



**Conditions for the application of
International Accounting Standards
for investment funds in the European Union**

A FEFSI discussion paper

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Conditions for the application of International Accounting Standards for investment funds in the European Union

Introduction

The adoption of a Regulation on IAS by the EU for European exchange traded entities preparing consolidated financial statements has significant implications for all those EU entities that must publish their accounts. As such the adoption of IAS by the EU constitutes a first step in establishing IAS as a common standard within Europe as well as reinforcing the global acceptance of IAS.

The effects on accounting and reporting will be far reaching, not least for European investment funds. As the European Commission left it - for the time being - to Member States to extend the application of IAS to all regulated companies and institutions, some of them may decide to include within the regulation's scope all entities quoted on a stock exchange and/or selling to the public. Thus, the application of IAS to the accountancy of UCITS and other collective investment schemes becomes a subject of consideration. EU Member States may tend to extend the IAS directly to CIS, e.g. those who have corporate legal form themselves. Moreover, IAS applying companies that invest in CIS may require an IAS compliant reporting that will have strong impact on the final accounting.

Against this background FEFSI established a working group with wide participation of experts, including those from the major auditing firms (PWC, KPMG, Ernst & Young, Deloitte & Touche), the main task of which was to analyse the implication of a potential application of IAS rules to European investment funds, in particular with respect to information benefits to the final retail investor.

The following report is the outcome of this discussion and identifies the conditions under which an efficient implementation of IAS for investment funds would be possible, whilst basing the report on the conception that accounting principles for investment funds should take into account the interests of institutional and retail investors. Fund accounts should be established mainly to provide investors with the (financial) information they need to achieve transparency with regard to their investments in CIS. On the other hand, what investors need to know is clearly described in two legal pieces that form the foundation to the European fund business: The 1985 UCITS Directive (Directive 85/611/EEC) in particular the annex on accounts, and in the most recent modification of this UCITS Directive (Directive 2001/107/EC), which entered into force on 13 February 2002, in particular the annex describing the content of the so-called simplified prospectus.

The underlying aim of providing information between IAS and EU legislation are not dissimilar but there is a fundamental difference in the approach and methods employed to achieve it. This report details a number of key significant differences but the differences are not limited to such. The differences, which have been considered but not retained in this report, are briefly described below:

- The capitalisation of formation expenses and its amortisation over a reasonable period, which is disallowed under IAS. Fortunately, some funds already expense

these costs in the year it is established, and, for the majority of other funds, the amount is not significant when compared to the fund's total net asset value.

- The classification of financial assets and liabilities is another example. IAS 39 has four classifications, which limit the way investments or financial instruments are presented in a fund. Should the new proposals on IAS 39 go through, investments will need to be specifically classified as “trading” or “available for sale” (or under the other two classifications) which has the direct impact of recording the change in values through the profit and loss account or through equity respectively. IAS 39 also requires “embedded derivatives” to be separately valued from their host contract unlike the current practice of valuing the combined instrument. Currently however, the new IAS 39 may use fair value accounting for these types of derivatives as well as for all financial assets and liabilities.
- We can also see differences in the area of consolidation where there are significant operational and cost ramifications on its application. The current practice of attaching the financial statements of master feeder funds would not be acceptable and the treatment of investments in a venture capital fund would also change. Under IAS 27, the feeder and venture capital funds would have to present consolidated financial statements for all entities under its control. This presents a substantial impact to promoters and administrators alike in the management, supply and presentation of information to investors. However this point has not been retained in this paper as this issue would normally not impact UCITS funds.
- Impairment test requirements under IAS 39 for financial assets would in principle not create significant issues for UCITS funds, as financial assets are normally valued at their market prices.

In short, IAS can only meaningfully be applied if and insofar as they are in line with these basics UCITS fundamentals. Against this background the FEFSI Experts Group is of the clear opinion that certain changes or interpretations with respect to the current IAS must take place to allow the latter's meaningful application to the European investment funds industry. Only in this case and in this sense IAS rules may constitute the nucleus of a comprehensive and common accountancy standard for all economic operators in the European Single Market.

