

# Investment company technical release

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## What's new for 2009?

In this latest technical release we summarise some of the main financial reporting and disclosure changes for 2009 which are likely to have an impact on investment companies. One of the principal developments for 2009 is of course the revised AIC SORP, and a number of investment companies have adopted this early, but there have also been changes in IFRS and some changes in the corporate governance regime. These changes will affect the primary statements in the accounts of investment companies as well as the content of some of the notes and related disclosures.

### Amendments to IAS 1 – Presentation of Financial Statements

The revised version of the IASB's key standard, IAS 1 Presentation of Financial Statements will affect the format and presentation of IFRS financial statements for periods beginning on or after 1 January 2009.

Changes include:

- the need for an extra comparative statement of financial position in certain circumstances (at the start of the

earliest period presented), including comparatives for the supporting notes. Unhelpfully, all entities reporting under IFRS will need to provide the additional balance sheet in the first year in which they apply the revised IAS 1 as one of the main circumstances under which it is required is where a new accounting standard is adopted (unless the standard change applies only prospectively)

- reporting performance in a statement of comprehensive income, which may be in one statement or two. The two-statement approach is similar to the current income statement and statement of recognised income and expense ("SORIE"). The one-statement approach joins the two together. As few investment companies currently have to produce a separate SORIE, we expect that many will choose to produce simply the one statement.

The changes relating to the statement of comprehensive income will need to be reflected in the half-yearly financial report.





### Changes to IFRS 7 and FRS 29 – Financial Instruments: Disclosures

As part of the IASB's response to the credit crisis there are expanded disclosure requirements in IFRS 7 which are also effective for annual periods beginning on or after 1 January 2009. Similar amendments to FRS 29 are in place for UK GAAP companies. The principal point of interest for investment companies is the introduction of a three-level hierarchy for fair value disclosures:

- Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices)
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs).

For financial instruments within the scope of IFRS 7 that are measured at fair value, investment companies will need to disclose the following for each class of financial instruments:

- the level in the fair value hierarchy into which the fair value measurements are categorised in their entirety
- any significant transfers between Level 1 and Level 2 and the reasons for those transfers
- for fair value measurements in Level 3, a reconciliation from the beginning balances to the ending balances. As well as highlighting purchases, sales, and gains and losses, this reconciliation will identify transfers into or out of Level 3 and the reasons for those transfers.

In addition, for any fair value measurements in Level 3 where changing one or more inputs to reasonably possible alternative assumptions would change fair value significantly, entities are required to disclose that fact and the effect of those changes.

The quantitative disclosures are to be provided in a tabular format unless another format is more appropriate.

One of the key points about the fair value hierarchy is that categorisation is based on the lowest level input that is significant to the fair value measurement of the instrument. The amendments make clear that when the fair value of an instrument is measured using some observable inputs, but these inputs require significant adjustment based on unobservable inputs, that fair value measurement should be categorised in Level 3.

For investment companies this will all require careful consideration and judgements will need to be made, particularly in terms of whether a particular input is significant. We will be issuing a further technical release dealing with the application of the fair value hierarchy disclosures to investment companies over the summer.

It is worth noting that in the first year of application of these amendments, comparative disclosures are not required.

### Amendments to IAS 32 and FRS 25 regarding puttable instruments and obligations arising on liquidation

The previous version of IAS 32 did not normally require an instrument to be classified as a liability solely on the grounds that it is repayable on liquidation. However, if liquidation is certain to occur and outside the control

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of the entity (for example, a limited life entity) or is uncertain but is at the option of the holder, IAS 32 required liability classification. This has affected many fixed life investment companies.

The amended IAS 32 requires that instruments with these liquidation obligations are classified as equity if all of the following conditions are met:

- The instrument entitles the holder to a pro rata share of the entity's net assets on liquidation
- The instrument is part of a class of instruments that is subordinate to all other classes of instruments
- All instruments in this most subordinate class have an identical contractual obligation for the entity to deliver a pro rata share of its net assets on liquidation
- The issuer must have no other financial instrument that is entitled to profits or changes in assets which has the effect of substantially restricting or fixing the residual return.

For investment companies with a fixed life but with only one class of ordinary shares in issue, with identical rights, the amendment could be expected to have the effect of restoring equity to their balance sheets. Split capital trusts with income and capital shares which currently present both share classes as liabilities will also need to consider the revised criteria and in particular whether capital shares will return to being equity.

The amendments to IAS 32 are effective for accounting periods beginning on or after 1 January 2009. For UK GAAP companies there are similar changes to FRS 25 effective one year later, from 1 January 2010 – but early adoption from 1 January 2009 is permitted.

