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Mind the GAAP- Accounting Update

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Agenda

Introduction

IFRS developments and trends for Asset Management

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IFRS developments and trends

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IFRS Developments and Trends

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Irish GAAP / UK GAAP Convergence to IFRS



Irish GAAP / UK GAAP Convergence to IFRS

***Possible
implications
of not being in
Tier 1 - SORP,
FRSME
(Financial
Reporting
Standard for
Mid-Sized
Entities), Irish
Funds' SORP?***

- Probable date of 2015
- Initially, in the ED issued by the ASB, Funds were defined as “publically accountable” and were included in ‘Tier 1’ which would have meant full IFRS
- Possible implications of not being in Tier 1 – SORP, FRSME (*Financial Reporting Standard for Mid-Sized Entities*), Irish Funds’ SORP?

Irish GAAP / UK GAAP Convergence to IFRS (continued)



- FRSME likely to need additional guidance on financial instruments to bridge the gap between FRSME and IFRS
- Some points from the paper – analysis of financial instruments split into ‘levels’ similar to FRS 29/IFRS 7; information around credit risk and collateral; maturity analysis of financial liabilities and sensitivity analysis for each type of market risk (interest rate risk, currency risk, other price risk).

IFRS 13 – Fair Value Measurement



IFRS 13 ‘Fair Value Measurement’

- On 12 May 2011 the IASB issued new guidance on fair value measurement and disclosure requirements for International Financial Reporting Standards (IFRSs) – IFRS 13 “Fair Value Measurement”.
- Effective for annual periods beginning on or after 1 January 2013. Earlier application is permitted. It is applied prospectively. However, it is not yet endorsed by EU.



Definition of fair value

IFRS 13 defines fair value as:

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

In the principal market

*Multiple markets?
Most advantageous
market*

Existing IFRSs define fair value as:

The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

IFRS 13 'Fair Value Measurement'

Defining fair value as an exit price

- The use of bid prices for asset positions and ask prices for liability positions is permitted if those prices are most representative of fair value in the circumstance, but not required.

Principal and most advantageous markets

- In the absence of evidence to the contrary, the market in which the entity would normally enter into a transaction to sell the asset or to transfer the liability is presumed to be the principal market or, in the absence of a principal market, the most advantageous market.

IFRS 13 'Fair Value Measurement' (continued)

Measuring the fair value of a liability

- Estimate a transfer price for a liability using the fair value of a corresponding asset.

Measuring the fair value of financial instruments within a portfolio

- Assumes that fair value is maximised by using the asset on a stand-alone basis.
- Proposed an amendment to IAS 39 specifying that the unit of account for a financial instrument is the individual financial instrument at all levels of the fair value hierarchy i.e. levels 1, 2 and 3.

IFRS 13 'Fair Value Measurement' (continued)

Premiums and discounts

- Fair value measurement incorporates premiums or discounts when they reflect a characteristic of the asset/liability that market participants would take into account in a transaction for the asset/liability.
- Prohibits the application of a 'blockage factor' – discount that reflects size as a characteristic of the holding rather than as a characteristic of the asset/liability being measured at fair value.

Measuring fair value when markets become inactive

- Entity must use a valuation technique to measure fair value when market activity declines.




Entity must use a valuation technique to measure fair value when market activity declines

IFRS 13 'Fair Value Measurement' (continued)

