

# Fund Accounting Update

## 2010

# Agenda

- IFRS 7 key disclosure reminders
- Debt v equity for financial instruments accounting reminders
- Latest on ED 10 - Consolidation
- Proposed changes to lease accounting

# IFRS 7 common issues in practice

## Disclosure of the three-level fair value hierarchy

- which items are covered by the disclosure (and which are not)?
- how do you allocate?
- format of the disclosure
- 'funds'
- quoted, but quoted prices not used
- broker / dealer prices
- alternative assumptions
- transfers in / out - what value?

# Which items have to be disclosed in the three level hierarchy?

- Purpose of disclosure is to provide more information about the relative reliability of the inputs to fair value measurements of:
  - **financial instruments** (assets or liabilities)
  - in the **balance sheet**
  - at **fair value**
- can be
  - designated at fair value through profit or loss
  - classified as held for trading (and thus at FV)
  - [available-for-sale (and at FV) - rare for inv cos]

# Examples of what is / is not in the disclosure

- Include
  - equities, bonds, derivatives, money market funds, structured products, AIFs
- exclude
  - debtors and creditors carried at cost, and cash at bank, borrowings
  - investment property (tangible asset)
- it depends
  - investments in subsidiaries and associates
    - Associates designated at FV or held for trading are included, as will subsidiaries carried at FV

# How do you allocate to the three levels?

level 1	unadjusted quoted prices active market identical assets or liabilities
level 2	observable inputs other than quoted prices direct (i.e. as price) or indirect (derived from price)
level 3	Inputs that are not based on observable data

- allocate on basis of lowest level input that is significant
- significance requires judgement
- factors specific to the financial instrument

# Format of the disclosure

- tabular format
- unless another format is more appropriate
  - If only level 1 securities, a sentence giving the numbers is common
  - If only level 3 securities, a table showing the reconciliation will be needed
- give by class of investment
- merging the three level hierarchy with disclosures about movement in investments not recommended
  - can be a problem i.e. Disclosure difficult to lay out

# 'Funds'

- consider
  - the fund, not its underlying assets that are important
  - daily NAV or price
  - monthly (or quarterly) NAV or price
  - no published price at valuation date - extrapolation between prices (or adjustment)
  - redemption restricted or suspended
  - lock-up periods
  - side pockets for illiquid assets in hedge funds

# Quoted, but quoted prices not used

- Relevant also to stocks that are quoted but not listed (AIM) and to exchange traded derivatives
- May be level 2 or level 3 depending on whether or not the inputs to the valuation are observable, directly or indirectly
- consider
  - thin market / infrequent trading
  - wide variability of prices (stock is not active?)
  - bonds during a credit crisis
  - listing for marketing purposes only

# Broker / dealer prices

- level 1 is unlikely - not an active market
- Can be a problem as person providing value often gives point figure, and nothing else
- Need to know
  - **how** was the fair value measured?
  - if a **model** was used - check its **validity** - does it give a fair value?
  - to what extent does the fair value use **observable inputs**?
- Same issue applies to bank quotes for OTC derivative

# Broker / dealer prices - level 2 or level 3

- Key issues
  - level 2
    - corroborate with observable market data
    - broker / dealer willing and able to trade at the price quoted
  - level 3
    - indicative prices
    - not willing and able to trade at the price quoted
    - alternative assumptions

# Alternative assumptions - for FV measurements in level 3

- if **changing**
  - one or more of the **inputs** to reasonably possible alternative assumptions
  - not the basis of FV
- would **change fair value significantly**
- **state that fact**
- **disclose**
  - the **effect** of those **changes**
  - how the **effect** of a change to was **calculated**

# Transfers in / out - what fair value?

- requirements
  - level 1 to/from level 2
  - level 1 to/from level 3 and level 2 to/from level 3
- **value attributed** to the financial instrument **immediately before transfer**

# Distinction between Debt v Equity – accounting reminders

# Debt v Equity

- Debt v Equity – why important
- Basis of classification process
- Exceptions to IAS 32 liability classification process
- Puttable instruments
- Conditions to be met to achieve equity classification
- Obligations arising on liquidation exception
- Summary of amendments requirements
- Instruments settled in an entities own equity instruments
- Fixed for fixed test – what is it and why important

