The COMMENT

COMMENT

GET READY FOR THE NEW INVESTMENT FIRMS PRUDENTIAL REGIME

PE houses must familiarise themselves with the new requirements and ensure their forecasting practices are up to standard, writes Karen Allan of Haysmacintyre

Due to come into play early next year, the Financial Conduct Authority's (FCA) upcoming Investment Firms Prudential Regime (IFPR) could pose a range of challenges to MiFID private equity firms of all sizes, from capital requirements, liquidity, and risk management to auditing, disclosure and reporting.

On 1 July 2021, the FCA issued their first policy statement on IFPR, which set out further details on the upcoming changes due to come into play. The changes, which include an expected increase to capital requirements for smaller firms, could see boutique private equity firms facing an additional set of costs, at a time when forecasting is already in disarray from the pandemic.

More than 3,000 FCA-regulated firms are expected to be affected by the upcoming changes, and although the new regime won't come into force until 1 January 2022, it's absolutely vital that affected firms get ready for the changes now: being prepared now will ultimately help them tackle the challenges ahead.

Preparation is key

It's particularly important for PE firms and their management teams to ensure they fully understand the implications of IFPR, both to the firm and to the group structure to which the firm is a party.

As a first step, a firm will need to review its General Partner (GP) to identify whether or not the consolidation rules apply: under the new IFPR, this will become relevant to many firms' GP, which had been set up to ring-fence the regulated entity. The new consolidation rules therefore mean the regulated entity, along with all other associated entities within the group, are treated as if they are one single entity.

As a result of potential changes to the GP, some UK PE firms may be subject to significantly increased capital requirements. This is a big change, particularly for those firms with low-level regulation and CAD exempt firms, which have previously been subject to €50k capital requirements. Firms will therefore be required to maintain higher own capital as a result of the costs of the new consolidation group being aggregated together, to identify the capital requirement. It is important to note that this fixed overhead requirement will fluctuate as the cost base of the consolidation group fluctuates.

Firms will also need to consider how they meet the reporting requirements going forward in regard to the calculations of the capital requirements – a key consideration for financial officers, in particular. This includes considering how the firm will set up ongoing monitoring of any group costs.

Management teams and CFOs will need to consider scenarios including underperforming entities in the group, which may be incurring significant costs or periods of heavy investment or growth. Forecasting will be a useful tool to help them keep on top of these scenarios of increased capital requirement.

Consideration will need to be given to the appetite to invest additional funds into businesses and where the sourcing of such funds will come from. A lot of PE firms are focusing on quantum and timing of capital injections, and for CAD exempt firms in particular, this is going to be a whole new way of thinking and assessment.

Accounting for greater costs

Firms will need to have sight of expected capital requirements and consider it could be recapitalised when necessary. As a result, management will need accurate and forward-looking data based on historic actuals and known changes to the group.

Finance teams specifically may need to grow in order to support the additional monitoring required, and reporting may need to become more frequent, particularly as the amount of data required will increase. Where firms have outsourced their bookkeeping, it may be that their service provider is able to assist with forecast or budgeting reporting.

At the crux of this set up, management teams need to consider whether or not they have the knowledge and expertise internally to meet these requirements, and inform the group on changing capital requirements and approaches to doing so.

Compliance advice is key if the firm has no internal compliance expertise of its own, and firms should be aware that the consultation process will take a significant amount of senior management time in preparing for the new processes. Timely and accurate financial information will be vital.

Forecasting and cashflow considerations

The introduction of ISA 570 Going Concern for periods commencing 15 December 2019 (December 2020 audits) was quite timely, albeit the impacts of this auditing standard were fast-tracked for many firms as a result of the pandemic. On a basic level, the standard required more rigorous challenge by auditors on budgets, forecasts and assertions made by management in relation to their ability to continue as a going concern for a period of at least 12 months from the date of signing the accounts.

This greater challenge, along with the need to try to see through some of the uncertainty, has prompted firms to focus more resources on being able to create and manage more detailed and accurate forecasts. For most PE firms, administrative cost-bases are relatively fixed, with the largest proportion of these driven by staff costs and rent-related expenditure. Revenue should be relatively straightforward to forecast given the nature of income, although performance fee income may be trickier to deal with.

Many firms are turning to the use of scenario planning and sensitivity analysis in these situations, considering the impact of receiving no performance fees or if management fee income was to reduce by a certain percentage.

It's unlikely this would change as the world re-opens, and although activity may become less uncertain, the use of forecasting and budgeting is expected to become an integral part of PE firm's financial management, especially given their use in managing expected liquidity requirements with regard to the IFPR. Fortunately, this auditing standard aligns with the IFPR in terms of ongoing monitoring, the need for accurate, timely information and challenge.

The changes coming into play from IFPR may see PE firms facing difficulties ahead, and could pose particular challenges for smaller, boutique houses. But familiarising themselves with the new requirements and ensuring their forecasting practices are up to standard will help firms mitigate any hurdles ahead. ◆