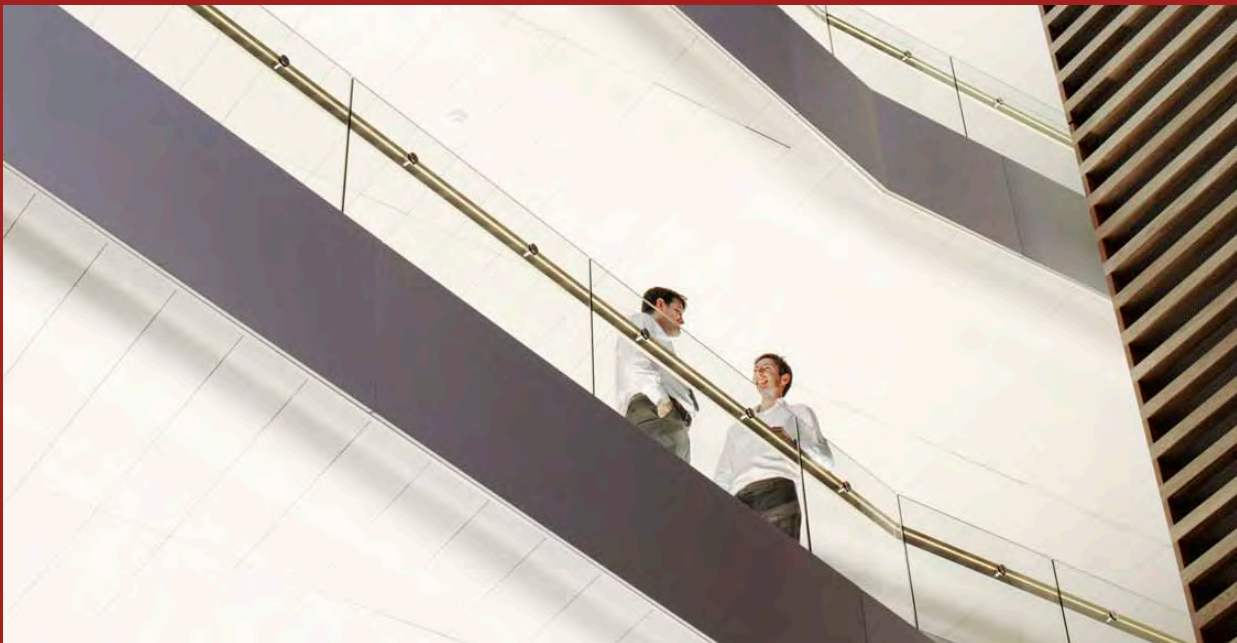
Disclosures about fair value measurements

- Level 3 positions:
 - i. reconciliation from opening to closing,
 - ii. quantitative information about significant inputs into valuation technique,
 - iii. valuation processes used by the entity and
 - iv. sensitivity to changes in significant unobservable inputs – narrative for all fair value measurements and quantitative analysis for financial instruments

Fair value measurement – What's changed

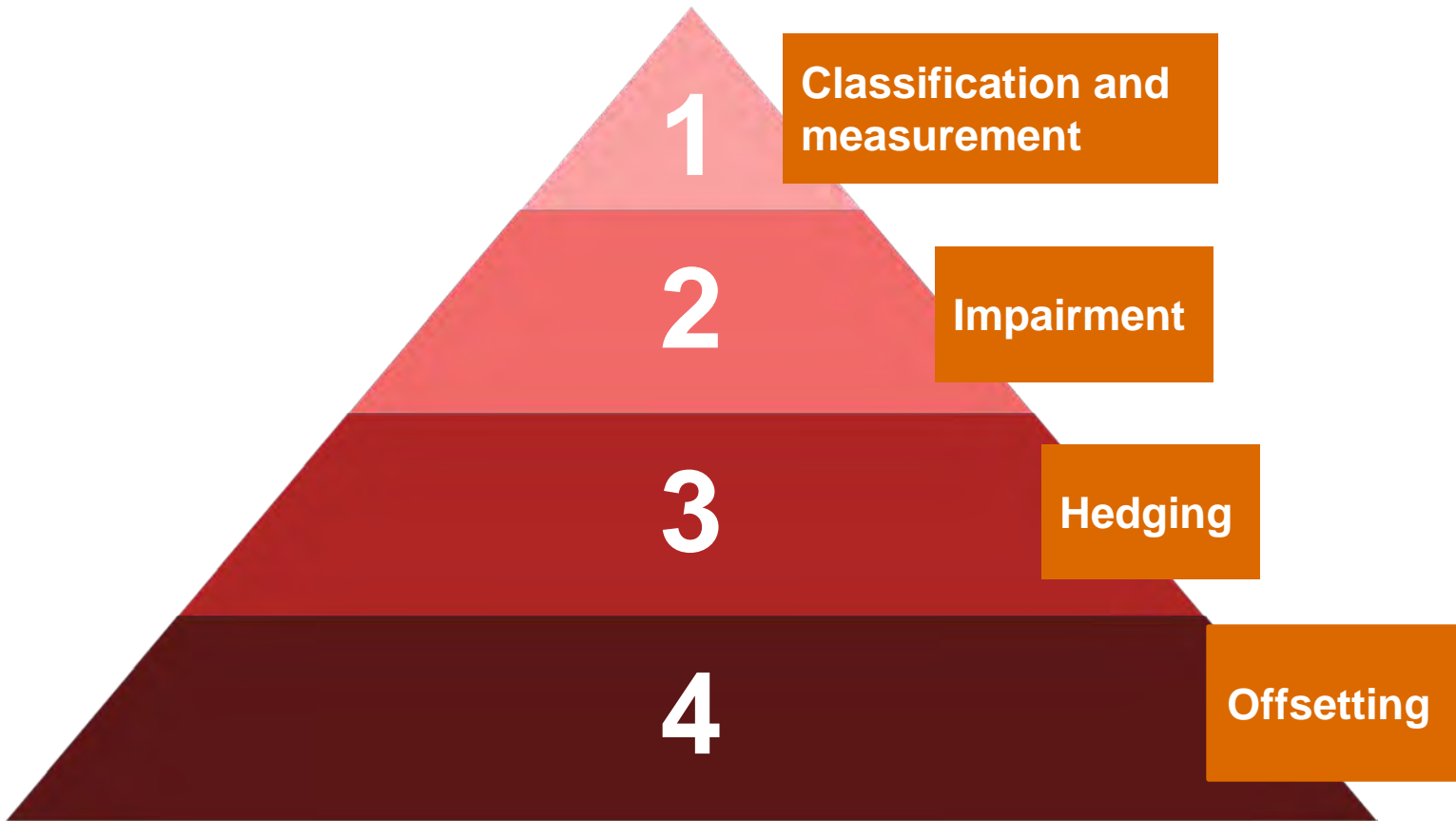
| Current | New |
|---|---|
| (1) Financial instruments | |
| <u>Bid-ask spread</u> Assets – Bid price Liabilities – Ask price |  <u>Bid-ask spread</u> Most representative price Use of Practical Expedient |
| <u>Derivative liabilities</u> Transferral, settlement or extinguishment |  <u>Derivative liabilities</u> Transferral |
| (2) Non-financial assets and liabilities | |
| <u>Fair value hierarchy</u> Not required |  <u>Fair value hierarchy</u> Required |