# Debt v Equity – why important

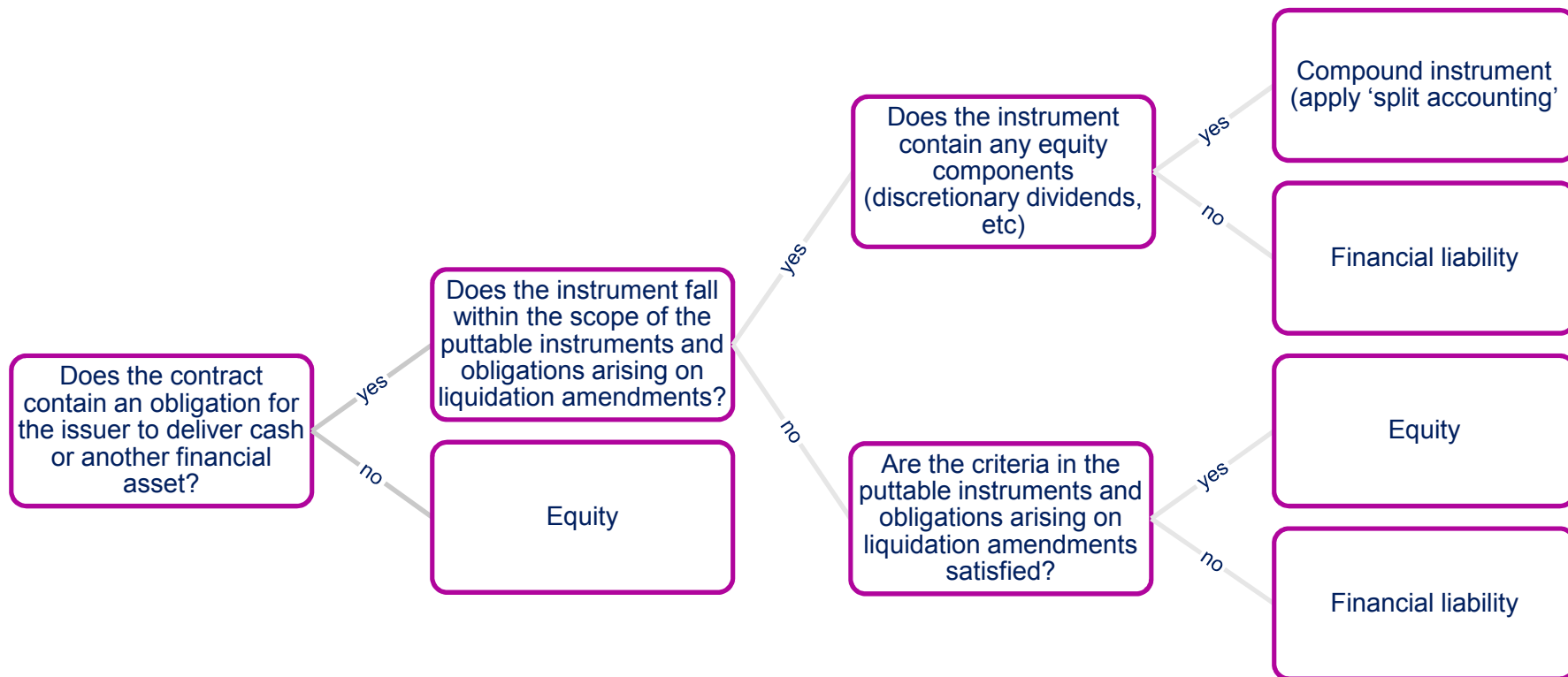
From an issuers point of view because

- If an instrument is debt:
  - It will be presented as a liability in the financial statements
  - It will be subject to IAS 39's recognition and measurement rules
  - The accounting will impact on the profit for the period