Steffen Matthias, 26 September 2003

Composition of the Experts Group:

Chairman:

Ms Kajsa LINDSTAHL, BANCO AB, Sweden

Experts:

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Executive Summary

Title	Statement of Unitholders'/Shareholders' equity - IAS 1
Priority	2
Issue	IAS 1 requires a statement of unitholders'/ shareholders' equity and disclose a reconciliation between the balances of each class of capital and reserves at the beginning and end of the period, separately disclosing each movement.
Impact	The requirement is onerous for multi-class multi-compartment funds, the usefulness and relevance of such information is doubtful, especially when share classes share one pool of assets, and not consistent with other GAAPs.
Technical solution	FEFSI to seek confirmation that for multi-class multi-compartments funds the IAS presentation should be at each compartment level with disclosure given for the rights, terms, charging structures and NAVs of each class of capital.
Title	Comparatives for portfolio statements - IAS 1
Priority	2
Issue	IAS 1 requires comparatives for all numerical information in the financial statements.
Impact	Disclosures for multi-compartment funds are onerous and it is not a requirement of the UCITS directive as comparatives for an already detailed year end portfolio statement is neither useful nor relevant.
Technical solution	FEFSI to seek confirmation that comparatives are not required for the portfolio statements.

Title	Cash flow statements - IAS 7
Priority	2
Issue	IAS 7 requires a cash flow statement as part of their financial statements.
Impact	Presentation of a cash flow statement would not provide more meaningful nor additional information, is an additional burden as it is not required in many EU countries and is not consistent with other GAAPs (US, UK, Canadian, etc...).
Technical solution	FEFSI to seek exemption for funds when: <ol style="list-style-type: none"> 1. investments are highly liquid; 2. investments are fair valued; 3. there is little or no debt in the funds; and 4. there is a statement of changes in net assets.
Title	Segmental reporting - IAS 14
Priority	2
Issue	Publicly traded enterprises should present financial information by segment in accordance with IAS 14.
Impact	Classification of financial information for funds is only appropriate at the "asset management" level.
Technical solution	FEFSI to seek confirmation that segmental reporting is not required for funds.
Title	Reporting currency for funds - IAS 21 & 29
Priority	2
Issue	SIC 19 requires the measurement currency to be useful and reflects the economic substance of the underlying events and circumstances relevant to that enterprise.
Impact	The base currency used by funds and as defined in the fund's prospectus may be different from the one required to be used as the measurement currency under IAS/IFRS.
Technical solution	FEFSI to seek confirmation that the current industry practice is in accordance with IAS 21.

Title	Classification of puttable instruments - IAS 32
Priority	1
Issue	Puttable instruments with a right to redeem their interest in cash meets the definition of a liability and is presented as such.
Impact	Funds with puttable instruments will no longer have equity resulting in illogical and confusing financial statements inconsistent with other GAAPs.
Technical solution	FEFSI to seek exemption from presenting puttable instruments as liabilities.
Title	Earnings per share - IAS 33
Priority	2
Issue	Basic and diluted EPS is required for publicly traded enterprises.
Impact	EPS is not meaningful nor transparent in presenting the performance of a fund. NAV per share is more accurate and fair.
Technical solution	FEFSI to seek confirmation on the use of NAV per share over EPS and to develop appropriate standards for NAV per share data.
Title	The use of bid price for quoted securities - IAS 39
Priority	1
Issue	IAS 39 requires the use of bid prices to value quoted securities in an active market.
Impact	Restriction on the valuation method used for quoted securities is contrary to the UCITS directive, inconsistent with other GAAPs and established market practice.
Technical solution	FEFSI to seek the use of the mid-market and last traded price as acceptable methods.

Statement of Unitholders' / Shareholders' equity - IAS 1

Priority 2

Preamble: Refer to paper on IAS 32 - puttable instruments. This paper assumes that the IASB will accept that fund shares or units to be treated as equity and not as debt. Otherwise, as stated in the IAS 32 paper, this provision will not be applicable.

Issue

IAS 1: Presentation of Financial Statements prescribes the basis for the presentation of general purpose financial statements.