IFRS 9 – Financial Instruments



IFRS 9 – Financial Instruments

IAS39 Replacement Agenda



IASB updates IFRS 9

The effective date for IFRS 9 is for annual periods beginning on or after 1 January 2015.
Not yet endorsed by the EU.

A financial asset shall be measured at amortised cost if both of the following conditions are met:

- The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.



IASB updates IFRS 9

Example:

- A money market fund holds various short term securities to maturity. The fund does not fair value the instruments for dealing purposes. Objective of the fund is to generate an attractive yield while attempting to maintain capital preservation. In this case, the fund may be able to value the short term instruments at amortised cost.
- Classification need not be determined at the reporting entity level. For example, an entity may hold a portfolio of investments that it manages in order to collect contractual cash flows and another portfolio of investments that it manages to trade to realise fair value changes.

Exposure Draft – Investment Entities



Exposure Draft: Investment Entities

IASB issued its exposure draft in August 2011. The comment period deadline was 5 January 2012.

The IASB propose 6 qualifying criteria that an entity must meet in order to be classified as an investment entity. Those entities that meet the criteria would be exempt from consolidating their subsidiaries in accordance with IFRS 10.

If adopted, the proposals would require investment entities to account for their subsidiaries at fair value through profit or loss.



Exposure Draft: Investment Entities

In order to provide investors with information about the nature and type of investments undertaken by the investment entity, the Board proposes introducing appropriate disclosure requirements that would complement the disclosures required by IFRS 7 and IFRS 13.

IFRS 11 – Joint Arrangement

IFRS 12 - Disclosure of interests in other entities



What is an investment entity?

Definition

No substantive activities besides multiple investments

Purpose is investment for income / capital appreciation –exit strategy documented

Ownership units entitled to proportionate net assets

Pooled investors and significant ownership by unrelated investors

Manages and evaluates investments on fair value basis

Reporting entity - provides financial information on its investments to its investors

Exposure Draft: Investment Entities (continued)

Disclosures

The exposure draft proposes a disclosure objective that would require an investment entity to provide information to enable users of the financial statements to evaluate the nature and financial effect of the investment activities in which it engages.

