

International Financial Reporting Standards: application to investment funds

An EFAMA discussion paper – June 2007

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Introduction

The IAS Regulation¹ concerning the application of international financial reporting standards (IFRS) was adopted on 19 July 2002 by the European Parliament and the Council. The Regulation applies to European publicly traded companies preparing consolidated financial statements and has significant implications for all those EU entities that must publish their accounts. As such, the IAS Regulation constitutes a first step in establishing a single set of international accounting standards within Europe, as well as reinforcing the global acceptance of IFRS.

The effects on accounting and reporting are considered to be significant, not least for European investment funds. For the time being the European Commission has left it to Member States to extend the application of IFRS to all regulated companies and institutions. Some of them have already decided to broaden the Regulation's scope at national level and others may do so in the future. Thus, the application of IFRS to UCITS and other collective investment schemes has become a subject of consideration. The UK and Ireland are already suffering from that situation as their national GAAPs are converging to IFRS even though IFRS have not been designed for open-ended investment funds. Other EU Member States may tend to extend the application of IFRS directly to CIS, e.g. to funds with corporate legal form. Moreover, companies which apply IFRS and which invest in CIS may require IFRS-compliant reporting, which will have a significant impact on shaping fund accounting.

This topic is not only on the European agenda but is being discussed on a global level. As the US represent currently 60% of the world fund market and as the fund world is becoming more and more global, with some funds being distributed in more than 30 countries, we have, therefore, included in this document - with the kind permission of the ICI - details of the current treatment in the US. The European Commission and the SEC have made a commitment towards convergence and therefore what is happening in the US is also highly relevant to Europe. EFAMA supports the convergence process but considers that, in general, US standards are more appropriate to open-ended investment funds than existing IFRS. Indeed, the US standards have been tailored to mutual funds and to investors' needs, and are more in line with the practices not only in Europe but also in the rest of the world.

This report identifies the conditions under which an efficient implementation of IFRS to investment funds would be possible, based on the premise that accounting principles for investment funds should be aligned to 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. In this regard, what investors need to know is clearly described in two legal pieces that form the foundation to the

¹ Regulation (EC) 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of International Accounting Standards.

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 came into force on 13 February 2002, in particular the annex describing the content of the “simplified prospectus”.

Should IFRS reporting principles be applied today, this would be very cumbersome. The information provided in line with these principles might be irrelevant and difficult to understand for retail investors, and in some cases even misleading.

Current situation in EU Member States

In order to understand which countries are contemplating the use of IFRS for their principal retail fund products (i.e. UCITS) EFAMA conducted a survey with respect to current practices among its Members.

In the majority of Member States, IFRS are not currently applied to investment funds. In most cases, the existing national laws require the use of local GAAPs that apply specifically to UCITS and there is no special obligation for the investment management company to prepare an annual report based on IFRS. This is also the case for UCITS listed on a stock exchange.

Regarding convergence of local standards towards IFRS, it should be noted that in most countries (including those outside Europe and, among them, the US), there is a strong resistance against convergence with IFRS as far as the investment fund industry is concerned. Even in those cases where there is a recommendation by the supervisor to converge as much as possible towards IFRS, there is a demand for certain derogations for investment funds in general and for UCITS in particular.

Ireland is one of the few countries where, under the revised legislation, UCITS have the option of preparing individual accounts under IFRS for accounting periods beginning on or after 1 January 2005. A UCITS listed on the stock exchange has the option of applying IFRS. The Accounting Standards Board (ASB), the standard setting body for IRISH and UK GAAP, has devised a convergence strategy to bring about convergence between UK standards and IFRS within a period of 3-4 years. This would involve implementing UK accounting standards, which are based on IFRS, with no changes other than those that are considered necessary or justifiable. Whilst it is unlikely that there will be specific exclusions or derogations for UCITS, they may not fall into the scope of certain standards.

IFRS and CIS – EFAMA’s findings

IFRS ignores the open-ended nature of a UCITS and the fact that financial reporting does not affect the share price. Investors rarely buy and sell their shares on the stock exchanges but rather, subscribe and redeem at a price (the NAV), which is calculated by the manager, the depositary or administrative agent.

This report details a number of key significant differences between IFRS and EU practices. Certain other differences, which have been considered but are not dealt with further in this report, are briefly described below:

- The capitalisation of expenses to set up an investment fund and its amortisation over a reasonable period, is not permitted under IFRS. 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.
- We can also see differences in the area of consolidation where there are significant operational and cost ramifications arising from its application. The current practice of attaching the financial statements of master feeder funds might 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, for example, might 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. This issue has not been discussed further in this paper, as it would normally not impact UCITS.
- 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.

Conclusion

In short, IFRS can be meaningfully applied only if, and insofar as, they are in line with basic UCITS principles and improve information for investors. EFAMA is of the clear view that under the current conditions IFRS cannot constitute the nucleus of a comprehensive and common accountancy framework for investment funds in the European Single Market and it is its intention to bring forward this position to the European Commission and the Committee of European Securities Regulators (CESR).