IAS 1p7 sets out the components of financial statements as follows:

- (a) Balance sheet
- (b) Income statement
- (c) A statement showing either:
 - a. All changes in equity; or
 - b. Changes in equity other than those arising from capital transactions with owners and distributions to owners;
- (d) Cash flow statement
- (e) Accounting policies and explanatory notes

IAS 1p86 states that:

86. *An enterprise should present, as a separate component of its financial statements, a statement showing:*
- (a) *the net profit or loss for the period;*
 - (b) *each item of income and expense, gain or loss which, as required by other Standards, is recognised directly in equity, and the total of these items; and*
 - (c) *the cumulative effect of changes in accounting policy and the correction of fundamental errors dealt with under the Benchmark treatments in IAS 8.*

In addition, an enterprise should present, either within this statement or in the notes:

- (d) *capital transactions with owners and distributions to owners;*
- (e) *the balance of accumulated profit or loss at the beginning of the period and at the balance sheet date, and the movements for the period; and*
- (f) *a reconciliation between the carrying amount of each class of equity capital, share premium and each reserve at the beginning and the end of the period, separately disclosing each movement.*

Multi-class multi-compartment funds

In the case of a single compartment fund with a single class of shares the requirements of IAS1p86 are not onerous. However in the case of large UCITS umbrella funds with several share classes in each compartment the requirements of IAS1p86(f) could result in a large amount of financial information being provided which may not be useful or meaningful to the reader. In the funds industry different classes are created to reflect different charging structures, pricing currencies, investment holdings, taxation aspects without necessarily creating different traditional shareholder classes, i.e. ordinary, preferred, etc.

Impact on the investment fund industry

The statement of changes in unitholders'/shareholders' equity provides the reader of the financial statements with information which links the net asset value at the start of the financial period with the net asset value at the end of the financial period. As such the omission of a statement of changes in unitholders'/shareholders' equity from the financial statements of a fund would reduce the usefulness of the financial statements to the reader.

However it is questionable whether the provision of the information required by IAS 1p86(f) for each class of share in a compartment of a UCITS is relevant or useful because where there are different shares classes, the investments of the compartment remain as one pool, and are not separately allocated to share classes. Where there is a different charging structure for each class, such differences will be reflected in the price of each share class. The prices will determine the amount receivable or payable by the compartment in respect of subscriptions and redemptions.

The amount of information, arguably not very meaningful, would be horrendous for example for a 20 compartment with 6 share classes

Current market practice regarding the production of a statement of unitholders'/shareholders' equity

- In many countries it is a requirement to produce a statement of unitholders'/shareholders' equity.
- Under US GAAP a statement of changes in net assets is provided in fund financial statements.
- Under UK GAAP both the OEIC SORP and the Authorised Unit Trust SORP require a statement of movements in shareholders' funds which is equivalent to a statement of movement in unitholders'/shareholders' equity.

Current market practice regarding multi-compartment/multi-class funds

- Practices vary in relation to this issue.
- Under US GAAP the statement of changes in net assets is provided on a total fund basis. However, details of capital share transactions and the financial highlights are provided for each share class.

- Under UK GAAP the OEIC SORP states that where there are different shares classes, the investments of the company or sub-fund remain as one pool, and are not separately allocated to share classes. Where there is a different charging structure for each class, such differences will be reflected in the price of each share class, and the proportion of the pool of investments attributable to each class. The prices will determine the amount receivable or payable by the company or sub-fund in respect of issues and cancellations of shares but these amounts are not required to be analysed by class in the statement of movement in unitholders' funds.

Technical solution

A statement of changes in unitholders'/ shareholders' equity (net assets) is an essential component of the financial statements of a fund.

In the case of a multi-compartment multi-class fund the statement of changes in unitholders' / shareholder's equity should be provided at the level of the compartment, which, in substance, reflects the interests of each category of shareholders. Where there is a different charging structure or currency for each class in the compartment, such differences will be reflected in the price of each share class. The net asset value of each share class at the start of the reporting period and the end of the reporting period should be included in the financial statements. The rights and terms attaching to each share class, including the rights on winding-up should be summarised in the notes to the financial statements.

FEFSI considers seeking confirmation that the Industry's practice as explained above is compliant with IAS.

Comparatives / portfolio statements - IAS 1

Priority: 2

Issue

According to IAS 1 comparatives must be given for all numerical information. Article 38 of IAS 1 requires: “Comparative information should be disclosed in respect of the previous period for all numerical information in the financial statements. Comparative information should be included in narrative and descriptive information when it is relevant to an understanding of the current periods financial statements”.

Impact on the investment fund industry

Current market practices

Presentation of comparative figures for previous year in respect of balance sheet and income statement is a generally accepted standard. However it is not a current practice in every European country for the financial statements of the fund industry. This situation is mainly explained by difficulties encountered in the presentation of financial statements especially in the case of multi compartments funds.

