

Liz Cole
ICAEW
Chartered Accountants Hall
PO Box 433
Moorgate Place
London EC2P 2BJ

31 August 2005

Dear Liz

Distributable profits: implications of IFRS for investment trust companies

Further to our recent conversations, I attach our views on Tech 21-05. This note concentrates on the recommendations in respect of how fair value gains on financial instruments recognised under IAS 39 should be apportioned between realised and unrealised profits.

We have no objection in principle to the suggestion that fair value gains and losses should be treated as realised profits and losses. However, we are unable to support the recommendation that fair value gains should be apportioned between realised and unrealised profits by estimating the price which would be secured if the entire holding in a financial instrument were sold at the balance sheet date (the 'block discount approach'). We do not believe that this recommendation can be complied with because it is not possible to estimate block discounts with a sufficient degree of accuracy and consistency. Our detailed comments on this point are **attached**.

Background

Investment trusts are public companies, listed on the London Stock Exchange, whose primary business is investing in a diversified portfolio of shares and securities. The industry is made up of over 300 companies and manages just under £65 billion of assets.

In other words, investment trusts are unique where listed companies are concerned in that their entire business revolves around holding financial instruments. Investment trusts very often own hundreds of individual holdings (we have some Members holding in excess of 700 different company shares).

Key issues

In principle, we have no objection to the treatment of fair value gains and losses as realised profits and losses. However, any guidance that is issued as to the determination of realised and unrealised profits must be achievable. The current proposal cannot meet this critical requirement.

Fair value gains cannot be apportioned between realised and unrealised profits according to the price that would be obtained if an investment trust were to sell its entire holding of shares on the balance sheet date. Our objection is not based upon administrative concerns, significant though these will be. It involves fundamental questions such as how, in the absence of actually trying to sell a holding which is large in the context of the market on which it is traded, an investment trust will be able to make an accurate assessment of the scale of any discount the sale would incur. Discussions we have had with major brokers to the sector indicate that there is no way of making such an assessment with any realistic degree of accuracy.

We also believe that taking a "prudent" approach to making such an estimate would risk creating an unfair and illogical mismatch between fair value profits being treated potentially as predominantly unrealised, whereas losses on similar investments are treated fully as realised, even though the valuation basis of both will be the same. This would be an unacceptable outcome.

Recommendation

The AITC recommends that fair value profits on financial instruments quoted in active markets which meet the criteria of IAS 39 be treated as fully realised. This fair value is, by definition, what IAS 39 considers to be:

“the amount for which an asset could be exchanged...between knowledgeable, willing parties in an arm’s length transaction.”

In our view, IAS 39 sees quoted bid prices as the best evidence available of what fair value is. This does not mean that all transactions in financial instruments would have to take place via the market from which the bid price has been

obtained. We therefore believe that the current draft guidance places too great an emphasis on a 'firesale' approach, which brings into play a range of unknown variables that, according to major brokers to the sector, would make any assessment of realisable value for many investments held by investment trusts little better than pure guesswork.

Therefore, provided that the bid price is obtained from an active market, we see no reason why fair value gains should not be treated as fully realised irrespective of the size of the holding.

Conclusion

If the ICAEW still believes it is possible to comply with the 'block discount approach', it is essential that it demonstrates clearly, in any final guidance, precisely how this should be done. If, as we expect, it is unable to do so, then the draft guidance must be amended, as it would be unacceptable for the ICAEW to issue guidance that it is impossible for reporting entities such as investment trusts to comply with.

I would be happy to discuss this matter with you further in due course. My direct line is 020 7282 5612.

Yours sincerely

Ian Sayers
Technical Director

THE 'BLOCK DISCOUNT APPROACH' FOR APPORTIONING FAIR VALUE GAINS BETWEEN REALISED AND UNREALISED PROFITS

AITC ANALYSIS

The ICAEW has proposed that fair value gains be apportioned between realised and unrealised profits according to a 'block discount approach'. The draft guidance states that the block discount is the discount:

“that might apply if the entire holding were to be disposed of at the balance sheet date”

This recommendation is impossible to comply with to any reasonable degree of accuracy and robustness. **The AITC strongly recommends that this proposal should not be retained in the final guidance issued by the ICAEW.**

