

The Association of Investment Trust Companies

Amendments to IAS 39 – Use of the Fair Value Option

URGENT ACTION REQUIRED

This note should be read urgently by all Members who will be preparing final accounts under International Accounting Standards (IAS) either for their current accounting period or for the one immediately following their current accounting period ('IAS companies'). This includes investment trusts which are either preparing their accounts under IAS for the first-time (whether on a voluntary basis or, more likely, by virtue of having to prepare consolidated accounts), as well as those offshore Members who may already be preparing their accounts under IAS. However, although different deadlines apply, it is also of relevance to Members preparing their accounts under UK GAAP ('UK GAAP companies').

The International Accounting Standards Board has recently published changes to IAS 39 which will amend the paragraphs relating to the use of the fair value option (the 'Amendment'). This Amendment provides certain options which could have a significant impact on the presentation of gains and losses on investments in Members' accounts. However, these options are subject to a number of conditions and are also subject to deadlines by which certain formal steps must be taken. This note explains the background to the changes, their impact and the steps that Members may need to take to avail themselves of the options provided by the Amendment.

In some cases, investment trusts may be required to take formal steps by 1 September 2005 and therefore URGENT ACTION may be required.

The comments below are general guidance. Some of the issues raised can only be finally determined by reference to the facts applying to individual investment trusts on a case-by-case basis. Members in any doubt over the application of the Amendment should contact their auditors immediately.

Background

As Members may be aware, the use of fair value for liabilities (other than derivatives) is currently severely restricted because IAS 39 was only partially adopted by the EU. This effectively made it illegal to fair value debt for accounts purposes.

The Amendment effectively permits the fair valuing of liabilities subject to certain conditions. It is understood that these conditions will be sufficient to remove EU objections to the use of the fair value option in respect of liabilities. IAS 39 (as amended) is therefore expected to be adopted in full so that liabilities can now be

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fair valued (subject to meeting the necessary conditions). However, for the reasons set out below, **the Association is not recommending that investment trusts opt to fair value their liabilities at this time.** (Where the document refers to liabilities, it should be assumed, unless otherwise stated, that this refers to liabilities other than derivatives, for which there are separate rules.)

However, in addition to liabilities, the changes made by the Amendment also apply to the fair valuing of assets and it is this aspect that is considered crucial for investment trusts.

The AITC's SORP recommendations

The Revised SORP Exposure Draft (issued on 24 June – deadline for comments 23 September 2005) is proposing (paragraph 23) that:

‘Investments held by an ITC should **normally be classified as at fair value through profit or loss** unless the entity believes that another classification would be more appropriate’

Although the SORP only applies to UK GAAP accounts, the UK accounting standards that apply to financial instruments are virtually identical to the IAS equivalent. **The rationale behind the SORP's recommendations is therefore as applicable to IAS accounts.**

The reason for the SORP's recommendation is that treating investments as a fair value through profit and loss (FVTPL) will enable an investment trust to present a three column Income Statement (i.e. its profit and loss account) and then to record fair value gains and losses on its investments, both realised and unrealised, in the capital column. This will keep the recognition and presentation of capital profits as close as possible to the past UK GAAP position (where companies which have been recording their realised and unrealised capital profits in the capital column of the Statement of Total Return). It is also more meaningful for investors, as changes in the fair value of investments will be shown in the primary performance statement.

For legal reasons explained below, companies preparing their accounts under UK GAAP ('UK GAAP companies') are currently unable to fair value their liabilities. The Revised SORP Exposure Draft therefore makes no recommendations on this issue.

The impact of the new rules

Under the old rules, there was discretion to designate all investments as at FVTPL (subject to a few exceptions, such as unquoted shares). In addition, as IAS 39 was originally only partially adopted, there was little scope to designate liabilities as at FVTPL. However, under the new rules, both assets and liabilities may be (but are not required to be) designated as at FVTPL if:

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- it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
- a group of financial assets, financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel....for example the entity's board of directors

Investments

Many Members, now well into their first IAS accounting period, may have already designated their investments as at FVTPL. However, if any of these investments do not meet the new criteria, then they will have to be 'de-designated' (i.e. reclassified as something other than as at FVTPL, most likely as available-for-sale). In addition, any new investments will have to meet these criteria if they are to be designated at FVTPL.

Nearly all investments held by investment trusts will meet the criteria and therefore existing and future investments will be capable of being treated as at FVTPL. However, in addition to meeting the conditions above, the Amendment requires that investments be '**designated**' as at FVTPL **and that this designation must take place by the deadline imposed**. It is likely that auditors will require evidence that such designation has taken place by the deadline imposed.

