/issues/revenue-recognition.html>

⁴ *IFRS 13 Fair Value Measurement*, The IFRS Foundation, <http://www.ifrs.org/issued-standards/list-of-standards/ifrs-13-fair-value-measurement/>

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Other projects have achieved partial convergence, albeit with some differences remaining. But there have been convergence failures as well, where efforts were either discontinued or the two boards have ploughed ahead with parallel standards.

One of the major areas of disagreement has been around impairments of financial instruments. Both boards have pursued ‘expected’ rather than ‘incurred’ loss models. However, there are discrepancies in how that loss is measured.

The FASB introduced the current expected credit loss (CECL) model for recognizing credit losses on financial instruments, which “requires organizations to immediately record the full amount of credit losses that are expected in their loan portfolios.”⁵ Under the IASB’s version, issued as part of IFRS 9, expected credit losses are accounted for from the date when financial instruments are first recognized. Entities are required to recognize 12-month expected credit losses, or lifetime expected credit losses where credit risk has increased significantly.

IFRS 9—What it means

Introduced as part of the IFRS’ response to the financial crisis, IFRS 9 effectively comprises three accounting standards in one.

i) Classification and measurement

The first phase, launched in 2009, focused on new requirements for classifying and measuring financial assets and liabilities, to make financial statements more fair value-centric. Following initial recognition, all assets within the scope of IFRS 9 are measured at:

- Amortized cost;
- Fair value through other comprehensive income (FVTOCI); or
- Fair value through profit or loss (FVTPL).

The FVTOCI classification is mandatory for certain debt instrument assets, unless the FVTPL option is taken. For equity investments, the FVTOCI classification is an election. Financial assets designated at FVTPL are not subject to the reclassification requirements of IFRS 9, giving asset managers the option to continue accounting in the same manner as before the new standard.

ii) Hedge accounting

The hedge accounting phase, designed to create a more principles-based approach to hedge accounting and “allow companies to better demonstrate their risk management activities in the financial statements,”⁶ followed in 2013. It includes a new general hedge accounting model and expands the items that can be deemed eligible as hedged items.

According to Deloitte, “hedge accounting allows an entity to reflect risk management activities in the financial statements by matching gains or losses on financial hedging instruments with losses or gains on the risk exposures they hedge.”⁷ IFRS 9 applies to all hedge accounting, with the exception of portfolio fair value hedges of interest rate risk (commonly referred to as ‘fair value macro hedges’).

⁵ Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326)*, FASB In Focus, 16 June 2016, http://www.fasb.org/jsp/FASB/Document_C/Document-Page&cid=1176168232790

⁶ *IFRS hedge accounting: Long-awaited standard looks to common sense*, PwC, <https://www.pwc.com/gx/en/services/audit-assurance/corporate-reporting/world-watch/ifrs-new-hedge-accounting-standard.html>

⁷ *IFRS 9 — Financial Instruments*, Deloitte, <https://www.iasplus.com/en-us/standards/international/ifrs-en-us/ifrs9>

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iii) Impairment

The impairment phase proved most intractable, with the project subject to extensive deliberation and revisions as the IASB and FASB struggled to align their respective approaches. The final version contained within IFRS 9 incorporates a new expected loss impairment model, designed to provide for ‘expected’ rather than ‘incurred’ losses.

IFRS 9 and Geneva

While IFRS 9 introduces new classifications, Geneva’s flexibility ensures the system will continue to support IFRS compliance. The real difference between IFRS 9 and the previous IAS 39 standard is the FVTOCI designation. This requirement to reclassify income into FVTOCI only really affects debt instruments. However, where a debt instrument is held within a business model for trading purposes (as should be the case for all asset managers), then it will be classified under FVTPL. This is the same as with other generally accepted accounting practices and previous standards, which Geneva has long supported.

Where a client does hold debt instruments for non-trading purposes (such as a bank or loan originator), these assets can be attributed to a separate business model in Geneva and will be easily identifiable for classification.

Flexible systems the key to compliance

The hope had been that the United States would, at some point, adopt IFRS. That seems unlikely, at least for the foreseeable future. In the absence of any further accounting convergence, the reality is that any firm with international reporting requirements will need the operational and technology flexibility to support multiple accounting standards.