The problem with estimating realisable value on such a basis

The ICAEW proposal envisages a theoretical 'firesale' approach to determining the proportion of any fair value gains which should be treated as realised and unrealised profits. However, it would be wrong to assume that, because the exchanges on which investment trusts trade their shares are normally active and liquid, that these shares could be disposed of without a significant discount arising. **Such discounts will arise but, critically, it would simply be impossible to estimate the level of the likely discount in a theoretical firesale situation, making the block discount approach unworkable.**

Order driven markets: The London Stock Exchange's SETS market is one of the deepest and most liquid markets in the world. Therefore, it might be tempting to assume that almost any deal size likely to be offered by an investment trust can be catered for without a significant block discount. This, in itself, would be an incorrect assumption to make in many cases. Markets such as SETS operate on the basis of matching buyers and sellers posting prices and volumes which they are committed to dealing at. How can such an assessment of any block discount be made in the absence of actually posting a sale transaction?

Quote driven markets: The problem of securing a realistic estimate for the realisable value of shares under a block discount approach is likely to be even more acute in a quote driven market. These markets operate through the presence of market makers who are required to indicate the size of deal and prices which they are prepared to transact.

UK market makers are obligated to deal at their screen prices in all stocks in which they make markets but only in respect of certain minimum deal sizes. On the London Stock Exchange, this guaranteed deal size is referred to as the Normal Market Size (NMS). Details of the NMS in a particular stock can be obtained from the London Stock Exchange. Although market makers will often quote prices and deal sizes which are a multiple of the NMS, they are not obligated to deal at these prices.

The greater the deal size in relation to the NMS, then the greater the likelihood of a block discount. For investment trusts, it is likely that the size of their holdings in the vast majority of their investments dealt with on quote driven markets will be many times the NMS.

To demonstrate this, Table 1 below shows information relating to a typical UK mid-cap investment trust selected at random. It shows the position in respect of the largest and smallest holding in each of the main stock market sectors in which the investment trust invests. It shows the market cap of the investee company, the current NMS in that particular stock, the current share price and thereby the maximum deal value that could be accommodated within the NMS. It then compares this to the value of the investment trust's holding in that company as per the latest accounts.

Table 1

Largest	Name of holding	Mkt Cap (£m)	NMS	Price (pence)	NMS by value (£)	Holding (£m)	Holding as % of 'NMS by value'
<i>Cyclical Services</i>	EMI	1,964	150,000	248.75	373,125	4.389	1176%
<i>Basic Industries</i>	Taylor Woodrow	1,858	75,000	322.50	241,875	4.249	1757%
<i>Financials</i>	Hammerson	2,510	25,000	870.00	217,500	4.559	2096%
<i>General Industrials</i>	Laird	488	10,000	339.00	33,900	3.016	8897%
<i>Non-Cyclical Consumer Goods</i>	Northern Foods	770	75,000	149.25	111,938	3.146	2810%
<i>Utilities</i>	Kelda	2,442	50,000	676.00	338,000	4.278	1266%
<i>Resources</i>	Lonmin	1,451	25,000	1,172.00	293,000	3.242	1106%
<i>Information Technology</i>	Misys	1,122	100,000	227.25	227,250	2.457	1081%
<i>Cyclical Consumer Goods</i>	Inchcape	1,536	5,000	2,104.00	105,200	2.562	2435%
<i>Non-Cyclical Services</i>	Somerfield	1,069	75,000	202.25	151,688	2.185	1440%

Table 1. cont.

Smallest	Name of holding	Mkt Cap (£m)	NMS	Price (pence)	NMS by value (£)	Holding (£m)	Holding as % of 'NMS by value'
<i>Cyclical Services</i>	Aegis	1,084	15,000	119.00	17,850	0.305	1709%
<i>Basic Industries</i>	Croda International	503	10,000	402.75	40,275	0.312	775%
<i>Financials</i>	Chesnara	115	10,000	156.75	15,675	0.211	1346%
<i>General Industrials</i>	AGA Foodservice	383	10,000	305.00	30,500	0.434	1423%
<i>Non-Cyclical Consumer Goods</i>	Dairy Crest	589	10,000	478.50	47,850	1.946	4067%
<i>Utilities</i>	International Power	2,875	150,000	225.75	338,625	0.059	17%
<i>Resources</i>	Paladin Resources	604	25,000	292.50	73,125	1.433	1960%
<i>Information Technology</i>	Arm Holdings	1,458	200,000	122.00	244,000	0.329	135%
<i>Cyclical Consumer Goods</i>	Headlam	353	5,000	432.75	21,638	0.324	1497%
<i>Non-Cyclical Services</i>	Thus	189	200,000	16.00	32,000	0.174	544%

Table 1 demonstrates that, with the exception of one share, every holding owned by the investment trust is well beyond that which could be catered for within the NMS. Some are more than 80 times NMS, and multiples in excess of 10 times are very common.