### **IFRS 8 Operating Segments**

IFRS 8 Operating Segments replaces IAS 14 Segment Reporting. Under IAS 14 most investment companies considered that they did not have geographical or business segments. The revised standard is more free form:

- Segments are identified based on internal reports that are regularly reviewed by the 'chief operating decision maker' (eg the Board)
- Any segment reporting would follow the way information is reported to management
- Some key disclosures apply even if there is only one segment – for example geographical revenues.

Investment companies will need to consider how they are affected by this revised standard according to how they allocate resources and assess performance and the information they use to do this. The early indications are that many companies are likely to continue to take the view that they only have one segment, although multi manager funds are likely to continue to be affected.

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#### **The revised SORP**

The 2009 SORP replaces the 2005 SORP and is effective for accounting periods beginning on or after 1 January 2009, with early adoption encouraged. Based on initial experience of companies early adopting the new SORP, the greatest impact in practice is proving to be in relation to three areas:

#### **The application of the SORP to VCTs**

The main change in the 2009 SORP is that the scope has been extended so as to formally include VCTs (SORP para 7). Historically some VCTs have elected to follow the SORP but others have discontinued this practice after relinquishing CA 2006, s833 status. Where VCTs are required to re-adopt the SORP or to follow it for the first time, Boards will need to consider relevant policy matters arising. For example, the proposed policy which the company will follow in relation to the allocation of management fees between revenue and capital will need to be clarified.

#### **The presentation of capital reserves**

By changing the way in which capital reserves are described, the SORP seeks to avoid some of the complications posed for accounting presentation following the finalisation of the ICAEW guidance on distributable profits (SORP para 17). Some companies adopting the revised SORP have chosen to present a single capital reserve on the face of the balance sheet and in the notes, accompanied by an explanation of how much of the reserve is made up of investment holding gains – in place of the traditional realised/unrealised terminology. An alternative approach which has been used is to re-label capital reserves as investment holding gains and

other capital reserves. Whichever method is chosen there are drafting changes required to the accounts and the accounting policy wordings and notes will need to be aligned.

The re-definition of realised profits/losses following the revised ICAEW guidance has also had practical implications – forcing some investment companies to curtail their share buy back activities or to seek conversion of share premium into a distributable capital reserve.

#### **The great C share debate**

One key area where, after much debate, the revised SORP has been unable to take a definitive position is on the question as to whether C shares issued by an investment company are equity or debt. Through the consultation process, the AIC had been seeking to explore the possibility of achieving consensus that C shares are equity in nature and there was enormous sympathy for this position. The obstacle to this has unfortunately proved to be rules-based accounting standards – the specific technical difficulty being that in many cases C share issues may fail the ‘fixed-for-fixed’ test in FRS 25, paragraph 16. The revised SORP therefore concludes that the accounting treatment will need to be determined on a case by case basis having regard to the specific terms of the issue (SORP para 21). Boards of companies with C shares will therefore need to consider accounting treatments with their administrators and auditors but changes in presentation have begun to appear. In future it may be that liability treatment could only be avoided if the terms are capable of being constructed such that the board has discretion as to whether or not the C shares are converted to ordinary shares;



in other words, where the company is under no legal obligation to convert.

#### Other features

Other features of the 2009 SORP include new guidance on:

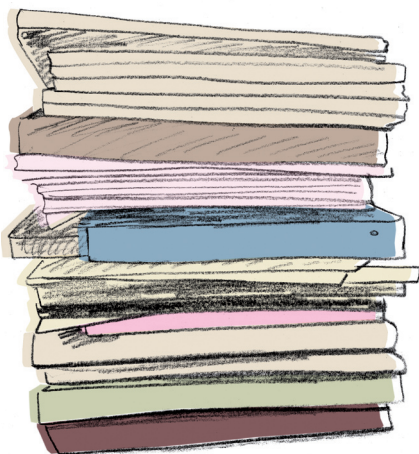
- Accounting for returns from derivatives – this guidance is broadly in line with the principles adopted by authorised funds and will help investment companies to determine when gains or losses on a derivative should be reflected as capital or revenue in the accounts, based on the motives and circumstances of the transaction (SORP para 74)
- Treasury shares – this guidance reflects current best practice in relation to accounts presentation and NAV per share disclosures (SORP paras 84 and 22).