Steffen Matthias, June 2007

Executive Summary

Current issues

Title	Statement of Unitholders’/Shareholders’ equity - IAS 1
Issue	IAS 1 requires a statement of unitholders’/ shareholders’ equity and disclosure of the 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 sub-fund funds and the relevance of such information is doubtful, especially as share classes share one pool of assets, and is not consistent with other GAAPs.
EFAMA recommendation	EFAMA to seek an exemption so that for multi-class, multi sub-fund funds, the IFRS presentation should be at each sub-fund level, with disclosure of the rights, terms, charging structures and NAVs of each class of capital.
Title	Comparatives for portfolio statements - IAS 1
Issue	IAS 1 requires comparatives for all numerical information in the financial statements. This would be a problem for the portfolio statement if included in the accounts.
Impact	Disclosures for multi sub-fund funds are onerous and are not a requirement of the UCITS directive, as inclusion of comparatives in an already detailed year-end portfolio statement is neither useful nor relevant.
EFAMA recommendation	EFAMA considers seeking confirmation from the EU commission that the portfolio statement, including sector or geographical allocation, can be included outside the annual accounts so that, should IFRS apply, no comparatives will be needed.

Title	Cash flow statements - IAS 7
Issue	IAS 7 requires a cash flow statement as part of the company's 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 US GAAP.
EFAMA recommendation	EFAMA believes that a statement of changes in net assets, as required by current European regulation, meets the objective of this IAS and therefore requests an exemption from preparing cash flow statements provided conditions similar to US GAAP are met.
Title	Segmental reporting – IFRS 8
Issue	Publicly traded enterprises should present financial information by segment in accordance with IFRS 8.
Impact	Classification of financial information for funds is appropriate only at the “asset management” level.
EFAMA recommendation	EFAMA to seek for an exemption from the application of IFRS 8 on segmental reporting.
Title	Revenue recognition – IAS 18
Issue	IAS 18 requires that pre-acquisition profits by way of dividend distribution be accounted for as a reduction in the cost of investment rather than income.
Impact	Significant extra costs would be generated for little added value in terms of information for the investor given that investments are already accounted for at fair value.
EFAMA recommendation	EFAMA to seek confirmation that separate accounting for the receipt by way of distribution of pre-acquisition profits need not apply to purchases of shares.

Title	Consolidation of subsidiaries – IAS 27
Issue	IAS 27 requires consolidation once a (parent) company has control over another company.
Impact	Consolidation for master-feeder funds, certain funds of funds, private equity funds (this list is not exhaustive), but also in certain circumstances by some investors investing in institutional funds or holding a significant stake in otherwise widely-held retail funds.
EFAMA recommendation	EFAMA to seek exemptions similar to those applicable in the US where, broadly, authorised funds are not required to consolidate

Title	Classification of puttable instruments – IAS 32
Issue	The exposure draft classifies instruments puttable at fair value as equity instruments when the holder has the right to the fair value of the pro rata share of the net assets of the entity.
Impact	The exposure draft does not deal with multiple classes of shares or differing types of shares, which exist in many investment entities. This would lead to potentially inconsistent financial statement presentations. The exposure draft also does not clarify how differing fees on different share classes would affect their ranking and therefore their classification.
EFAMA recommendation	EFAMA to seek confirmation that the exposure draft will either be withdrawn or re-drafted after performing a further fundamental reconsideration of the classification criterion and in depth consultation with relevant industry representatives.

Title	Earnings per share - IAS 33
Issue	Basic and diluted EPS is required for publicly traded enterprises.
Impact	EPS is not meaningful nor transparent in presenting the performance of an open-ended fund. Indeed, this information in the context of open-ended funds will normally not provide information which is meaningful to any individual holder of shares and, in addition, in many cases would be misleading. NAV per share and change in NAV per share is the internationally recognised measure of the performance of a fund.
EFAMA recommendation	EFAMA to seek confirmation that the use of NAV per share data meets the requirement of IAS 33 and to develop appropriate standards for NAV per share data.

Title	The use of bid price for quoted securities - IAS 39
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, and inconsistent with other GAAPs and established market practice.
EFAMA recommendation	EFAMA to seek confirmation that the use of the mid-market and last traded price are acceptable methods in addition to bid prices, as foreseen by the recent FASB draft fair value measurement statement and as is the current practice in the US and most European countries.

Title	Effective interest rates - IAS 39
Issue	Complexity of the rules to be applied for bonds in general and certain categories of bonds in particular.
Impact	Significant extra costs would be generated for little added value in terms of information for the investor.
EFAMA recommendation	EFAMA to seek confirmation that changes in amortised cost arising from changes in predicted future cash flows may be included within the movement in fair value of investments rather than interest income.

APPENDIX

Issues dealt with

Title	Reporting and functional currency - IAS 21
Issue	The guidance in IAS 21 requires the functional currency to be useful and reflect 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 would generally be similar to the one required to be used as the measurement currency under IFRS. However, there may be some exceptions.
EFAMA recommendation	EFAMA understands that current industry practice is, generally, in accordance with IAS 21.