The exposure draft includes some examples which **may** be appropriate to meet the disclosure objective:



Exposure Draft: Investment Entities (continued)

- Per-share 'Financial Highlights' type disclosures
- Ratios of expenses and net investment income to average net assets including methodology for computing the ratios
- Total return including methodology



Exposure Draft: Investment Entities (continued)

Consolidation

Under the proposals the parent of an investment entity consolidates all entities it controls, including those controlled through an investment entity, unless the parent is itself an investment entity.



Scope exclusion in IAS28

IAS 28 allows mutual funds, unit trusts and similar entities to irrevocably elect to measure investments in associates and joint ventures at fair value through profit or loss. The exposure draft proposes an amendment to IAS 28 to require **investment entities**, and only those entities, to measure their investments in associates and joint ventures at fair value through profit or loss.

Conclusion

A number of issues are still unclear/subject to debate (e.g. revision of the scope-out of IAS 28) in the exposure draft.

IFRS 10 - Consolidation



Consolidation standard (IFRS 10) revises definition of control

What is the issue?

The IASB has issued the long-awaited IFRS 10, 'Consolidated financial statements', as part of the group of five new standards that address the scope of the reporting entity. IFRS 10 replaces all of the guidance on control and consolidation in IAS 27, 'Consolidated and separate financial statements', and SIC-12, 'Consolidation – special purpose entities'.



Consolidation standard (IFRS 10) , The control model overview

Definition of control:

An investor controls an investee when the investor is exposed, or has rights, to **variable returns** from its involvement with the investee and has the **ability to affect those returns** through its **power** over the investee.

Power over the investee

- Power arises from rights
- *to direct the relevant activities*
- Substantive rights vs. protective rights

Variable returns

- Broad definition, including fixed returns



Link between power and returns

- Principal vs. agent

Principal vs. agent

- Investor with decision making rights-principal or agent?

If a single party has substantive removal rights to remove the decision – maker without cause



then the decision – maker is an AGENT

In all other cases



all these factors must be considered:

- ✓ **Scope of decision-making authority**
- ✓ **Rights held by other parties**
- ✓ **Remuneration**
- ✓ **Exposure to variability of returns from other interest**

IFRS 10 – Do the fund managers consolidate the funds they manage?

Scenario

A fund manager establishes, markets and manages a fund that provides investment opportunities to a number of investors. The fund manager must make decisions in the best interests of all investors and in accordance with the fund's governing documents. However, the fund manager has **wide decision-making discretion**. The fund manager receives a **management fee of 1%** of the net asset value and **20%** of the profits as a **performance fee**.

The fund manager has a **20% interest** in the fund. The investors can remove the fund manager by a simple majority vote, but only for breach of contract.

Solutions:

| Scope of decision-making authority | The fund manager has the power to direct the fund's activities. |
|--|--|
| Rights held by other parties | Investors only have protective rights as they can only remove the fund manager with cause. |
| Remuneration | In line with the market norms. |
| Exposure to variability of returns from other interest | The fund manager may have sufficient exposure to returns. |
| Conclusion | Significant exposure to variability of returns may indicate the fund manager is a principal. |

IFRS 10 – Do the fund managers consolidate the funds they manage?

Scenario

Same fact pattern as previous **Scenario**, except that the fund has a **board of directors**, all of whose members are **independent** of the fund manager and are appointed by the investors. The board of directors appoints the fund manager annually. The investors have **substantive rights to remove the fund manager** – the board of directors can remove the fund manager with reasonable notice period in line with industry practice .

Solutions:

| Scope of decision-making authority | The fund manager has the power to direct the fund's activities. |
|--|--|
| Rights held by other parties | Investors have rights through the Board to remove the manager without cause. |
| Remuneration | In line with the market norms. |
| Exposure to variability of returns from other interest | The fund manager may have sufficient exposure to returns. |
| Conclusion | The fund manager is an agent. No control. |

IFRS - Sources of Information

- **Global Illustrative financial statements**
- **PwC Inform**
- **Straight away guidance newsletters**



