

Investment company technical release

July 2010

Keeping our eye on the ball - what's new for 2010?

In this latest technical release we summarise some of the main financial reporting changes for 2010 which are likely to affect investment companies. This year sees fewer changes to accounting requirements than 2009, which is likely to be a welcome relief for many investment company boards and administrators. There are however changes in the corporate governance regime to get to grips with and there are further accounting changes building up in the pipeline, notably the culmination of the ASB's proposals in relation to the replacement of UK GAAP. There are also a number of significant IFRS revisions now beginning to emerge.

The future of UK GAAP

The ASB published a consultation in 2009 setting out its plans to replace UK GAAP with a three tier system incorporating the IFRS for SMEs:

Tier 1 - full IFRS for publicly accountable entities

Tier 2 - IFRS for SMEs applicable to non-publicly accountable entities

Tier 3 - the ASB's existing Financial Reporting Standards for Smaller Entities (FRSSE) for small entities

So far as investment companies are concerned, the key proposals contained in the consultation were twofold:

- a move to full IFRS for all listed entities in 2012; and
- the proposed discontinuation of SORPs

The consultation has generated heated debate particularly around the role of SORPs. The good news however is that the ASB has bowed to pressure for the retention of a number of SORPs and their continued endorsement of these - this is expected to include that published by the AIC for investment trust companies and venture capital trusts.

The change of plan by the ASB partly reflects the major role which the SORP has played in investment company financial reporting over a number of years. More specifically, it acknowledges that as IFRS makes no distinction between capital and revenue, the absence of an endorsed SORP would be problematic for the industry, particularly in relation to tax. The ASB has also decided to retain the authorised funds SORP.

As regards the proposal to require listed entities to report under IFRS, this will be deferred to 2013 from the original proposed application date of 1 January 2012. This would give ITCs and VCTs currently reporting under UK GAAP a further year for transition.

UK GAAP and narrative reporting changes

Pending the finalisation and implementation of the proposals on the future of UK GAAP, the ASB will be seeking to make minimal changes to existing UK accounting standards. Changes to financial reports arising from the implementation of the Companies Act 2006 took effect last year and most 2010 changes to UK GAAP are therefore the result of updating UK standards that are converged with IFRS. The most significant of these for investment companies is in relation to debt/equity classification for limited life entities.

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

The previous version of FRS 25 did not normally require an instrument to be classified as a liability solely on the grounds that it was repayable on liquidation. However, if liquidation is certain to occur and outside the control of the entity (for example, a limited life entity) or is uncertain but is at the option of the holder, FRS 25 required liability classification. This has affected a number of fixed life investment companies.

The amended FRS 25 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 the position of capital shares.

The amendments to FRS 25 mirror amendments made to IAS 32 and are applicable for accounting periods beginning on or after 1 January 2010. The IAS 32 amendments became effective in 2009.

Changes to the directors' remuneration report

As noted above, nearly all the changes to the annual report arising from the Companies Act 2006 have already now been brought into effect. One change, which related to the directors' remuneration report, was however delayed for a year. For periods commencing on or after 6 April 2009 the report must contain a statement of how pay and employment conditions of employees and of other undertakings in the same group were taken into account when determining directors' remuneration for the year.

This is likely to affect only a handful of investment companies.

Changes to directors' remuneration disclosures for AIM companies

In February 2010, revised AIM rules were published which included the introduction of new requirements for disclosure of directors' remuneration. The key new requirement is that the annual accounts must disclose directors' remuneration earned in the year by each director. These disclosures are effective for annual periods ending on or after 31 March 2010.

Previously directors' remuneration disclosures for AIM companies stemmed only from Companies Act 2006 and accounting standards on related party transactions. Directors' remuneration is defined in the AIM rules for the purpose of the new requirements although fee disclosures in investment companies should be a relatively straightforward matter.

UK Corporate Governance Code 2010

In May 2010 the FRC issued the latest version of the Combined Code and retitled this as the 'UK Corporate Governance Code'. The new Code will apply to annual periods commencing on or after 29 June 2010, so in practice 30 June 2011 year ends onwards, once the necessary changes to the Listing Rules have been made by the Financial Services Authority.

The purpose of the Code is essentially unchanged. Companies continue to be required to apply the main principles of the Code and report to shareholders on how they have done so. The 'comply or explain' approach is retained and, for now, the corporate governance statement remains part of the annual report. A further change considered in the review was whether to allow companies a choice of putting the statement on a website instead. The response to this was mixed, but it will be looked at again as part of the FRC's wider project focussing on the reduction of complexity in financial reporting.