Statement of Unitholders' / Shareholders' equity - IAS 1

Preamble: Under IAS 32 redeemable fund shares/units are currently treated as puttable instruments and therefore considered as debt. This paper assumes that the IASB, as announced in its December update, implements its proposals that redeemable fund shares/units will instead be treated as equity.

Issue

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

IAS 1.8 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 1.96 and 1.97 state that:

96. An entity shall present a statement of changes in equity showing on the face of the statement:

- (a) profit or loss for the period;
- (b) each item of income and expense for the period that, as required by other Standards or by Interpretations, is recognised directly in equity, and the total of these items;
- (c) total income and expense for the period (calculated as the sum of (a) and (b)), showing separately the total amounts attributable to equity holders of the parent and to minority interest; and
- (d) for each component of equity, the effects of changes in accounting policies and corrections of errors recognised in accordance with IAS 8.

A statement of changes in equity that comprises only these items shall be titled a statement of recognised income and expense.

97. An entity shall also present, either on the face of the statement of changes in equity or in the notes:

- (a) the amounts of transactions with equity holders acting in their capacity as equity holders, showing separately distributions to equity holders;
- (b) the balance of retained earnings (ie accumulated profit or loss) at the beginning of the period and at the balance sheet date, and the changes during the period; and
- (c) a reconciliation between the carrying amount of each class of contributed equity and each reserve at the beginning and the end of the period, separately disclosing each change.

IAS 1.101 states that :

101. The requirements in paragraphs 96 and 97 may be met in various ways. One example is a columnar format that reconciles the opening and closing balances of each element within equity. An alternative is to present only the items set out in paragraph 96 in the statement of changes in equity. Under this approach, the items described in paragraph 97 are shown in the notes.

Multi-class multi sub-fund funds

In the case of a single sub-fund fund with a single class of shares, the requirements of IAS1.96 and 97 are not onerous. However in the case of large UCITS umbrella funds with several share classes in each sub-fund, the requirements of IAS1 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 and 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 1 for each class of share in a sub-fund of a UCITS is relevant or useful because, where there are different shares classes, the investments of the 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. The prices will determine the amount receivable or payable by the sub-fund in respect of subscriptions and redemptions.

The additional information is, arguably not very meaningful and would be highly onerous for an entity with, for example, 20 sub-funds, each with 6 share classes.

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

1. Europe

- In many European countries it is a requirement to produce a statement of unitholders' /shareholders' equity. Under UK GAAP, the authorised fund SORP requires a statement of movements in shareholders' net assets, which is called a statement of change in shareholders' net assets.

2. *US*

- Under US GAAP a statement of changes in net assets is provided in fund financial statements.

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

1. *Europe*

- Practices vary in relation to this issue.
- Under UK GAAP the authorized funds SORP states that where there are different share 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. 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.

2. *US*

- 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.

EFAMA recommendation

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-sub-fund multi-class fund, the statement of changes in unitholders' / shareholder's equity should be provided at the level of the sub-fund, 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 sub-fund, 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.

Comparatives for portfolio statements - IAS 1

Issue

The UCITS Directive imposes the presentation of a portfolio statement which, if included in the accounts, would require comparatives under IFRS. According to IAS 1 comparatives must be given for all numerical information. Paragraph 36 of IAS 1 requires: “Comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements. Comparative information shall be included for narrative and descriptive information when it is relevant to an understanding of the current period’s financial statements”.

Impact on the investment fund industry

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

Nevertheless we consider that there is one piece of information for which comparatives should not be provided. That is in relation to the detailed portfolio.

Although not specifically required by IFRS, according to the European Directive, detailed information of the composition of the year-end portfolio must be provided in the notes to the annual accounts.

In relation to the portfolio statement, however, a comparative at the end of the prior year is not relevant information. The comparison of two portfolios, which are snapshots of situations at the two respective year-ends, is not informative. A narrative explanation of the fund manager’s objectives and actions during the period along with the principal movements of the portfolio, are considered to provide more relevant information.

Current market practice

1. Europe

The presentation of comparative figures for the previous year in respect of the balance sheet and income statement is a generally accepted standard. However it is not current practice in every European country for financial statements within the funds industry. This situation is mainly attributable to difficulties encountered in the presentation of financial statements in relation to multi sub-fund funds.

2. US

In the US, it is not mandatory to present comparatives for the portfolio statement. Although the presentation of a summarised portfolio is possible, the general market practice in the US is to present a full portfolio statement.

EFAMA recommendation

EFAMA to consider seeking confirmation from the EU commission that the portfolio statement, including sector or geographical allocation, can be included outside the annual accounts so that no comparatives will be needed, should IFRS apply.

Cash flow statements - IAS 7

Issue

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.

Cash comprises cash on hand and demand deposits. 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, (IAS 7.6).

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 method (cash flows derived from aggregating cash receipts and payments associated with operating activities) or indirect method (cash flows derived from adjusting net income for transactions of a non-cash nature such as depreciation). Although the direct method is encouraged, either method is acceptable.