Impact for the Funds Industry

It is a generally accepted standard that comparatives are to be given for all information and disclosures and it would be impossible to obtain from the IASB an exception on this point because there is no relevant justification for such a demand. Compliance with IAS in this respect will therefore require disclosure of much more information especially for multi-compartment funds.

Nevertheless we consider that there is one information for which comparatives should not be provided. That is the case for the detailed portfolio.

According to the European Directive, detailed information of the composition of the year-end portfolio must be provided in the notes of the annual accounts.

But for this information, a comparative at the end of the prior year is not relevant information. The comparison of the two portfolios, which are photographs of situations at the year-ends, is not informative. It does not show the portfolio movements, which would be the only relevant data. Actually a narrative explanation of the fund manager objectives and actions during the period completed with the principal movements of the portfolio provides more relevant information.

Technical solution

FEFSI considers seeking confirmation that comparatives required in the financial statements of the fund industry should not include previous year detailed portfolio on the grounds that such information is neither relevant nor useful

Cash flow statements - IAS 7

Priority 2

Issue

IAS 7 was released December 1992, and became effective for accounting periods beginning 1 January 1994.

The objective of IAS 7 is to require the presentation of information about the historical changes in cash and cash equivalents of an enterprise by means of a cash flow statement, which classifies cash flows during the period according to operating, investing and financing activities.

Definition of Cash

Cash includes overdrafts repayable on demand but not short-term bank borrowings, which are considered to be financing flows.

Cash equivalents are short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. An investment normally qualifies as a cash equivalent only when it has maturity of 3 months or less from its acquisition date.

Direct / Indirect Method

IAS 7 requires that the cash flow statement must report inflows and outflows of cash and cash equivalents. The cash flow statement may be prepared using either the direct (cash flows derived from aggregating cash receipts and payments associated with operating activities) or indirect (cash flows derived from adjusting net income for transactions of a non-cash nature such as depreciation). The direct method is encouraged, however either method is acceptable.

Format

The cash flow statement should split cash flows during the period between operating, investing and financing activities.

Operating Activities – are the main revenue producing activities of the entity that are not investing or financing activities, so include cash received from customers and cash paid to suppliers and employees.

Investing Activities – are the acquisition and disposal of long-term assets and other investments that are not considered to be cash equivalents.

Financing Activities – are activities that alter the equity capital and borrowing structure of the entity.

Interest and dividends received and paid may be classified as operating, investing, or financing cash flows, provided that they are classified consistently from period to period.

Cash flows arising from taxes on income are normally classified as operating, unless they can be specifically identified with financing or investing activities.

Consistency with other GAAP

IAS is inconsistent with both US GAAP and UK GAAP on this issue. IAS 7 allows for no exemptions to presenting a cash flow statement. Under UK GAAP, FRS 1 allows exemptions given certain conditions, for some entities including mutual life assurance companies, pension funds and open-ended investment funds.

UK GAAP differs from IAS with regard to the classification of cash and cash equivalents. Under UK GAAP, cash is defined as cash in hand and deposits receivable on demand, less overdrafts repayable on demand. Cash equivalents are not included in cash but are dealt with in the management of liquid resources section.

Format of the cash flow statement under US GAAP is similar to IAS, requiring separate classification between operating, investing and financing activities. However, UK GAAP requires more detail and separate classification of activities between 8 different categories.

Impact on the investment fund industry

All funds would be required to produce a cash flow statement under IAS.

Currently the limited exemptions from the requirement to produce a cash flow statement available under both US GAAP and UK GAAP are quite similar. The conditions, which are imposed, would effectively provide an exemption all open-ended retail investment funds (all UCITS).

Hence producing cash flow statements under strict IAS for funds would not provide more meaningful or additional information than currently provided in funds' financial statements.

Current market practice

- In many EU countries there is no requirement to produce a cash flow statement. The introduction of IAS would impose this additional burden.
- IAS/IFRS is not consistent with US GAAP (FASB 102).
- IAS/IFRS is not consistent with the requirements under UK GAAP (FRS 1 and the OEIC SORP).

Technical solution

FEFSI considers seeking an introduction of exemption from preparing cash flow statements provided conditions similar to US and UK GAAP are met namely:

- During the period substantially all of the enterprise's investments were highly liquid (marketable securities and other assets for which a market is readily available); and
- Substantially all of the enterprise's investments are carried at fair value; and
- The enterprise has little or no debt, based on average debt outstanding during the period in relation to the average total assets; and
- The enterprise provides a statement of changes in net assets.