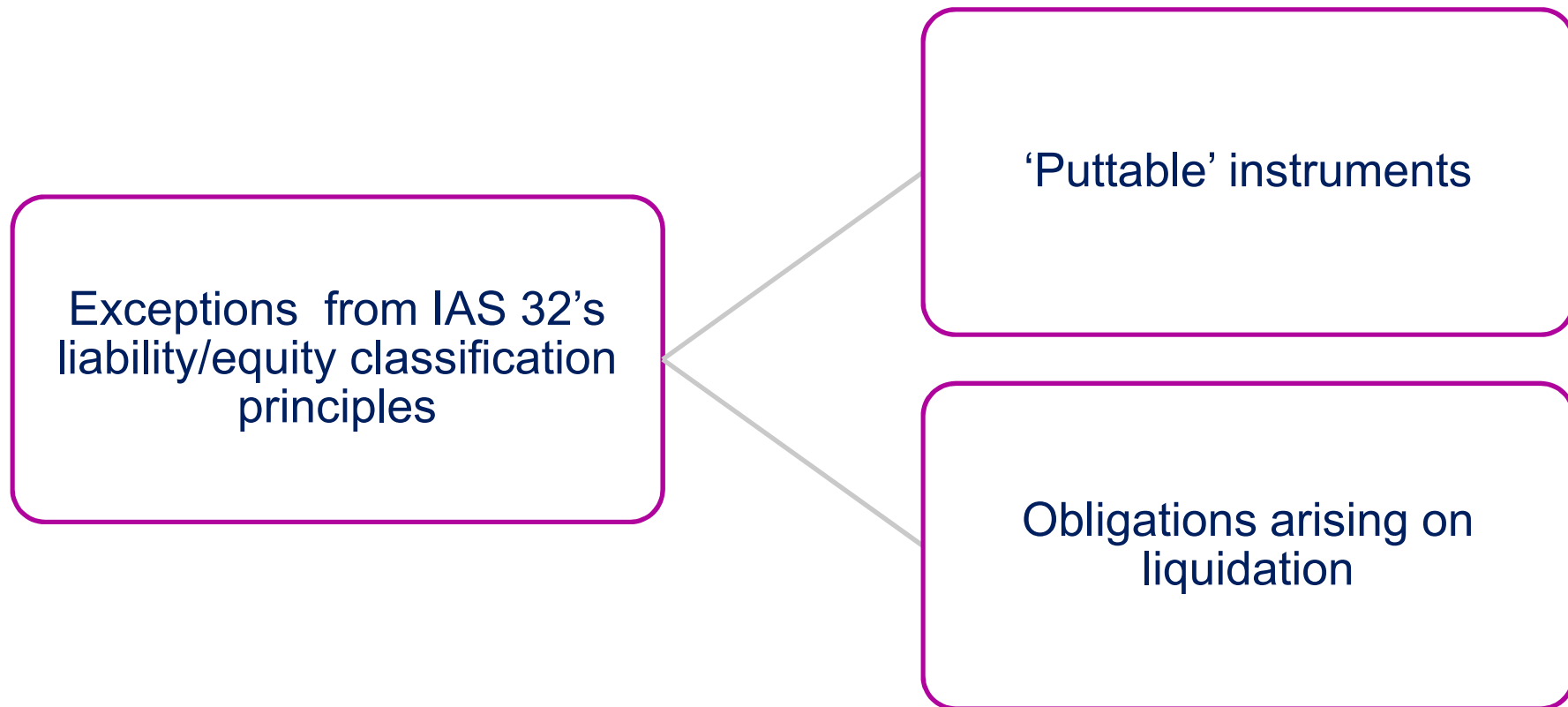
# Debt v Equity – why important

- If an instrument is equity
  - The proceeds received are credited directly to equity and are not re-measured
  - It is not subject to IAS 39 accounting by the issuer
  - There is no impact on profit or loss for the period

# Basics of classification process



# Exceptions to IAS 32's Liability classification principles



# What is a puttable instrument?

“ A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset or is automatically put back to the issuer on the occurrence of an uncertain future event or death or retirement of the instrument holder”

# Examples of what is and what is not a Puttable instrument

<b>Puttable instruments</b>	<b>Not puttable instruments</b>
<p>Instruments giving holder option to redeem</p> <p>Instruments automatically put back to the issuer on occurrence of an uncertain future event (eg change of control) death of the holder retirement of the holder</p>	<p>Instruments with a mandatory fixed redemption date</p> <p>Instruments giving the issuer an option to redeem Instruments redeemable on an event that is certain to happen</p>

# Conditions to be met to achieve equity classification

1. The instrument must entitle the holder to a pro rata share of the assets on liquidation e.g. Fund with 2 sub-funds with 2 classes of puttable shares.
2. The instrument is part of a class of instruments that is subordinated to all other classes of instruments – no priority over other claims to other assets on liquidation.
3. All financial instruments in this most subordinate class have identical features i.e. watch out for different voting rights when 2 or more share classes

## Conditions to be met to achieve equity classification

4. Apart from the obligation on the part of the issuer to redeem/repurchase there must be no other contractual obligation to deliver cash or other assets associated with the instrument. E.g. Minimum dividend entitlements
5. Expected cash flows attributable to the instrument over its life are based substantially on profit/loss or change in the net assets of the entity over the life of the instrument.
6. No other financial instrument that is based on profit or loss or change in net assets of the entity and has the effect of fixing the residual return to the puttable instrument holders.