IAS 7 allows for no exemptions from the requirement to present a cash flow statement. Under US GAAP, the presentation of a cash flow statement is not mandatory unless the fund is leveraged. UK GAAP also provides exemptions for certain types of funds. IAS is therefore inconsistent with US and UK GAAP on this issue.

Impact on the investment fund industry

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

Producing a cash flow statement would not provide more meaningful or additional information than is currently provided in funds' financial statements.

Current market practice

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

In many EU countries there is no requirement to produce a cash flow statement. The introduction of IFRS would impose this additional burden. It would bring extra costs with no clear benefits. Furthermore, it would result in unnecessary divergence from the US.

EFAMA recommendation

EFAMA to seek confirmation that a statement of changes in net assets (as required by European regulation) meets the objectives of IFRS and therefore to request an exemption

from preparing cash flow statements provided conditions similar to US GAAP are met, namely:

- During the period substantially all of the Fund'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 Fund has little or no debt, based on average debt outstanding during the period in relation to the average total assets; and
- The Fund provides a statement of changes in net assets.

Segmental Reporting – IFRS 8

Issue

The IASB, as part of its convergence with US GAAP, has recently issued IFRS 8 *Operating Segments*. This requires a management approach to segmental reporting.

Impact on the investment fund industry

IFRS 8 replaces IAS 14 so that certain information provided is based on “operating segments” as determined by management. There are a number of concerns with this.

The first issue is the determination of who would be considered to fall within the definition of “management” in the context of the investment fund industry, where numerous services are outsourced. These service providers are often fiduciaries rather than preparers of financial analyses from a management perspective.

Secondly, it may prove impossible to clearly define separate and distinct business segments for the fund industry.

Thirdly, the disclosure requirements, such as revenue per segment, would not be relevant for the fund industry where the net assets are considered to be more important from a financial and performance perspective.

The composition of the investment portfolio is currently provided in the financial statements as part of the schedules of investments. Providing other information as required by IFRS 8 will bring no added value.

Current market practice

Investment portfolios for funds (or sub-funds in the case of umbrella funds) are constructed based on guidelines defined within a Fund’s prospectus. These may be oriented toward specific business segments or geographical territories. Financial statements generally provide an analysis of a portfolio by industry sector and/or geographical segment.

EFAMA recommendation

Segmental reporting is neither appropriate nor consistent with the activities of investment funds. Furthermore, presenting information as required by IAS 14 may cause investors to question why a fund appears to be managed in a manner other than is stipulated within the fund’s prospectus. An investment fund should have only one operating segment and EFAMA is therefore seeking an exemption from IAS 14/IFRS 8.

Revenue recognition – IAS 18

Issue

Paragraph 32 of IAS 18 requires:

“...When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost...”

Where the return on investments is reported as a single line item in the Income statement, this requirement has no reporting significance, although the requirement to deduct the receipt from the cost of investment might create certain book-keeping issues.

The expectation to provide a sub-analysis of the return on investments is not a general IFRS requirement. There has therefore been little focus on how it might impact funds.

Three scenarios would appear to be relevant for a fund that invests in a company with a 31 December 2005 year end:

- 1) the share is acquired for E105 on 31 December 2005 and a dividend of E5 is declared and paid in March 2006 in respect of the year ended 31 December 2005;
- 2) the share is acquired for E105 on 1 January 2006 and a dividend of E5 is declared and paid in March 2006 in respect of the year ended 31 December 2005; and
- 3) the share is a acquired for E105 on 1 March 2006 after the declaration of a dividend of E5, which is paid later in March 2006 in respect of the year ended 31 December 2005.

The receipt in scenario 1 would appear to be able to benefit from the “arbitrary basis” rule and therefore would be regarded as income.

The receipt in scenario 2 might be able to rely on the same rule. The passing of 1 day without there being more information available would seem an arbitrary basis on which to re-characterise the return as a return of capital.

The greatest difficulty arises in scenario 3. Clearly where a share is quoted cum-dividend, the price that is paid reflects the right to receive that known amount and, indeed, it is frequently possible to buy the share at a lower price if the right to the dividend is surrendered. The income would appear to be from pre-acquisition profits and therefore a strict interpretation of paragraph 32 would lead to recognition as a capital gain rather than dividend income.

This treatment for purchases creates an inconsistency with the treatment of sales as, if a share is sold, there is no corresponding requirement to deduct the dividend from the acquisition cost.

Impact on the investment fund industry

Significant system developments would have to be made for an accounting treatment, which is not consistent with the treatment of sales. Furthermore, significant extra costs would be generated for little added value in terms of information of the investor given that investments are already accounted for at fair value.

Current market practice

The acquisition cost of the security is not currently reduced by the receipt of a dividend even in the case of the scenario 3. The same accounting treatment applies in the US.

EFAMA recommendation

EFAMA to seek confirmation that separate accounting for receipts by way of distribution of pre-acquisition profits need not apply to share purchases.