Segmental reporting - IAS 14

Priority 2

Issue

According to IAS 14 segmental information should be given by business and geographical segment.

IAS 14 requires that entities whose financial instruments are publicly traded provide segmental information of its activity as defined in the standard requirements.

Current market practices

Portfolios are invested with specific orientations defined within the prospectus of the funds. They may be oriented towards certain business segments or geographical territories. Financial statements of funds generally provide analysis of their portfolio by business and / or geographical segments. Nevertheless no segmental information is given today in the annual accounts of UCITS.

Impact on the industry

FEFSI group of experts considers impossible to define a common classification of business and geographical segments to be accepted in various countries. This is due because:

- There are no official or generally accepted standards for the classification of financial instruments by business segments.
- There is a conflict between geographical and currencies classification.

After discussing this question at FEFSI level it was agreed that the appropriate business segment for the fund industry is at the “Asset management” level and that no other segmental information should be given.

Technical solution

It is recommended that the European Commission express its position in this matter in line with this European Directive and seek confirmation that the only segmental reporting to be given should be as currently provided, i.e. an analysis of the investments by geographical and or business segment.

Reporting currency for funds - IAS 21 & 29

Priority 2

Issue

In which currency should funds financial statements be denominated under IFRS?

IAS 21 prescribes the accounting treatment for an enterprise's foreign activities, i.e. foreign currency transactions and foreign operations.

SIC 19 states: “ Reporting currency – measurement and presentation of financial statements under IAS 21 and IAS 29:”*If a particular currency is used to a significant extent in, or has a significant impact on, the enterprise, that currency may be an appropriate measurement currency*”.

It should also be noticed that SIC 19 states: “*although an enterprise normally presents its financial statements in the same currency as the measurement currency, the SIC also agreed that it may choose to present its financial statements in a different currency.*”

Finally the SIC states that “*the measurement currency ... should provide information about the enterprise that is Useful*”

Impact on the investment fund industry

Funds do convert foreign currency transactions at the rate prevailing at transaction date and assets and liabilities are translated at the rate prevailing at reporting date. Exchange differences are recognized in the income statement. This practice is in line with IAS 21 and will not generate difficulties for funds.

Regarding the **measurement currency** and based on the above-mentioned interpretation, one could assume that the currency for reporting should be the one used for the bulk of activity of a given fund.

This could mean that if a fund denominated in EUR invests mainly in USD denominated investments, then the measurement currency should be the latter (USD). One can object that this fund can also use hedging techniques (protect EUR against USD fluctuations). Thus the use of USD is not anymore pertinent.

In addition, the capital activities in a fund, which represents a significant portion of the fund's transactions, should also be taken into account. Subscriptions, redemptions and distributions are key in determining a fund's currency, as these are part of the investor's decisions in entering into a fund. They have a fundamental affect on the nature and management of a fund.

Funds do usually define the base currency at the inception as the currency of expression of the NAV (Net Asset Value). This is defined in the prospectus of the fund for itself and each of its sub-funds. Promoters of Funds do choose the relevant measurement currency in considering the currency of distribution (the one relevant for investors' decision making) and/or the currency of activity (the relevant currency in which investments are mainly denominated).

Current market practice

The current market practice is that funds financial statements are usually presented in the currency of reference of the investor. This may often differ from the measurement currency of the fund. Investors take their own investment decisions based on the prospectus, which presents the investment policy, targeted markets and relative denomination currencies, information relative to subscription and redemptions and the currency of the expression of the Net Asset Value. It seems unrealistic to move to another currency because of the fund activity only. This would mean that the investor choice is not fully respected.

Consideration of the currency of expenses (management, custody, administration, audit, ...) is relevant for investors information when it is directly linked to the changes in the NAV of their fund (the performance), it means the currency in which they buy and sell funds.

FEFSI group of experts agreed with the concept that the reporting currency should be the one in which the Fund has initially been sold (currency indicated in the constitutive documents of the Fund) whatever the activity of the Fund looks like or whatever the payments made to managers are.

Technical solution

FEFSI considers seeking confirmation that the current practice as set out above is compliant with IAS 21 & 29.