# Obligations arising on liquidation exception

- Similar conditions that need to be achieved to meet equity classification of a puttable instrument
- Conditions 1,2,3 and 6 relating to puttable instruments essentially the same conditions to meet equity classification of an obligation arising on liquidation.
- But some important differences.

# Obligations arising on liquidation exception

Differences are:

1. There is no requirement that there is “no other contractual obligation” (in addition to the obligation arising on liquidation);
2. There is no requirement to consider the expected total cash flows throughout the life of the instrument;
3. The only feature that must be identical among the instruments in the class is the obligation for the issuing entity to deliver to the holder a pro rata share of its net assets on liquidation.

## Changes in classification as a result of the amendments

- Extensive conditions attached to equity classification – could meet it in some periods and fail in others.
- An entity might correctly classify a puttable instrument or an instrument with an obligation arising on liquidation as equity might, for example, subsequently issue another, more subordinated class of instruments. This would require the instrument to be reclassified as a liability.

# Summary of amendments' requirements

- An instrument is classified or reclassified into equity from the date it meets all of the applicable conditions
- The instrument is reclassified into liabilities if it ceases to meet all those conditions;
- If an instrument is reclassified from liability to equity the amount transferred to equity is the carrying value of the financial liability at the date of reclassification.
- If an instrument is reclassified from equity to liability, the initial carrying value of the liability is its fair value at the date of reclassification. Any difference between this fair value and the carrying value of the equity instrument is recorded in equity.

# Instruments settled in an entities own equity instruments

- Contract for settlement in own equity
  - Issue of warrants or options to investors
- Investors' perspective = financial assets
- Accounting by issuer crucially depends on what is termed the “fixed-for-fixed test”

# What is Fixed for Fixed Test?

- IAS 32.11(a) states that "a financial liability is any liability that is:
  - a contract that will or may be settled in the entity's own equity instruments and is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments

# What is Fixed for Fixed Test?

- A contractual right or obligation to receive or deliver anything other than a fixed number of the entity's own shares will result in liability classification of the instrument

# Why is Fixed for Fixed Test Important?

- If contract passes fixed for fixed test, account for as equity.
  - No re-measurement
- If it fails, account for as a financial liability
  - Often a derivative – account for at FVTPL

# Why is Fixed for Fixed Test Important?

- Particularly important in the context of debt instruments, such as convertible bonds, that include contractual terms which may involve conversion to the issuer's own equity.
- If the conversion option fails fixed for fixed test, account as embedded derivative liability.
- Conversion right re-measured at each reporting date and FV measurement impacts on results.

# Why is Fixed for Fixed Test Important?

- Fixed for fixed test not relevant in the case of options or warrants issued in exchange for good and services e.g. Share options to employees.
- Compound instruments e.g. Convertible bonds ensure conversion right passes fixed for fixed test before splitting the instrument.

# Consolidated Financial Statements Staff Draft (ED10)

# Consolidated Financial Statements

- Back ground
- New definition of control
- Assessing control
- Rights & power
- Options & convertible instruments
- Principal & Agency relationships
- Silos
- Disclosure

# Background

- Staff draft is part of joint IASB/ FASB consolidation project
- Staff draft is for information only and subject to change
- Introduces a new control model
- IASB plans to issue by end of 2010
  - IFRS on consolidation to replace IAS 27 and SIC-12
  - A separate IFRS requiring enhanced disclosure about consolidated and unconsolidated entities

# New definition of control

- Single control model used
- An investor controls an investee when it is exposed or has rights to variable returns from its involvement with that investee and has the ability to affect those returns through its power over that investee.
- To have power, necessary for the investor
  - To have *existing rights* that give it the *current ability* to direct activities that significantly affect the investee's returns

# Assessing Control

- Assessing control – “gating question”
- Determines whether voting or potential voting interests are the focus of analysis **or** whether other interests are more important to the analysis

# Assessing control

- Determine
  - Voting rights
  - Contractual arrangements
    - Ability to direct relevant activities
      - Understand purpose and design of investee
      - Understand how decision about how activities are made, who has ability to direct activities and who receives returns from those activities
  - More complex
    - Consider series of factors
      - Special relationships with the investee and evidence of power

# Assessing control – other than voting rights

- Also consider
  - Purpose and design of the investee
    - Decisions made at investee's inception
    - Investor's involvement in the investee's design
    - Investor's commitment to ensure that the investee continues to operate as designed
  - Special relationships
    - Investor has more than a passive interest in the investee
  - Large exposure to variability of returns

# Rights and Power

- Power arises from rights
- Different rights, either individually or in combination, can give an investor power over significant activities on an investee
  - Current and potential voting rights
  - Rights to appoint or remove investees key management
  - Decision making rights arising from a management contract
- Host of power scenarios to consider!