Consolidation of subsidiaries – IAS 27

Issue

In accordance with IAS 27, when a (parent) company has control over another company, the parent company should prepare consolidated accounts and consolidate the subsidiary company. Under IFRS, control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. An indication of control is presumed when the parent company owns, directly or indirectly through subsidiaries, more than 50 % of the voting power of an entity. This, however, is only one indication of control, as de facto control may exist with an ownership of less than 50 %.

In the EU, several conditions of the IAS-regulation have to be met before IFRS will be required:

- The fund has to be a company;
- The fund has to prepare consolidated financial statements;
- The fund has to be listed in the EU, (as defined). There are, however, certain listings in the EU that are not 'listed' as defined in the EU-regulation.

In most cases consolidation will not lead to better financial reporting for funds, because the underlying investment is already accounted for at fair value. Additionally, consolidation will normally require a minority interest to be included in the consolidated financial statements, and this may well confuse the reader rather than provide additional information or greater transparency.

Impact on the investment fund industry

The issue to consider is whether X should consolidate Y in the following cases:

1. X is a fund with > 50 % of Y, where Y is a company;
2. X is an investor and invests > 50 % in fund Y

These scenarios are discussed further below

1 Fund X is investing > 50 % in a company Y

All investments are at fair value (marked to market), so consolidation may result in a decrease in the net asset value of the fund, as the accounting for the assets and liabilities of the company would generally not equal the value of its listed shares. Therefore consolidated financial statements would not result in either a fuller or more accurate presentation of the underlying economic situation. In fact, one may argue that they distort the financial position of the fund and that this is contrary to the objective of consolidated financial statements, to present a true and fair view of the structure's economic reality.

2 Investor X is investing > 50 % in fund Y

Consolidation may be inappropriate for the following reasons:

- For open-ended funds, investors can subscribe and redeem very easily, which means that no investor really can have control of the underlying fund. At the most, there can be temporary control, but this generally cannot be intentional. An investor cannot control. who is subscribing and/or redeeming.
- The investment can only be seen as a speculative activity instead of the managing of a subsidiary or an associate.
- The decision making power is not at the level of the investors, due to the fact that they cannot change the financial, operating and investing policies of the fund. . These policies are predetermined in the prospectus. In general the only power the investor has is to redeem his or her money out of the fund. The investor does not generally have any other business activities with the fund.
- The investment fund can be seen as a financial product and not as a company.
- The management of the fund is the responsibility of another company or party.

Specific guidance must, however, also be followed with respect to SPEs. If the fund is an SPE (as defined in SIC12) and the investor has > 50 % of the risks and rewards, then the investor should generally consolidate the fund under IFRS.

Current market practice

Under current practice, a fund will not consolidate another fund in which it owns more than 50%. The investment (for the fund) is disclosed at fair value, with the related unrealised gain/loss accounted for in the profit and loss account.

Also, under other GAAPs, including that in the US, a fund is not required to be consolidated by its' investors.

EFAMA recommendation

In the case of the fund of funds structure EFAMA is seeking an exemption such that consolidation should not be required, unless there is a major risk, which can only be addressed through consolidation, or certain specific conditions are not met. As an alternative to full consolidation, additional disclosures could be required or one-line consolidation considered.

Classification of puttable instruments - IAS 32

Issue

IAS 32 (paragraph 18) 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 18 to the position of open-ended mutual funds:

“The existence of an option for the holder to put the instrument back to the issuer for cash or another financial asset means that the puttable instrument meets the definition of a financial liability. 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 asset value of the issuer. “

This results in funds having no residual equity. In the UK and Ireland, which have already been required to implement this presentation as recently as 2005, an accounts format has been adopted which, in practice, seeks to minimise any potential confusion.

The IASB has, however, published an exposure draft of proposed amendments to IAS 32, potentially enabling entities such as funds to classify puttable instruments as equity if certain conditions are met.

The treatment of fund shares and units as debt paradoxically renders the application of a number of provisions within certain IFRSs inapplicable, namely:

- IAS 1 – presentation of statement of changes in equity
- IAS 32 – presentation of dividend payments and ability to accrue proposed dividends
- IAS 33 – earnings per share disclosures

If the IASB reverts to showing puttable instruments as equity, this will create potential issues regarding the application of these other standards. Significant issues arising are referred to elsewhere in this paper on the assumption that IAS 32 is amended.

Impact on the investment funds industry

IAS 32 as it is presently framed results in fund accounts, which show no residual equity. This is neither logical nor informative for share/unitholders, for whom the accounts are primarily intended.

For UK and Ireland, who have already been required to implement IAS 32 style presentation, there is some frustration at the prospect of having to change accounting practice again after a very short period of time.

Current market practice

Current practice has been 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 required in IAS 32, citing such matters as:

1. 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.
2. Presenting shares/units as liabilities makes sense only if these are not the residual interest in the entity, as it leaves the fund with no equivalent of shareholders' equity. IAS 32 treatment is 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.
3. IAS 32 is inconsistent with most other national accounting standards, including US, Canada and, until recently (as noted above), the UK. General practice in Europe is also for unitholders' funds to be shown as equity.