Classification of puttable instruments - IAS 32

Priority 1

Issue

The exposure draft of proposed IAS 32 (paragraph 22) deals with the situation where an entity has issued a financial instrument that gives the holder the right to put the instrument back to the issuer in return for cash (or another financial asset) and refers to these as “puttable instruments”. Specific reference is made in paragraph 22 to the position of open-ended mutual funds:

“ For example, open ended mutual funds, unit trusts, partnerships and some co-operative entities may provide their unitholders or members with a right to redeem their interests in the entity at any time for cash equal to their proportionate share of the net asset value of the entity. Even when the legal form of a puttable instrument gives the holder a right to the residual interest in the assets of an entity, the inclusion of an option for the holder to put that right back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a liability and is presented as such.”

Impact on the investment funds industry

What is proposed will result in fund accounts, which are neither logical nor informative for share/unitholders – for whom the accounts are primarily intended. Other users such as regulators and analysts will also struggle to understand and interpret these financial statements

The funds industry will have to consider how best to meaningfully present financial performance as the treatment of shares/units as liabilities will potentially result in a balance sheet with nil NAV and a performance statement with a nil result for the year.

Presentation of meaningful NAVs will also require consideration.

Current market practice

Current practice is that investment funds show shares issued as the residual equity in the fund.

Most people in the funds industry would disagree with the logic of what is proposed in IAS 32, citing such matters as:

1. Presenting shares/units as liabilities only makes sense if these are not the residual interest in the entity as it leaves the fund with no equivalent of shareholders equity and a net profit (after reflecting the change in value of the liability to repay unitholders) of nil for each accounting period.
2. The substance is that the shares/units in a mutual fund are that of a residual interest (i.e. giving entitlement to a share in net assets and to payment of profits available for distribution) and the accounting should follow the substance.

3. What is proposed is inconsistent with most other national accounting standards, including UK, US and Canada.
4. What is proposed would be potentially confusing to shareholders who expect to see financial statements which reflect their share of a pool of assets and the performance of the fund over the period.

Most of the above points will presumably have been made to the IASB at the time of consultation on proposed Interpretation SIC - D34, where this issue originated. It is evident from the exposure draft that the IASB has specifically considered the position of mutual funds and has concluded that there are no grounds for special treatment. Instead, the IASB seem to envisage that a fund may deal with the issue by presenting liabilities to unitholders as “net assets available to unitholders” on the face of the balance sheet and may present changes in the value of these as “changes in net asset value available to unitholders” on the face of the income statement [see page 13 of exposure draft].

From a funds industry perspective there are few arguments to suggest that what is proposed in IAS 32 represents an improvement in financial reporting for funds relative to what is already in place. There is nothing confusing or misleading about the overall presentation of shareholders funds currently and arguably the funds industry is being asked to accept reduced clarity (and potential confusion) in financial reporting in order that there may exist a consistent form of presentation designed to address issues in other reporting entities.

In conclusion, the proposals in IAS 32 will have a significant impact on the format and presentation of accounts for mutual funds. There is a serious risk that investment funds that have a choice may, rather than apply IAS, turn to US GAAP in the face of these proposals (alone).

Other issues

The treatment of fund shares and units as debt will paradoxically render the application of a number of provisions within certain IAS invalid, namely:

- IAS 1 – Statement of changes in Equity,
- IAS 32 – Dividend payments (instead interest will have to be accrued)
- IAS 33 – Earnings per share

Furthermore, in the case of funds constituted as legal entities such as SICAV and SICAF, investors have rights similar to shareholders of companies. These rights include attending and voting at AGM and EGM on issues pertaining to appointment of directors, auditors, amendments to articles and prospectus and liquidation of the fund

Technical solution

FEFSI considers seeking an exemption from the requirement of IAS 32 to reflect redeemable shares issued by the fund as liabilities or acceptance that redeemable shares are equity interests

Other action

If the industry accepts what it is proposed it is important that the IASB's forthcoming proposals on the format of the performance statement offer the required flexibility to describe such items as changes in net asset value and dividends payable in an understandable manner. This should be kept under review by FEFSI.

Earnings per share - IAS 33

Priority 2

Preamble: Refer to paper on IAS 32 – puttable instruments. This paper assumes that the IASB will accept that fund shares or units to be treated as equity and not as debt. Otherwise, as stated in the IAS 32 paper, this provision will not be applicable.

Issue

IAS 33 “Earnings per share” applies to enterprises whose ordinary shares or potential ordinary shares are publicly traded and by enterprises that are in the process of issuing ordinary shares or potential ordinary shares in public securities markets.