Designation

The Amendment gives no formal guidance as to what the process of designation should entail. Whilst Board minutes formally dealing with this issue would be the ideal approach, other evidence of designation may be acceptable. It is understood that, for example, an investment trust that has already produced its IAS interim accounts showing its investments as at fair value through profit or loss may be considered to have already effectively made such a designation. Evidence of approval by the Chairman of the Audit Committee may also constitute designation. **However, Members in any doubt over this matter are strongly advised to contact their auditors.**

Deadline

Investment trusts which have or will have commenced their first IAS accounting period on or before 1 September 2005 have until 1 September 2005 to make the necessary designation. So, an investment trust with an accounting period ending

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30 June December 2006 will have until 1 September 2005. This company will almost certainly not have prepared any interim accounts under IAS by 1 September 2005 and therefore will not be able to rely on this as evidence of designation.

Investment trusts whose first IAS accounting period commences after 1 September 2005 and before 30 December 2005 must ensure that designation has taken place by the end of the current accounting period. So, an investment trust whose first IAS accounts will be prepared for an accounting period ending 30 November 2006 must ensure that designation has taken place by 30 November 2005.

In line with the SORP's recommendations, the AITC believes that, unless Members consider that another classification is more appropriate, classification of all investments as at FVTPL would represent best practice. Therefore Members need, as a matter of urgency, to review their position and satisfy themselves that the designation is in place by the appropriate deadline.

Liabilities

As far as liabilities are concerned, due to the legal restrictions that arose as a result of the partial adoption of IAS 39, it is extremely unlikely that any liabilities have previously been designated as at FVTPL. Therefore the question of de-designation will not arise. However, the possibility remains that Members might wish to treat some or all of their liabilities as at FVTPL. The deadline for doing so is the same as for assets.

As Members will be aware, the AITC currently collects NAVs with debt at fair value. It may therefore seem logical to recommend that all Members should take full advantage of the above option as far as possible where debt liabilities are concerned and classify them as at FVTPL. However, this is not as straightforward as it may seem and the following issues would need to be considered:

- does the typical investment trust financial liability (e.g. debt taken out for gearing purposes) meet the above conditions? Though it would appear that there are grounds for arguing that these conditions are met, this would need to be confirmed with the company's auditors;
- even if these conditions are met, the timetable for designating existing liabilities as at FVTPL is short. For some investment trusts, the deadline will be as early as 1 September 2005. This therefore raises the possibility that some investment trusts will fail to meet this deadline and therefore have to continue to treat their liabilities at amortised cost through 'default';

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- the position with regard to UK GAAP companies is unclear. Although we would expect UK standards to exactly mirror IAS, the EU legislation that prevents UK GAAP companies legally from fair valuing liabilities operates in a different manner to the way it originally prevented IAS companies from fair valuing debt. Therefore, unless European legislation is changed, UK GAAP companies will still be legally prevented from fair valuing their liabilities other than through the use of the 'true and fair override' (which is unlikely to be an option). IAS companies might therefore end up presenting their accounts on a fundamentally different basis to the majority of the industry (the AITC estimates that 2/3^{rds} of the industry are likely to remain under UK GAAP for the foreseeable future).
- the tax position of any fair value profits and losses on liabilities is far from certain, as the relevant tax rules have yet to be finalised. Though this is unlikely to have an adverse affect on 842 status, we would consider it is likely that fair value gains will give rise to taxable profits.

On balance, therefore, the AITC is not recommending that Members preparing IAS accounts should designate their liabilities as at FVTPL. The AITC will continue to make representations to the relevant accounting bodies with a view to reaching a position where, should it be considered appropriate at some future date, all investment trusts (both IAS and UK GAAP companies) would be able to switch to the fair valuing of debt on a consistent basis.

UK GAAP companies

The Amendment only applies to investment trusts preparing their financial statements in accordance with IAS. However, the Accounting Standards Board is planning to introduce a similar amendment which will mean that investment trusts preparing their financial statements in accordance with UK GAAP will also face the task of designating their investments (and potentially their liabilities) by tight deadlines. In this case it is expected that the earliest deadline will be 1 December 2005. However, we would recommend that Members begin planning for this as soon as possible.

Conclusion

If you have any questions regarding the content of this note please do not hesitate to contact John Stevens (020 7282 5605; e-mail: john@aitc.co.uk) or Ian Sayers (020 7282 5612; e-mail: ian@aitc.co.uk).