***Statement of Recommended Practice
Financial Statements of Authorised
Funds (“SORP”)***

Sally Cosgrove

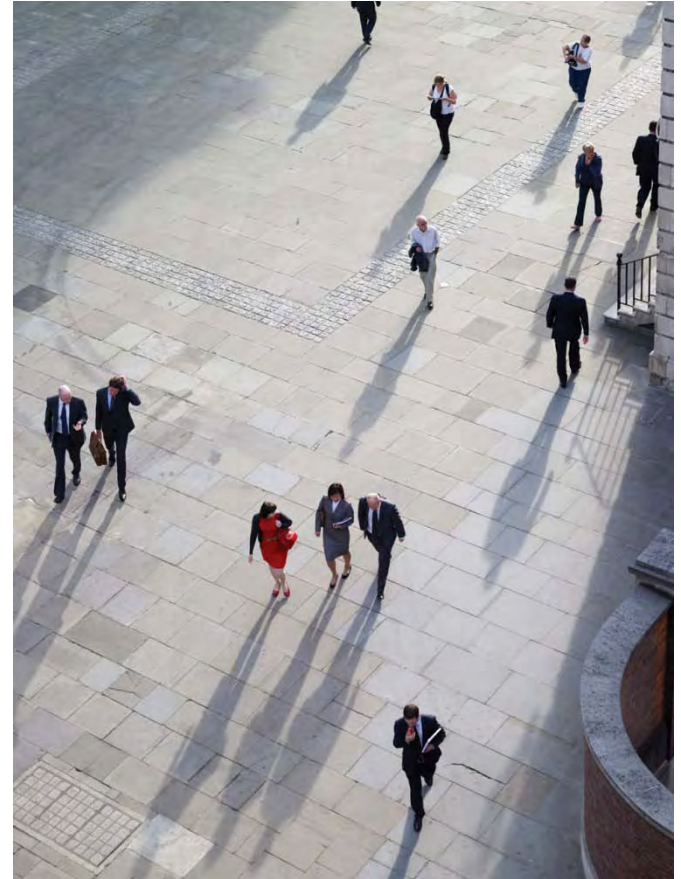
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UK Funds SORP

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- 1. Objective of the UK Funds SORP**
- 2. Effective yield**
- 3. Returns on derivatives**
- 4. Future developments**