EFAMA recommendation

EFAMA to seek confirmation that the exposure draft will be either withdrawn or re-drafted after performing a further fundamental reconsideration of the classification criterion and in-depth consultation with relevant industry representatives.

Earnings per share - IAS 33

Preamble: Under IAS 32, redeemable funds shares/units are currently treated as puttable instruments and therefore considered as debt. This paper assumes that the IASB, as announced in its December update, implements its proposals that redeemable fund shares/units will instead be treated as equity.

Issue

IAS 33 “Earnings per share” applies to entities whose ordinary shares or potential ordinary shares are publicly traded and to entities 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 entities in the same period and among different accounting periods for the same entity. 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 33.31]

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.

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, and providing both earnings per share and current NAV per share data will confuse investors.

The inclusion of an earnings per share figure in addition to the net asset value per unit would not meet the objective of IAS 33 as it will not be capable of being reconciled to the movement in NAV per share over the period because of the opened ended nature of the fund.

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

Current market practice

Earnings per share must be disclosed for listed entities under IFRS, US GAAP and UK GAAP. The three frameworks 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.

Under UK GAAP, the authorised funds SORP does not require the disclosure of any earnings per share data. Practice varies elsewhere around Europe. In most countries, EPS disclosures are not made.

EFAMA recommendation

EFAMA considers that NAV per share data is more meaningful than earnings per share for the fund industry and is to seek acceptance that such information should be disclosed instead. EFAMA to consider developing an 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

Issue

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 39.BC 99 and 39.AG 72).

The investment management industry has historically 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 set out in the fund's incorporation and offering documents.

Impact on the investment fund industry

Use of bid price for the accounts and other valuation methods for daily valuation of the Fund may lead to confusion. European Union directives on UCITS provides as a benchmark, the valuation of quoted securities at the last known stock exchange price.

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.AG 69 notes, underlying this definition is a presumption that an enterprise 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 at 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.

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 not to dilute the performance of the existing investors' holdings 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 not to dilute the performance of the existing investors' holdings. This is the reason for the use of a dilution 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, 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 possibility of having the same method as the one used for the NAV calculation should be retained.

Current market practice

1. Europe

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

2. US

In the US, closing prices are generally used; alternatively, mid prices may be used.

EFAMA recommendation

EFAMA to seek confirmation that the use of the mid-market and last traded price are acceptable methods in addition to bid prices, as foreseen by the recent FASB draft fair value

measurement statement and in line with current practice in the US and most European countries.

Effective interest rates - IAS 39

Issue

IAS 39 envisages that interest income on fixed interest securities is recognised on an effective interest rate (“EIR”) basis. The investment fund industry is committed to providing its investors with full and appropriate information on the overall return on their investment. The issue relates to the complexity of the rules to be applied and the inappropriateness of certain aspects of the implementation guidance to investment funds.

Impact on the investment funds industry

The high level of complexity of this methodology combined with the increasing range and complexity of debt instruments held by investment funds has caused significant increased complexity and costly systems changes in member states such as the UK and Ireland where EIR methodology is in the course of being adopted. This cost and complexity needs to be considered in the context of the fact that because investment funds carry their investments at fair value, the use of an amortised cost methodology of income recognition such as EIR has no effect on the NAV of the fund; it affects only the analysis of the fund’s gains between investment gains and interest income, and therefore, in some member states, the tax treatment.

One particular area of complexity which has caused difficulty relates to the handling of changes in estimated future cash flows on a bond. In order to enable the original EIR to continue to be used after the cash flow change, the application guidance in the standard requires that the revised cash flows are discounted back at the instrument’s original EIR, creating a change in amortised cost which flows through interest income. For funds which distribute interest income (and therefore have to show interest income as a separate item in their accounts) this has the potential to cause significant volatility in distribution payments for investment products that generally are bought by investors seeking a relatively high and predictable distribution flow.

Current market practice

Some member states use a form of effective yield accounting for bonds, although it is a less complex method than is envisaged in IAS 39. If there are changes in estimated cash flows, these would give rise to a change in the EIR rather than the change in amortised cost referred to above.

Some member states, such as UK and Ireland, historically have recognised bond income on an accrual of coupon basis unless the bond was issued at a significant discount or premium, in which case an effective yield based method will have been used. If there are changes in estimated cash flows, these would again give rise to a change in the EIR rather than a change in amortised cost. As mentioned above, the UK and Ireland have, as part of UK GAAP convergence with IFRS, begun to transition towards an IAS 39 EIR methodology.

EFAMA recommendation

EFAMA to seek confirmation that changes in amortised cost arising from changes in predicted future cash flows may be included within the movement in fair value of investments rather than interest income. This issue might also be raised as part of a general observation on IFRS, as it illustrates some of the complexity and difficulty, which can arise from the provision of excessively detailed application guidance, which reduces the flexibility in implementing what are claimed to be principles-based standards.