In many cases, the requirements for IFRS are less specific than GAAP. In such situations, treatment under GAAP will often work for IFRS. However, other areas will require different accounting treatment or financial reporting, which will impact on how firms operate and account for their investment activity.

Ideally, firms should be able to produce compliant statements for both standards from the same system, with minimal incremental overhead. That requires an accounting and reporting platform with the capability to:

- i) Allow firms to capture any additional data needed to ensure proper treatment and reporting of accounting results.
- ii) Apply different sets of accounting rules to the same underlying datasets. This is critical for any fund that may need to report in both standards, since the alternative is tracking a second complete set of books.
- iii) Present the results in ways that are compliant with both standards without ongoing manual intervention.

The Geneva solution

SS&C Advent’s Geneva® investment management and accounting platform has been designed to handle firms’ complex global investment strategies. The system is able to track users’ trades from execution to settlement, while simultaneously calculating profit and loss, and recording the impact to the general ledger.

As a global investment accounting solution, Geneva supports all instruments, transaction types and currencies. The system accurately processes and accounts for vanilla and complex investment and transaction activity—including global fixed income instruments, equities, credit and interest rate derivatives, bank debt, funds of funds, and forward and FX contracts—using a single, consolidated general ledger. And the industry-standard general ledger database at Geneva’s core is designed to ensure the integrity and timeliness of accounting data in both open and closed periods.

Geneva is a multi-tenant, multi-consumer system. Powerful native functionality enables it to support different workflows for the various accounting standards with minimal duplication of effort. Firms can apply different accounting rules to funds on an ad hoc basis, giving users the ability to create multiple 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.

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Figure 1: **Key Geneva features provide the flexibility to support multiple standards:**

<p>Pricing</p>	<p>Geneva can store multiple prices per investment, including bid and ask prices, and apply the bid/ask logic required by IFRS.</p>
<p>Accounting parameters</p>	<p>Geneva’s Accounting Parameter sets (including book currency, amortization settings, and price schedule and bid/ask settings) allow firms to define multiple accounting rules that can be saved and applied when generating financial reports.</p>
<p>Customizable chart of accounts</p>	<p>Firms can add/subtract from Geneva’s chart of accounts as necessary (e.g. to create different accounts for owner interest).</p>
<p>Customizable general ledger maps</p>	<p>Firms can define multiple sets of mapping logic that determine how the general ledger accounts flow through to different reports (e.g. under GAAP, realized and unrealized gains are mapped to separate classifications on the Statement of Operations; for IFRS they may be combined).</p>
<p>Accounting view</p>	<p>Special accounting views can be associated to specific transactions where required, so they can be included on some statements, but excluded from others where firms need to suppress consolidation or reclassification entries on their GAAP or IFRS statements.</p>
<p>Accounting filters/business units</p>	<p>Geneva supports tracking of sub-accounts for different business segments within a given portfolio. For IFRS reporting, firms can choose to generate statements for whole funds or segments separately, with no additional effort.</p>
<p>Inventory state</p>	<p>Inventory state tracking keeps detailed records of unsettled positions, and supports reporting from trade and settle date perspectives.</p>

The flexibility architected into SS&C Advent's Geneva system enables users to produce accurate, on-the-fly data in many different formats, without the need for multiple, standard-specific sets of records or general ledgers.

Geneva's extendable data model also means firms can store additional information—unlimited prices, business segments, investment data, market data, transaction data and descriptions—to support their different reporting requirements. The flexible accounting model ensures firms can apply different accounting parameters, price hierarchies, functional currencies, general ledger maps and accounting views to generate IFRS and GAAP compliant accounting results, and thereby make reporting in the two standards possible with a single system.

Conclusion

As long as divergence between the different accounting standards remains, firms that want or have to adhere to multiple standards must assess how their systems can or cannot meet their accounting needs, and determine what type of configuration or customization will be necessary.

The flexibility architected into SS&C Advent's Geneva system enables users to produce accurate, on-the-fly data in many different formats, without the need for multiple, standard-specific sets of records or general ledgers. This database flexibility similarly ensures Geneva will remain compliant even when new standards are introduced, as with the rollout of IFRS 9 financial instruments. So as new standards arise, and variations between IFRS and GAAP persist or emerge, Geneva can future proof users against the expense and challenges that come with change.