The FRC believes that more attention needs to be paid to following the spirit of the Code. Thus, the tone of the Code has been changed to signal the importance of general principles guiding board behaviour. There are some new Code main principles, supporting principles and provisions as well as changes to existing ones. Certain new provisions have been restricted to apply to FTSE 350 companies only. Some of the main changes from the Combined Code 2008 are highlighted below:

- Composition of and appointments to the board - the main principle on board balance and independence has been revised to emphasise the need for a balance of skills, experience, independence and knowledge of the company. This aims to encourage boards to be well balanced and to consider the benefits of diversity in board composition, including gender diversity.
- Re-election of directors - the new Code includes a provision for annual re-election for directors of FTSE 350 companies. This gives shareholders of FTSE 350 companies a more frequent opportunity to express their views on the performance of the board, although some might argue that this will allow shareholder activists an increased opportunity to flex their muscle. On the subject of re-election, VCTs may also wish to bear in mind that the transitional provisions dating from 2007 relating to the listing rule provisions on board independence and annual re-election of non-independent directors expire on 28 September 2010.

After that date the independence provisions of LR15.2.11-15.2.13A are applicable, bringing VCTs into line with other chapter 15 investment companies.

- Performance evaluation - the new Code provides for the evaluation of the board of FTSE 350 companies to be externally facilitated at least every three years. Due to the limited availability of external providers of this service, this provision has been restricted for the time being at least, to the largest companies. There will be a financial cost attached to compliance with this provision, although this will depend on the nature and extent of the service provided.
- Financial and business reporting - companies need to include in the annual report an explanation of the business model (ie how they generate or preserve value over the longer term) and the strategy for delivering the objectives of the company. Companies are encouraged to include this description in the same part of the annual report as the business review which is required by section 417, Companies Act 2006. For investment companies most of the relevant material is likely to be covered by the discussion of investment objectives and strategy and the investment policy disclosures currently required by the listing rules.
- Risk - there is a new principle emphasising the board's responsibility for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The FRC's view is that this was a significant omission from previous versions of the Code. The relevant guidance on reviewing effectiveness of risk management and internal control systems continues to be found in the latest incarnation of the Turnbull Guidance on Internal Control (although this is due to be reviewed later in 2010).

Non-UK companies and the Combined Code

As part of the restructuring of the listing rules the FSA has sought to strengthen the corporate governance standards for overseas companies.

Overseas investment companies with a premium listing will be required to comply or explain against the UK Combined Code for periods beginning after 31 December 2009. For periods beginning after 29 June 2010 the relevant reporting will be against the UK Corporate Governance Code as referred to in the previous section. They are also required to apply the overlapping DTR 7.2 requirements relating to corporate governance statements. This basically brings non-UK companies' corporate governance reporting into line with companies incorporated in the UK.

The impact of this change in practice will be mixed as some overseas investment companies already choose to follow the Combined Code. Also, for those who do not, there has historically been a listing rule requirement to

disclose whether or not the company complies with the corporate governance regime of its country of incorporation and the ways in which corporate governance practices differ from those set out in the Combined Code. Nonetheless offshore investment companies will have to review their governance policies and annual report disclosures in the light of the recent changes.

The UK Stewardship Code

The FRC issued its Stewardship Code on 2 July 2010. This sets out best practice for institutional investors who choose to engage with the companies in which they have invested. In its final form the Code is very similar to the code published by the Institutional Shareholders' Committee (ISC) in November 2009.

The Code consists of seven principles and provides guidance on each of these. This involves having policies in relation to:

- the discharge of stewardship responsibilities
- managing conflicts of interest
- monitoring of investees
- intervention as a means of protecting/enhancing shareholder value
- collective engagement with other investors
- voting and disclosure of voting activity
- reporting on stewardship and voting activities.

The code is addressed in the first instance to firms who manage assets on behalf of institutional shareholders and the FRC expects that managers will disclose on their websites how they have applied the Code. The FSA is currently consulting on the introduction of a formal requirement for authorised asset managers (excluding venture capital firms) to either disclose the nature of their commitment to the Code or to explain their alternative business model. The FRC is however also encouraging institutional shareholders to report if and how they have complied with the Code.

Investment company boards will need to consider their policy and approach to the new Code. Institutional shareholders remain free to choose whether or not to engage with investees but investment companies seeking to follow the Code would need to ensure that the stewardship policies to be followed are reflected in any mandates given to fund managers or other agents. Boards would need to consider their approach to reviewing any reports on engagement published by managers and consider how they will go about making any relevant disclosure to shareholders.

IFRS changes - financial instruments

2010 sees fewer IFRS changes than 2009. There are the usual annual raft of changes arising from the IASB's "annual improvements" programme although these involve mostly minor amendments and clarifications.