APPENDIX 1

Issues dealt with which are no longer considered critical

Reporting and functional currency – IAS 21

Issue

Under IFRS an entity has to determine its functional currency and its presentation currency.

The presentation currency is defined as the currency in which the financial statements of an entity are presented. Due to the fact that an entity can choose any currency as its presentation currency, this will in fact not be an issue for funds that apply IFRS.

The functional currency is defined as the currency of the primary economic environment in which the entity operates. IFRS now dictates how a fund should determine its functional currency and requires that this functional currency has to be used to record all of the transactions which an entity enters into. In the case of investment funds, this means calculating the net asset value in the functional currency.

The guidance in IAS 21, which has to be used by management to determine the appropriate functional currency, has been written for operational entities and is not specific for investment funds. For an investment fund, the sole activity is to hold financial assets on behalf of investors and to maximise the performance of those investments. For such entities, the application of IAS 21 is not clear.

Due to the fact that the fundamental objective of a fund is to provide a competitive return to an investor, the primary economic environment of the investors also has an impact on the operations of the fund itself.

If one considers all indicators of IAS 21, the message is very often mixed, since the majority of funds are influenced by a multitude of factors, including:

- (a) the economic environments in which the financial assets are invested;
- (b) the economic environment(s) of the investors;
- (c) the regulatory environment;
- (d) the competitive environment;
- (e) the fee structure, even if this is normally minor compared to the expected return on investment.

When the above indicators are mixed and the functional currency is not obvious, IFRS states that management should use its judgement to determine the functional currency that most faithfully represents the economic effects of the underlying transactions, events and conditions. In doing this, however, it states that management should give priority to

indicators in paragraph 9 (which is written more from the perspective of an operational entity which sells goods or services) over paragraphs 10 and 11 (which deal with the currency in which funding is raised and retained and has more direct relevance to funds). In making its decision, some management may consider that, in paragraph 9 terms, the services which are provided by a fund are those of managing the financial investments of the investors and that the functional currency of the fund should reflect the functional currency of the investors. Where a fund is considered to be an SPE, a similar conclusion may be reached, as the functional currency of the fund would arguably also be driven by the functional currency of the investors.

This is likely to lead to the functional currency of the fund being determined by such matters as the economic environment of investors (including their residence), the currency of the share capital of the fund and the currency in which returns are made to investors. It is likely that in many cases this will result in the functional currency being the same as the desired presentation currency. Once determined, the functional currency is not changed unless there is a change in those underlying transactions, events and conditions.

Impact on the investment funds industry

Functional currency would require to be considered on a case-by-case basis. For a large number of funds it is probable that there would not need to be any change. It is possible that some funds may require to reconsider their functional currency, however - for example those which have various currency shares in issue and where the fund is being sold in various jurisdictions.

Current market practice

The current market practice is that funds' financial statements are usually presented in the currency of reference of the investor. This would rarely differ from the functional currency of the fund.

Conclusion

No further technical solution is proposed as current market practice seems likely to be in line with IFRS for the majority of funds. It is noted, however, that there may be some funds for which a change in functional currency may be required.

APPENDIX 2

Current status in Member States regarding the application of IFRS for investment funds

(Go to next page)

IFRS: application to investment funds (as of mid 2006)												
Issues	Austria	Belgium	France	Germany	Ireland	Liechtenstein	Luxembourg	Portugal	Sweden	Switzerland	Turkey	UK
i. Is the use of local GAAPs for UCITS required? If so, would this entail the use of general GAAPs or specific GAAPs applying to investment funds?	According to the investment funds law there is no special obligation for the investment fund management company to prepare an annual report based on local GAAPs. There is the opinion that accounting and reporting requirements of funds should be deduced from local GAAPs, but there does not exist any common, legally binding standard.	The use of local GAAPs for UCITS is required. These are specific GAAPs applying to investment funds. The specific GAAPs are moreover a different version for UCITS versus the specific category of closed-end real estate investment funds.	Specific local GAAPs applying to investment funds are required.	There are specific GAAPs applying to investment funds.	Irish legislation provides the flexibility for UCITS to apply Irish & UK GAAPs, IFRS, US GAAP, Japanese GAAP or Canadian GAAP. The general body of accounting standards applicable to all companies in each jurisdiction applies to investment funds.	Specific local GAAPs for investment funds are required.	Luxembourg has specific GAAPs for funds as defined in Appendix B of the Law of December 2002.	Specific local GAAPs are applied for UCITS.	Local GAAPs apply to both UCITS and investment funds.	Specific local GAAPs apply to investment funds.	Specific GAAPs apply to investment funds, but investment funds are not UCITS.	UK GAAP is applied to UCITS. However, whilst UK GAAP has converged with some of the key IFRSs eg. IAS39, the requirements of the UK standard which converges the UK with the IAS39 requirements do not yet apply to authorised funds.
ii. Does your country have to apply IFRS to UCITS? Is this mandatory or optional? And if so, as from which date?	This question has not been yet answered. As Austria has transformed EU decree No 1606/2002 of 19th July 2002 into national law, there seems to be a high possibility that IFRS	There is no obligation to apply IFRS for UCITS, <u>except</u> when investment funds have a legal obligation to be listed on the stock exchange (this is the case for the closed-end real estate funds, see	No	No	The application of IFRS to UCITS is optional, unless the UCITS is an EU listed entity and produces consolidated accounts. In such circumstances,	No	Luxembourg legislation does not require the application of IFRS for UCITS	It cannot be strictly said that IFRS are being applied to UCITS. However, the Regulation concerning the accountancy of funds dates from	No	No	No	In the UK there is no current requirement to apply IFRS to UCITS. Furthermore, UCITS may not elect to apply IFRS.