# Substantive rights and Protective rights

- Only substantive rights and rights that are not protective are considered when assessing power.
- Substantive rights need to be exercisable and the holder needs to have practical ability to exercise those rights
- Requires judgement e.g.
  - Barriers for investor to exercise rights
  - Do other parties need to agree for rights to become exercisable?
- Protective rights only apply in exceptional circumstances as don't have power and thus control over investee.

# Options and convertible instruments

- Need to be considered when assessing if the reporting entity has the power to direct the activities of an entity that significantly affect returns.
- Consider all fact and circumstances associated with options and convertible instrument.

# Principal – agency relationships

- Agent is engaged to act on behalf of another party or parties (the principal) that delegates some decision making authority to the agent.
- When assessing if the reporting entity has the power to direct the activities of an entity, the principal considers the decision making authority it has delegated to agents.
- The agent does not have power over another entity only because decision making has been delegated to it.
- But consider all facts and circumstances to the relationship.

# Principal – agency relationships

- Consider
  - Scope of decision making authority over the investee
  - Is remuneration linked to investee's performance
  - Exposure to variability of returns
  - Who holds rights i.e. Who has removal rights?

# Silos

- Guidance provided on when an investor would assess power over specified assets (i.e. Silos) instead of over a legal entity.
- Applies only if
  - In substance, the assets, liabilities and equity of the silo are separate from the overall investee such that none of those assets can be used to pay other obligations of the investee and those assets are the only source of payment for specified liabilities of the silo; and
  - No other party has rights or obligations related to the specified assets or to residual cash flows from those assets.

## Disclosures to understand

- a) The significant judgements and assumptions made by the reporting entity in determining whether it controls (or does not control) another entity and / or the reporting entity's involvement with structured entities;
- b) The interest that the non-controlling interest have in the group's activities;
- c) The effect of restrictions on the reporting entity's ability to access and use assets or settle liabilities of consolidated entities, as a result of where the assets or liabilities are held in the group;

## Disclosures to understand

- d) The nature of, and changes in, the risks associated with the reporting entity's control of the consolidated structured entities or involvement with unconsolidated structured entities.

# Comprehensive Disclosure Standard

- Will include disclosure requirements for
  - Subsidiaries
  - Joint arrangements
  - Associates
- Will address a reporting entity's involvement with other entities.
- Will contain disclosure requirements for unconsolidated structured entities (SPE)

## And finally...

- IASB and FASB as part of the consolidation project, plan to publish, by the end of 2010, an exposure draft that will propose an exception to the consolidation requirements from investment companies (to be defined).

# Changes to Lease Accounting

# Leases

- What is going to change & why
- Accounting
- Implications

# What is going to change?

- Distinction between operating and finance lease to disappear
- Eliminate off-balance sheet accounting for operating leases
- ED proposes a single accounting model for lessees to apply to all leases

## Why change

- The proposals are in response to concerns raised by investors and other users of financial statements about the current lease accounting model.
- IAS 17's distinction between finance leases and operating leases can have the effect that two quite similar leases are accounted for differently.
- Affects comparability and creates incentives to design leases to fall just within the operating category.

# Accounting

- ED introduces a single accounting model to apply to all leases
- Lessee recognises a “right of use asset” and a liability to pay rentals
- Lessors apply a new hybrid accounting model. Either apply
  - Performance obligation approach
  - Derecognition approach
- Assets and liabilities recognised by lessees and recognised at amortised cost, based on PV of payments over the term of the lease

# Accounting

They would be measured on the basis that

- a) Assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease
- b) Uses an expected outcome technique to reflect the lease payments, including contingent rental and expected payments under term option penalties and residual value guarantees, specified by the lease.

# Accounting

- c) Is updated when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since previous reporting period

# Implications

- Balance Sheet Implications
- Asset and performance ratios will be affected by the recognition of all leased assets on the balance sheet.
- Gearing calculations in particular may be affected by the increase in the lessee's reported borrowings. The effect on loan agreements and bank covenants may need to be considered.
- Entities subject to regulation may need to hold more capital.

# Implications

- Profit and Loss Implications
- For leases that are currently treated as operating leases, the proposed model will result in earlier recognition of rental expense as a result of using the effective interest rate to amortise the lease liability.
- It will however be possible to measure short-term leases (less than 12 months) on an undiscounted basis. It would mean that short-term lease rentals would be calculated on a straight-line basis, providing a potential incentive for lease structuring.

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