IFRS however continues to evolve, meaning that more changes are on the way beyond 2010. In particular there are major revisions to financial instruments standards which will apply from 2013 as part of the IASB's project for replacing IAS 39 Financial Instruments: Recognition and Measurement. A brief overview of some key current IASB financial instruments projects where revised standards and exposure drafts have been published or are due imminently is set out below.

IFRS 9 Financial Instruments

The IASB have divided their project to replace IAS 39 into three main stages:

- Phase 1: Classification and Measurement
- Phase 2: Impairment Methodology
- Phase 3: Hedge Accounting

In November 2009, the IASB published the first instalment of IFRS 9 Financial Instruments - representing the main part of Phase 1 of the project. This addresses the classification and measurement of financial assets. The mandatory effective date is annual periods commencing on or after 1 January 2013. Early application is not currently permitted in the European Union as the standard has not yet been adopted by the EU, nor is it likely to be in the near future. Once the standard has been adopted by the EU, early application may be permitted.

Separate projects are also underway to replace IAS 39's requirements on measurement of liabilities and on derecognition. The output from these various projects, along with phases 2 and 3 mentioned above, will form part of IFRS 9 in due course.

Classification and measurement of financial assets

IFRS 9 will reduce the number of categories of financial assets and requires that these be measured at either amortised cost or fair value. Other IAS 39 measurement categories (including available for sale and held to maturity) are largely superseded. This broadly endorses the current fair value through profit or loss approach recommended by the AIC SORP and followed by most investment companies.

Amortised cost accounting is required if the entity's business model is to hold the financial asset to collect contractual cash flows and the contractual cash flows from the asset relate solely to payments of principal and interest. The business model would generally need to be considered on a portfolio basis and where a portfolio is managed on a fair value basis these conditions are unlikely to be met. Some companies could however have different portfolios and as

with all accounting standards the application to specific facts and circumstances will need to be considered.

VCTs may be particularly interested in the fact that although IFRS 9 requires that all investments in equity instruments must be measured at fair value, it also now discusses the limited circumstances under which cost may be an appropriate estimate of fair value. IFRS 9 notes that this may be the case if insufficient more recent information is available to determine fair value. It also notes that cost might be appropriate as an estimate of fair value if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range. IFRS 9 provides a list of indicators of when cost might not be representative of fair value and when an alternative estimate of fair value may be necessary.

Classification and measurement of financial liabilities

In May 2010 the IASB published an exposure draft dealing with financial liabilities. This involves amendments to the presentation of changes in the fair value of liabilities which arise from changes in the issuer's creditworthiness. The proposals published will therefore have limited applicability to the investment company sector where liabilities are typically reflected at amortised cost and it will only affect entities that choose to apply the fair value option to their financial liabilities. The exposure draft proposes to leave the financial liabilities measurement rules in IAS 39 largely unchanged other than in relation to this aspect.

Impairment and effective interest rate accounting

In November 2009, the IASB published its exposure draft Financial Instruments: Amortised Cost and Impairment. This is the second phase of the project to replace IAS 39. The primary impact of this on investment companies will stem from the fact that it sets out the methodology for effective interest rate accounting, which affects recognition of revenue from debt securities.

The central proposal is to move from the current 'incurred loss' impairment method in IAS 39 to one based on expected losses. This will involve building any initial estimated future credit losses into the initial effective interest rate when the asset is acquired. This could mean lower effective rates in certain instances, and is a direct response to criticism of IAS 39 that it has resulted in potentially overstated interest revenue during the financial crisis.

Hedge accounting

The IASB is planning to issue an exposure draft in 2010 with a view to simplifying the current IAS 39 requirements in relation to hedge accounting. A relatively small number of investment companies have felt the need to use hedge accounting but those who have done so and have tried to follow the excessively complex provision in IAS 39 will welcome this review.

Derecognition

The IASB has also been planning to amend IAS 39 in relation to derecognition of financial assets and financial liabilities. An exposure draft was issued in 2009 and a final standard was expected to be issued towards the end of 2010.

One of the key issues relevant to investment companies has been accounting for stocklending. Under the IASB's initial proposals, lent stock would be derecognised if the borrower has the ability to transfer this for their own benefit. At present companies would typically continue to recognise lent assets because they continue to have the risks and rewards of ownership. Understandably, the proposals have not been well received and following discussions the indications are that the IASB may put them to one side for the time being. The final standard later this year may therefore differ significantly from the exposure draft - if so, this is to be welcomed.

Financial instruments with characteristics of equity

The IASB is planning to issue an exposure draft addressing what instruments are classified as equity (as opposed to financial liabilities) with a view to replacing IAS 32 Financial Instruments: Presentation.