IFRS: application to investment funds (as of mid 2006)												
Issues	Austria	Belgium	France	Germany	Ireland	Liechtenstein	Luxembourg	Portugal	Sweden	Switzerland	Turkey	UK
	regulations (esp. IAS 27, SIC 12) could be applicable to certain investment funds products. Especially the „Spezialfonds“, which can be owned by no more than ten business clients, could be target of IFRS regulations.	answer 3).			the UCITS must apply IFRS for the purpose of the consolidated accounts for accounting periods beginning on or after 1 January 2005. Under revised Irish legislation, UCITS have the option of preparing individual accounts under IFRS for accounting periods beginning on or after 1 January 2005.			2003, and at the time of its drafting the Supervisory Authority tried to include rules that are converging to IFRS.				
iii. Is the answer to the question above the same if UCITS are listed on the local stock exchange? If yes, please comment.	Austrian investment funds (UCITS) are generally not listed on the local stock exchange.	The closed-end real estate funds are in Belgium obliged to be listed on the stock exchange. They have been recommended to use IFRS for the financial year 2006, and are obliged to use IFRS from the financial year 2007 onwards.	No	Even if UCITS are listed on the local stock exchange, specific GAAPs are applied to UCITS	A UCITS listed on the Irish Stock Exchange has the option of applying IFRS.	N.a	European regulation is applicable for companies listed in Luxembourg and presenting consolidated accounts. There are no UCITS consolidating in Luxembourg.	N/A. (The only funds that are listed are closed-ended, therefore not covered by UCITS).	UCITS and investment funds are applying the same specific GAAPs. IFRS are only applicable on the consolidated financial reporting for listed	UCITS are listed in a specific segment on the SWX - Swiss Exchange. The specific local GAAPs to investment funds apply.	Open-ended funds are not listed on the Istanbul Stock Exchange (ISE) . In Turkey close-ended investment trusts, real estate investment trusts and venture	In the UK authorised funds follow UK GAAP and the IMA Statement of Recommended Practice for reporting of authorised funds. This is part of the regulations.

IFRS: application to investment funds (as of mid 2006)												
Issues	Austria	Belgium	France	Germany	Ireland	Liechtenstein	Luxembourg	Portugal	Sweden	Switzerland	Turkey	UK
		Note that in the Belgian context these real estate funds often have <u>both consolidated and non consolidated published accounts.</u>							companies. Since investment funds and UCITS are not a legal entity IFRS are not applicable.		capital investment trusts are listed on the ISE and applying IFRS is mandatory starting in 2005.	
iv.Are local GAAPs converging towards IFRS? Is it envisaged to have specific derogations for investment funds in general or UCITS in particular?	As IFRS only apply to group accounting, it cannot be said that local GAAPs are converging towards IFRS. VÖIG would seek to receive derogations for investment funds in general or UCITS in particular.	There is a strong recommendation by the supervisor to converge as much as possible to IAS/IFRS principles when redrafting local GAAPs. There is certainly a strong demand from BEAMA members to argue for derogations, even when local GAAPs for UCITS are converging to IFRS.	No, none.	No	The Accounting Standards Board (“ASB”), the standard setting body for Irish and UK GAAP, has devised a convergence strategy to bring about convergence between UK standards and IFRS within a period of 3-4 years. This will involve setting UK accounting standards which are standards based on IFRS with no changes other than those that	No	Luxembourg UCITS legislation does not comply with IFRS . Local industry (ALFI) position is to support EFAMA position when finalised and this has been made clear with the regulator as well as in the Annual report of the Fund Association for 2005/06.	It seems that the only issue to which the Portuguese framework is not being compliant with is the IAS 39 - Bid Price, since the use of the closing prices at Fair Value is required.	Yes. Local GAAPs are in general converging towards IFRS. Specific GAAPs for investment funds are not.	Yes. Switzerland will have a new law on collective investments by beginning of 2007. The details on accounting are not yet defined.	No convergence towards IFRS	In respect of UK’s convergence with IFRS, the authorised funds at the moment only have to comply with the UK standard that converges with the presentation requirements of IAS 32. From the statements made by the UK Accounting Standards Board it is anticipated that IAS 39, IAS 32, IAS 21 to apply to authorised funds at some point over the next few years though the relevant UK standards the converge with international