Other amendments to the SORP are less major, but include the following:

- a change to the way in which FRS 19 tax reconciliations are presented. Such reconciliations should be based on the

total column of the income statement rather than the revenue column as was previously recommended by the 2005 SORP (SORP para 67)

- reinstatement of some of the old Listing Rules' disclosures relating to the provision of information such as the largest 10 investments, details of large unquoted investments, co-investment information for VCTs etc (SORP para 80)
- further clarification as to the circumstances when an investment company should prepare its financial statements on a break-up basis (SORP para 11)
- a requirement to disclose both increases and decreases in value of unquoted investments, where material (SORP para 27). Previously the requirement to disclose decreases in value was in the Listing Rules.



### **Sundry UK GAAP changes**

The UK Accounting Standards Board (ASB) has issued an amendment to FRS 8 Related Party Disclosures. This is to eliminate inconsistencies between FRS 8 and new statutory related party disclosure requirements set out in The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 made under the Companies Act 2006. The amendments to FRS 8 apply for accounting periods beginning on or after 6 April 2008, to tie in with the introduction of these regulations.

One implication of this is that parent companies are no longer completely exempt from disclosure of related party transactions in their individual accounts. This would affect investment companies with subsidiaries which are not wholly owned, as disclosure of transactions with these companies will now be required.

### **Companies Act 2006 changes**

Part 15 of the Companies Act 2006 sets out the statutory requirements relating to preparation and publication of a company's annual accounts and statutory reports such as the directors' report and directors' remuneration report. Apart from some limited provisions introduced earlier, for example the expanded business review requirement in the directors report, the legislation largely came into force for annual periods beginning on or after 6 April 2008. Whilst many accounting provisions are carried forward from the Companies Act 1985 largely unaltered, there are some changes.

These include the following:

- New disclosure requirements for off-balance sheet arrangements which apply to both IFRS and UK GAAP accounts. The range of such arrangements is in principle very wide but the risks or benefits from the arrangements have to be material to warrant disclosure. For most investment companies this might not be expected to routinely give rise to significant changes in reporting practice
- An overarching requirement is introduced that directors must not approve accounts unless they give a true and fair view
- A requirement for website publication of annual reports and accounts for quoted companies
- The content of the directors' remuneration report is now specified by Schedule 8 to The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 although for investment companies the changes are of limited applicability.

### **Corporate governance changes**

Changes have been made to the Combined Code and to the Disclosure and Transparency Rules ('DTRs') which apply for annual periods beginning on or after 29 June 2008.

The Combined Code has been updated to:

- remove the restriction on an individual chairing more than one FTSE 100 company; and
- allow the chairman of a listed company below the FTSE 350 to be a member of, but not chair, the audit committee provided he or she was considered independent on appointment.

After three years of what has been a relatively stable financial reporting environment, 2009 seems likely to be the year that draws a veil over that era.

To coincide with the application of the Combined Code 2008, the FSA has amended Listing Rule LR 9.8.6(5) to require a statement of how the listed company has applied the main principles set out in Section 1 of the Combined Code (the word “main” being inserted). The intention of this change is to help give greater latitude towards reducing the amount of boilerplate disclosures.

Changes to the DTRs have also been made to implement two recent European Directives, Directive 2006/43/EC (Statutory Audit Directive) and Directive 2006/46/EC (Company Reporting Directive). The key requirements relate to audit committees and corporate governance. In the UK, the Combined Code already addresses many of these matters as they affect listed companies. However, the DTR changes do put requirements onto a statutory footing.

Some specific points of change include the following:

- DTR 7.2.5 requires the corporate governance statement to contain a description of the main features of the company’s internal control and risk management systems in relation to the financial reporting process
- DTR 7.2.10 requires a company which is required to prepare a group directors’ report under the Companies Act 2006 to include in that report, or if presented separately, in the corporate governance statement, a description of the main features of the group’s internal control and risk management systems in relation to the process for preparing consolidated accounts.

Some investment companies may have to consider adding these disclosures to their governance statements.

## **Conclusion**

After three years of what has been a relatively stable financial reporting environment, 2009 seems likely to be the year that draws a veil over that era. In addition to the changes outlined above which are already on-stream, the general ongoing process of IFRS improvement, IFRS/US GAAP convergence and the IASB’s forthcoming proposed improvements to financial instruments measurement standards all loom on the horizon. In relation to financial instruments, accounting for stocklending and valuation of restricted securities are two particular areas under discussion which will be of interest to investment companies. And of course we also await the ASB’s proposals on the future of UK GAAP and SORPs which are due to be published over the summer.

As financial reporting activity picks up once more there is likely to be much with which to keep up to date in the coming months.

# Contact us

The investment company technical release is now available electronically. If you would like to receive an electronic copy, please contact Louise Lerego at [louise.lerego@gtuk.com](mailto:louise.lerego@gtuk.com)

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