This will be an important publication for investment companies as it may have implications in various areas including, for example, debt/equity classification in limited life entities, and accounting treatment of instruments such as warrants, C shares and subscription shares. The exposure draft had been expected this summer but the indications are that it may now be early 2011 before it is published.

Other proposed IFRS changes

Another key area for investment companies to keep an eye on is the IASB's plan to publish a single IFRS on consolidation, to replace the current IAS 27 and SIC 12 on special purpose entities.

As part of this project the IASB has tentatively agreed that they should be considering an exception to consolidation for investment companies holding portfolio investments. The detail of this remains to be published and consulted upon but this is a welcome development after many years of trying to persuade the IASB that consolidation of portfolio holdings which are managed on a fair value basis does not produce useful accounting information. There will be issues to resolve regarding the definition of investment companies for this purpose and clarification of the additional disclosures which will be required, but these matters are expected to be the subject of an exposure draft due to be published later this year.

Other reporting changes - ICTA s842

Following recent tax legislation rewrites, the rules in section 842 of Income and Corporation Taxes Act 1988 dealing with investment trust status have taken on a new appearance. The new legislation is contained in Chapter 4 of Corporation Tax Act 2010.

The old section 842 is substantially unchanged but has been repackaged in s1158 to s1165 inclusive, such that:

- s1158 contains the definition of 'investment trust'
- s1159 contains the conditions for approval
- s1160 contains the rules on calculation of income
- s1161 contains the exceptions to the income retention condition
- s1162 contains the exceptions to the 15% holding limits
- s1163/4 set out the meaning of 'holding in a company'

References in annual reports and accounts will need to be updated accordingly. As the new legislation applies with effect for periods ending on or after 1 April 2010, current and prospective references will generally be to section 1158 or section 1159 (depending on what is being referred to) whilst historic references, for example where referring to HMRC's granting of approval for 2009, will be to section 842.

2011 filing changes for accounts at Companies House and corporate tax returns

HM Revenue and Customs (HMRC) has announced that from 1 April 2011 for any accounting period ending after 31 March 2010, all Company Tax Returns must be filed online with accompanying financial statements and computations in iXBRL format (inline eXtensible Business Reporting Language).

Whilst the online filing requirements of Companies House for all accounts will align with HMRC's approach for Corporation Tax returns, Companies House has not yet confirmed from when this will be applicable.

iXBRL is a new, electronic format for business information, which HMRC expects to provide benefits in the preparation, analysis and communication of business and financial data. iXBRL is becoming a global standard for financial reporting.

The exact scope of the HMRC and Companies House requirements has yet to be finalised and various industry bodies are lobbying for certain types of entity to be exempted. Although HMRC say they are expecting that substantially all companies will be covered by the requirement to file financial statements and tax computations using iXBRL, the special format of investment trust and VCT accounts is likely to pose special challenges.

For tax computations and returns a number of software suppliers have developed beta versions of software solutions with final versions expected to be available well before the April 2011 deadline.

The solutions for financial statement submission are more complex and companies will need to take some planning actions.

The generic options available are the following:

- Software embedded within accounting software - where the accounts production process uses a software package, many software providers are planning to provide an iXBRL solution.
- Conversion - many companies produce accounts using Word, Excel or desk top publishing packages. Solutions which enable these documents to be converted to iXBRL documents are being developed by software providers. This process, although electronic, will require manual tagging to take place. Companies will need to be planning for this within their accounts production cycle.
- Outsourcing - the conversion process can be outsourced to organisations who will prepare the iXBRL document for filing by the company.

Investment company boards should be discussing with their service providers the planned solutions for both financial statements and tax filing requirements prior to the mandatory deadline.

Conclusion

Compared to recent years, the forthcoming reporting season for investment companies is going to be one of the quieter years in term of direct changes arising from accounting standards. This is a welcome as it gives an opportunity to focus more on fine tuning disclosures, improving layout, cutting back any areas of duplication which may have materialised in the annual report over the years - and just generally catching breath.

As ever however there is plenty going on. The process of improving and replacing parts of IFRS is beginning to build momentum and investment companies will need to keep on top of developments as they arise. Some of these developments may well turn out to have favourable consequences for the sector - for example the IASB's proposals on consolidation of portfolio investments, but inevitably changes will bring with it the usual challenge of detailed assimilation, interpretation and implementation planning. A lot of the major accounting framework changes now seem to have acquired a 2013 focus - it looks as though this would be the year in which investment companies on UK GAAP might move to IFRS for example, and also the year of implementation of revised financial instruments standards. Keep an eye out for more exposure drafts and policy announcements over the remainder of 2010.

Contact us

If you would like to discuss any of the matters raised in this release further, please contact one of our investment trust experts listed below.



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