The objective of IAS 33 is stated in the standard as follows:

“The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share which will improve performance comparisons among different enterprises in the same period and among different accounting periods for the same enterprise. The focus of this Standard is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances financial reporting.”

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to ordinary shareholders by the weighted average number of ordinary shares outstanding during the period [\[IAS 33.10\]](#).

For the purpose of calculating diluted earnings per share, the net profit attributable to ordinary shareholders and the weighted average number of shares outstanding should be adjusted for the effects of all dilutive potential ordinary shares [\[IAS 33.24\]](#)

Current IAS treatment versus US GAAP and UK GAAP

Earnings per share must be disclosed for listed entities under all three frameworks. IAS, US GAAP and UK GAAP are substantially the same in their methods of calculating earnings per share components.

Under US GAAP investment funds do not present earnings per share information. However they do present financial highlights, either as a separate schedule or within the notes to the financial statements. Per share amounts presented are based on shares outstanding throughout each period presented.

The following per share information is presented:

- Net Asset Value at the beginning of the period.
- Per Share net investment income or loss.
- Realised and unrealised gains and losses per share.
- Total from investment operations, which represents the sum of net investment income and realised and unrealised gains and losses.

- Distributions to shareholders.
- Purchase premiums, redemption fees or other capital items.
- Payments to affiliates.
- Net Asset value at the end of the period.

Under UK GAAP the neither the OEIC SORP, which applies to open ended investment companies, nor the Authorised Unit Trust SORP require the disclosure of any earnings per share data.

Impact on the investment fund industry

Calculation of Earnings per share as prescribed by IAS 33 will completely change the way in which performance of a fund is measured. It will provide information to investors, which will not be very meaningful and hence it cannot be said to enhance presentation and transparency to investors. Providing both Earnings per share and current NAV per share data will also confuse investors.

Current market practice

- Practice varies around Europe. In most countries EPS disclosures are not made.

Other issues/proposed solution

From an investor's perspective the performance of a fund is a function of the performance of the net asset value per share. Net asset value ("NAV") per share disclosures are currently made in UCITS fund financial statements.

The inclusion of an earnings per share figure in addition to the net asset value per unit would not met the objective of IAS 33 for the following reasons:

- Performance comparisons between investment funds are generally done via percentage changes in the NAV per share performance. NAV per share is the key measure of performance in a fund. However due to the fact that funds have different nominal share values and are denominated in different currencies the only valid performance measure, which is usable for comparison between different investment entities is the % change in NAV per share. This is illustrated in the attached example, which demonstrates that using absolute amounts per share as opposed to percentages changes in NAV per share is misleading. Using absolute changes per share would suggest that Fund B was the better performer when in fact that correct position is that Fund A is the better performing fund on a per share basis.

	Absolute numbers		% Changes	
	Fund A	Fund B	Fund A	Fund B
Currency	Euro	USD	Euro	USD
Opening NAV	10	100	10	100
Closing NAV	12.5	120	12.5	120
Change in NAV per unit	2.5	20	25%	20%

- Performance comparisons across different periods for the same investment entity are also generally based on the percentage performance of the NAV per share in the period. Due to market fluctuations the level of assets from which performance (income and gains) is derived varies from year to year. As a result the absolute performance from year to year may vary. However without taking account of the assets on which the performance in the period is based the performance comparisons across different periods under different market conditions is misleading. As an example. In the case of Fund A using absolute performance per share it appears as if the fund performed better in year 2. However when percentage changes for Fund A are used, the correct picture emerges. The performance was better in year 1 than in year 2.

	Absolute numbers		% Changes	
	Year 1	Year 2	Year 1	Year 2
	Fund A	Fund A	Fund A	Fund A
Currency	Euro	Euro	Euro	Euro
Opening NAV	100	125	100	125
Closing NAV	125	155	125	155
Change in NAV per unit	25	30	25%	24%

- In addition, the following illustrates why EPS may give an askew view of the performance in a fund:

Total initial NAV: \$100, number of units: 1 with an NAV per unit of \$100

Profit at time D: \$10

Total NAV at D: \$110, number of units: 1 with an NAV per unit of \$110

Just after time D, fund receives subscription of 10 units at \$110 per unit

Loss at D+1: \$11

Total NAV at D+1: \$1,199, number of units: 11 with an NAV per unit of \$109

Net loss for the period: \$1 (\$11-\$10)

EPS is therefore negative: \$-0.09 but

NAV increased by \$9 per unit (\$109 - \$100)

The inclusion of performance data, which takes the specific features of investment funds into account, should be considered. The provision of absolute performance figures on a per share basis (such as EPS) fail to meet the objectives of IAS 33 and fail to provide a true and fair view of the performance of the investment entity as has been demonstrated above.