From an overview of the remaining holdings in the portfolio, we would expect that less than a handful of holdings out of the 100+ holdings in the portfolio could be accommodated with the NMS. This is not because the companies the investment trust invests in are small. Some of the investee companies are in excess of 2bn market cap. Nor is it because the investment trust itself is particularly big (it would probably be referred to as medium-sized within the investment trust industry).

This demonstrates that, if an entire shareholding were to be sold on the balance sheet date, there is a strong possibility that a block discount might apply. How much of a discount would be impossible to estimate as this would depend on the market conditions prevailing. It also demonstrates that this problem would not arise in respect of a few holdings, but rather would be the case in respect of most investment trust holdings.

Outside the NMS, there are no guarantees of the price that might be obtained on an effective 'firesale' basis. Although market makers will often offer deal sizes above the NMS, these are still very unlikely to be of sufficient size to cater for typical investment trust holdings. For such deals, it is possible that the market

maker will demand a significant discount from the screen price, or might even refuse to deal in that size at all. Where the market maker is prepared to deal at the size required, the scale of discount is a matter of commercial negotiation that is dependent on the market maker's own position at the time of the trade, a position that is constantly changing. The problem with the draft guidance is that, in the absence of actually trying to sell the holding, and entering into such a negotiation, there is simply no way of knowing whether any or all of the market makers would be prepared to take the entire line of stock and what the level of discount might be.

Even in the unlikely event that, on the balance sheet date, there was an announcement of a trade in a size comparable with that of the investment trust's holding, even this would not be sufficient evidence that this would represent realisable value on the balance sheet date. Under the rules of the London Stock Exchange, for example, market makers are able to delay announcements of trades for up to 5 days where large deal sizes are concerned.

Therefore, the announcement that, say, a market maker has acquired a substantial block of shares equivalent to the investment trust's holding in the same company may only represent the position the market maker was prepared to take on 5 days ago. It is unlikely to represent the position that the market maker would be prepared to take on today (indeed, given that the market maker has taken on such a large position, it is probably less likely that it would be prepared to take on another such large position so soon).

Again, this substantiates the view that the only robust way to estimate the realisable value of large holdings is to actually try and sell the holding. This is, of course, not a viable option. Brokers that we consulted felt that any other approach would not provide a sufficiently accurate and robust measure of realisable value. More colloquially the view was that such estimation techniques would very often turn out to be "wildly out" and little more than a "finger in the air". Whilst these techniques could no doubt be made to look sophisticated and scientific on the surface, in reality they would provide little reassurance as to what would actually occur in a dynamic, negotiated business situation.

We enclose a copy of a report prepared for the AITC some years ago which discusses secondary liquidity in the investment trust market. Appendix II provides a useful insight into the vagaries and variables that dealing large blocks of shares can present. However, as the report comments:

“The reality of the situation is that ‘price and size’ is not just determined by what is on the screen.....There is therefore an art to dealing which takes years to fully master and above all it is a relationship activity.”

Conclusion

An investment trust cannot possibly attempt to estimate across its entire portfolio on a stock-by-stock basis the actual result of what, in the real world, would be a dynamic, negotiated, business transaction subject to countless unpredictable factors. The unpredictable nature of such transactions would be compounded by the fact that a typical investment trust would be holding shares in many hundreds of companies, trading on more than one stock exchange (both UK and overseas) and possibly on more than one trading platform on the same exchanges.

We therefore strongly recommend that the proposed block discount recommendation be removed before publication of the final guidance and that fair value gains on financial instruments calculated by reference to the bid price on an active market should be treated as fully realised, irrespective of the size of holdings in those instruments.