Objective of the UK Funds SORP

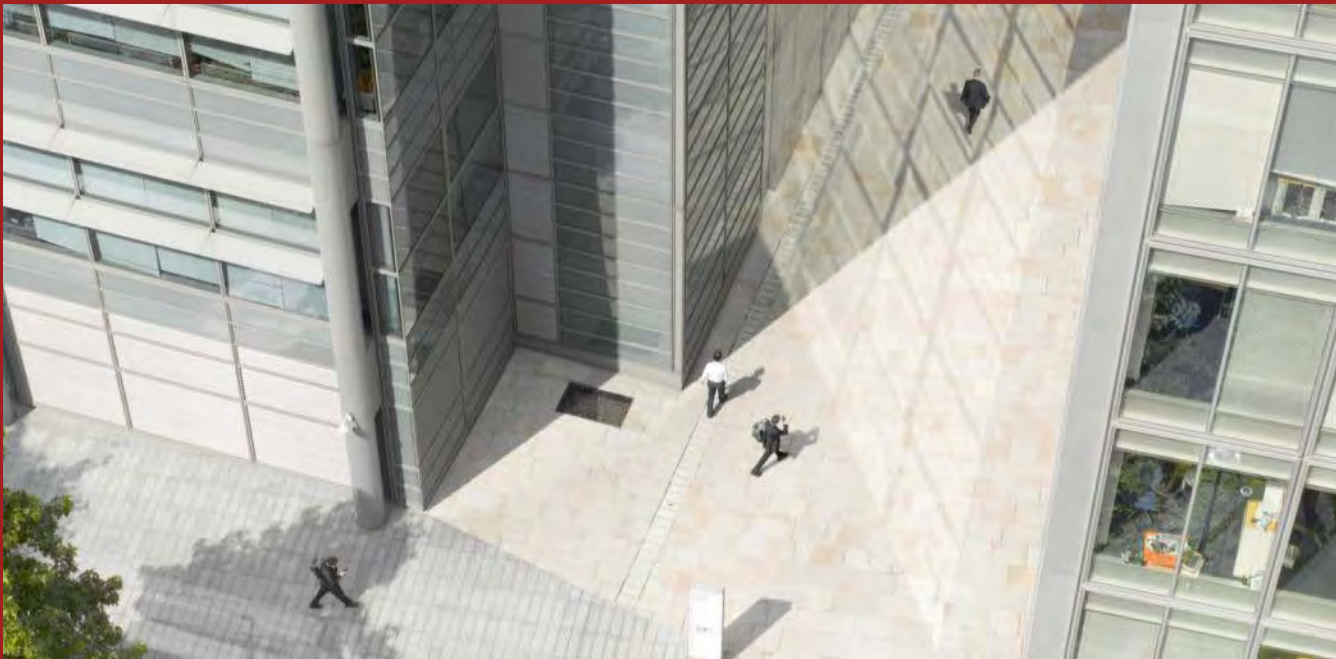


Role and objective of the UK Funds SORP

Reminder of the objectives of the UK Funds SORP

- SORPs are recommendations on accounting practices for specialised industries
- Not an alternative for referring to the relevant standards or interpretations (SSAPs, FRSs, UITFs)
- Provides standard interpretations to accounting standards and other legal and regulatory requirements in so far as they relate to authorised funds
- Establishes principles for determining the nature of items as revenue or capital for the purposes of distribution and taxation.

Effective yield

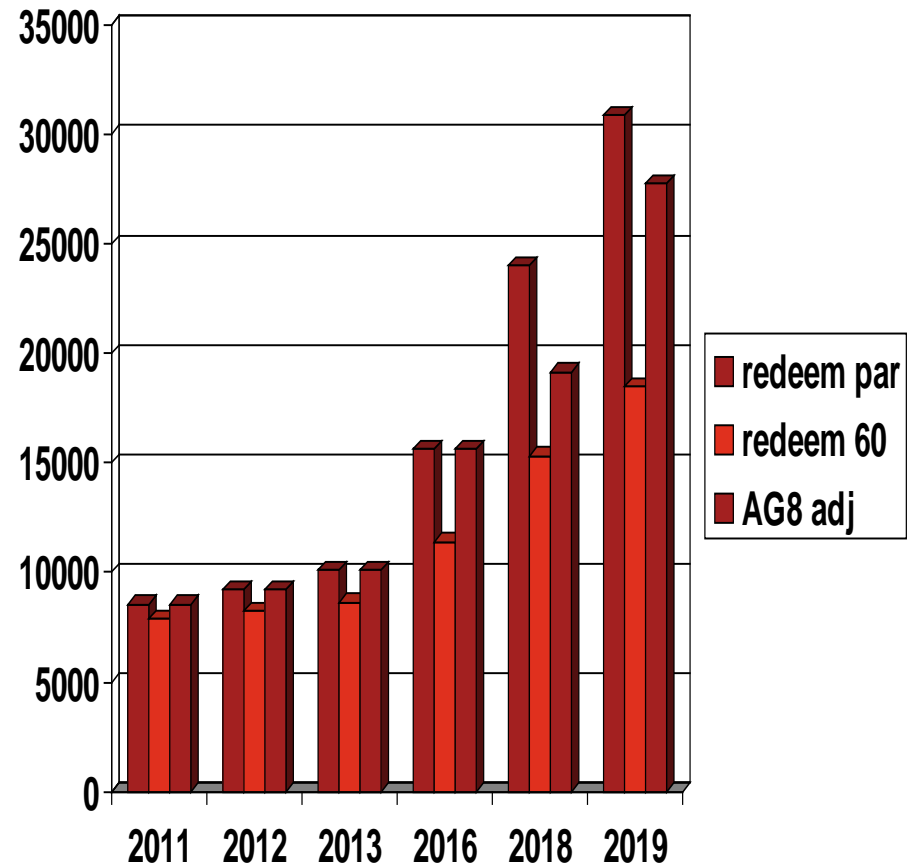


UK Funds SORP – Effective yield summary

| Buy at | Coupon | EIR | Impact on revenue |
|---------------|---------------|------------|--------------------------|
| Discount | X | <Y | Increase |
| Premium | X | >Y | Decrease |
| At par | X | =Y | No Impact |

The importance of estimating cash flows at time of purchase

| Year | Coupon, amortisation: bond redeems at £100,000 | Coupon, amortisation: bond redeems at £60,000 | Coupon, amortisation with AG8 in 2017 |
|--------------|--|---|---------------------------------------|
| 2011 | 8,560 | 7,860 | 8,560 |
| 2012 | 9,210 | 8,210 | 9,210 |
| 2013 | 10,110 | 8,650 | 10,110 |
| 2016 | 15,620 | 11,390 | 15,620 |
| 2018 | 23,990 | 15,320 | 19,150 |
| 2019 | 30,880 | 18,490 | 27,730 |
| Total | £150,000 | £110,000 | £136,000 |



The importance of identifying securities likely to default

S&P – Weekly
Corporate Defaults
reach 21 month high

Rate to reach
3.1% by
September 2012

Not at the heady heights of the credit crisis but important point here is that defaults rates are on the rise.