Technical solution

FEFSI considers obtaining acceptance that NAV per share data is more meaningful than EPS per IAS 33 for the fund industry and that such information should be disclosed instead. We also recommend that FEFSI develop the appropriate standard for NAV per share data that would be disclosed in the financial statements of funds.

The use of bid price for quoted securities - IAS 39

Priority 1

Issue

International Accounting Standards (IAS) 39 requires the use of the published price in an active market as the best evidence of fair value. It notes that the appropriate value for a quoted security held is the current bid price with a further note that it may also be appropriate to use mid-market prices when an entity has matching asset and liability positions (IAS 33.99).

The investment management industry has used the mid-market price, i.e. the average of bid and offer prices, and the last traded price or the closing price as the principal valuation methods for quoted securities in a fund's investment portfolio. The method of valuing the investment portfolio and arriving at the net asset value of the fund is normally spelled out in the fund's incorporation and offering documents. As standard practice, the board of directors, trustees or general partner have an obligation to revalue any security should the normal method of valuation not give a fair view of the security's realisable value.

Impact on the investment fund industry

Use of bid price as the sole valuation method for a quoted security in an active market is not only inequitable but may lead to confusion and dilution of the relevance established by the methods currently in place. European Union directives on UCITS provides as a benchmark, the valuation of quoted securities at the last known stock exchange price. In the United States, best practice or generally accepted accounting principles is to use the last quoted sales price with the bid and mid-market prices being methods also acceptable under U.S. generally acceptable accounting principles.

Current market practice

The use of the mid-market and of the last traded price for valuing quoted securities has been widely used in the industry and today, is the accepted norm. Investors are familiar with these commonplace methods and because they have been applied as the industry's best practice, they represent useful and meaningful methods for investors.

- **Fair value**

Fair value is defined in IAS 39 as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. As IAS 39.98 notes, underlying this definition is a presumption that an enterprise, the fund, is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. It is in this spirit that the investment management industry has used either the mid-market or last traded price to value their respective investment portfolios.

Valuation of quoted securities using bid price does not necessarily provide a better indication of the fair value than the mid-market or last traded price. As the various methods of valuation uses historical prices, what is certain is that the price for the next transaction, the sale of the quoted security, would normally be different from what was quoted. In fact, the quoted bid or offer prices do not necessarily represent the prices on which transactions have been concluded and it is therefore arguable in certain circumstances that the more accurate indicative value would be the last traded price.

- **Use of bid price**

For days on which there are net subscriptions or net redemptions, the use of bid or offer prices respectively would be more equitable when valuing quoted securities. Effectively, when an investor is entering the fund, the fund manager will have to buy securities with the cash he has received to keep the fund fully invested. The securities will be bought at the offer price and therefore, in theory, in order to not dilute the performance of the existing investors at the time of the subscription, the Net Asset Value (NAV) should be calculated using offer prices. In contrast, in the case of net redemptions, the NAV should be calculated using bid prices in order to not dilute the performance of the existing investors. This is the reason for the use of a distribution levy in the UK and the use of swinging prices by some fund promoters. However, in order to avoid the fact that net asset values for subscriptions and redemptions would be askew if either bid or offer prices were used, the investment management industry has been using the mid-market price method as a simplified neutral method for equalising the levies or costs associated under these circumstances.

In an efficient active market, the differences on the valuation of quoted securities arising from using the bid, mid-market or last traded prices are small and negligible. Taken individually, the respective methods have their own merits and do in essence provide fair and reliable measures. In the situations outlined above, the use of bid prices may not lead to the most optimal view for an investor. It should be noted that these valuation methods in themselves will not always guarantee a fair value without the necessary appropriate relevant checks and balances in place. Therefore, in order to avoid confusion at the investor level and unnecessary administrative burden without added value, the same method or the one used for the NAV calculation should be retained.

Technical solution

FEFSI considers seeking the use of the mid-market and last traded price as acceptable fair valuation methods.

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