- Necessitates the need for monitoring to ensure securities in default or likely to default are:
 - a) Identified
 - b) Amortisation is switched off where the company looks like it will make some capital payment or will not recover.

Returns on derivatives



Application of the SORP on returns on derivatives

Motives AND circumstances to be considered

“Where positions are undertaken to **protect or enhance capital**, and the circumstances support this, **the returns are capital**”

“Where positions are undertaken to **protect or enhance revenue**, and the circumstances support this, **the returns are revenue**”

“Where positions **generate total returns** it will generally be appropriate to apportion such returns between **capital and revenue** to properly reflect the nature of the transaction”

Example: Currency forwards

Forward currency contracts used to hedge against risk of unfavourable change in value of foreign denominated investments as the result of currency movements.

Motive: Hedging currency risk

Circumstances: Forward contracts being used to hedge against the 'capital' value of the investments

Application: No yield on the underlying currency movements so gains/losses on forward currency contracts taken through capital as this is what the contracts were being used to hedge.

Example: Credit default swaps

Think of insurance; pay a periodic fee to another party, and if an accident occurs, you get a lump sum compensation – only in this case the accident is your asset defaulting! Where would the premium go: capital or revenue?

Buying Protection

Bought to provide protection on risky asset – periodic premium could be taken to **capital**

Bought to provide protection on a risky asset that has a high income stream- periodic premium could be taken to **revenue.**

Selling Protection

If a CDS is sold – effectively long a bond – periodic premium received is similar to a coupon and generally taken to **revenue**

Speculation

If the CDS is bought /sold due to speculation on the movement in credit spreads, then the premium is generally taken to **capital.**

Example: Total return swaps

A swap whereby one counterparty receives the total return (capital gain/loss and interest payments) from a specified reference asset.

e.g. FTSE 100 or even the gain/loss and ticket sales on the Mona Lisa

The other counterparty receives a specified fixed or floating cash flow that is not related to the creditworthiness of the reference asset.

e.g. European Central Bank base rate or even the gate receipts from Old Trafford

Application: depends on the nature of the reference asset but as the name suggests we would generally expect both revenue and capital from a total return swap

Future developments



Likely future UK Funds SORP developments

- Risk disclosures – SORP or UK GAAP (IFRS for SMEs)
- Derivative returns – more guidance or a SORP update?
- Master feeder structures
- Taxes on capital
- Offshore funds and recording of reported income
- Reporting layout and portfolio statements



Disclosure requirements under UCITS IV

Karen O'Sullivan

Director, PwC Luxembourg

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Disclosure Requirements under UCITS IV

Prospectus

- Box 24 ESMA Guidelines
 - › Provide investors with information about risk related to derivatives

Financial Statements

- Box 25 ESMA Guidelines
- UCITS IV Directive
 - › Increased transparency for investors

Disclosure Requirements under UCITS IV

Leverage should be calculated as the sum of the notionals of derivatives used

- Method used to calculate Global Exposure
 - › Commitment Approach, Absolute VaR or Relative VaR
- Reference Portfolio if using Relative VaR
- VaR limits
 - › Highest, lowest & average
- Level of leverage
 - › Expected/Actual

Disclosure Requirements under UCITS IV

Lack of practical guidelines for other reporting requirements

- Transaction costs
 - › Definition
 - › Industry view
- Master- Feeder funds
 - › Information sharing
 - › Disclosure in feeder financial statements

Application dates / methods

Different application dates/methods of application will not harmonise disclosures

1. Luxembourg
 - i. CSSF Circular 11/512
 - ii. Applicable y/e 31 December 2011 onwards
 - iii. Awaiting further guidance from Regulator / industry bodies

2. Ireland
 - i. Applicable accounting periods beginning 1 July 2011 onwards
 - ii. Awaiting further guidance from Regulator

Application dates / methods

Different application dates/methods of application will not harmonise disclosures

3. United Kingdom
 - i. FSA COLL Update July 2011
 - ii. ESMA Guidelines - funds to individually determine extent of disclosure required

UCITS IV
***Delivering the
value you need***

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Q&A



In conclusion



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