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Ms Sandra Thompson
Senior Project Manager
International Accounting Standards Board
30 Cannon Street
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Ref: john\letters.2004\s.thompson

Dear Ms Thompson

Exposure Draft April 2004 – The Fair Value Option (Consultation)

The Association of Investment Trust Companies (AITC) is the trade association that represents the interests of investment trust companies (ITCs). ITCs are public companies, listed on the London Stock Exchange, whose primary business is investing in the shares and securities of other companies. The AITC currently represents the interests of around 240 Members and the industry has total assets of approximately £60 billion. We estimate that about a third of ITCs are companies with subsidiaries who will therefore, from January 2005, be required to prepare their financial statements in accordance with IAS.

Being collective investment funds, ITCs invest in a wide range of shares and securities issued by companies, governments etc. In addition, due to their legal structure as companies, ITCs can (and do) issue financial instruments over and above just standard equities. In summary, an ITC's primary business is to invest in and issue financial instruments – and so IASs 32 and 39, and the Consultation, are of extreme importance.

At present, under UK GAAP (including recommendations set out in the AITC's 2003 SORP) the basic position is that an ITC will measure and disclose its investments at market value or, where such a value does not exist (such as for unquoted investments) at directors' valuation which will be an estimate, usually based on an accepted methodology, of fair value. Any change in value from one accounting period to the next will be disclosed in the ITC's Statement of Total Return which is its primary performance statement, including its Profit and Loss Account. The liability side of the balance sheet is usually maintained at cost (or close thereto).

Although, unlike open-ended funds, nobody is dealing directly on the back of an ITC's net asset value, nevertheless the net asset value will be one of the main factors influencing its share price. Clearly it is very important that the net asset value of the ITC is as robust as possible.

All this is by way of background and the AITC was largely content with the December version of IAS 39 which seemed to us to continue to give an ITC sufficient scope to value its investments at market value, take the changes in value though the Income Statement and maintain its liabilities at cost (with the added option to value them at fair value). Clearly we had some issues, such as the treatment of embedded derivatives, but on the whole the December version represented an acceptable outcome.

The changes proposed in the Consultation, however, raise several concerns. Whilst we appreciate some of the background issues and sympathise with the IASB's extremely difficult position, we are beginning to wonder whether the outcome of attempting to accommodate the various differing views will be a standard that satisfies no-one and, more importantly, gives rise to less meaningful financial statements.

In our view, there is a real danger that the ongoing difficulties over IAS 39 (as evidenced most sharply by the fact that the 'final' version of IAS 39 was published in December 2003, only for it to be followed by an announcement a few weeks later that it was to be revised) will undermine the credibility of the standard setting process and thereby the standards themselves. The investment management industry produces a wealth of statistical information for investors outside the annual accounts and there is no absolute requirement for this other information to be based on the principles established by accounting standards. However, it would be deeply disappointing if these were to diverge too widely as a result of IAS 39 failing to provide sufficient flexibility over the use of the fair value option, with the end result that the market begins to perceive the accounts of ITCs as offering the less relevant financial information.

We respond to the specific questions set out in the Consultation as follows:

Questions 1), 2) and 4)

Based on our reading of the proposals we raise the following concerns:

a) In paragraph BC15 you very helpfully note the requirements of ITCs (and others) where you state that they may want to use the fair value option. Having said that, the fair value option now includes a verifiable test and our first concern is that this test will effectively EXCLUDE most, if not all, holdings in unquoted investments (not being subsidiaries or associates which are covered by separate standards, although IAS 28 effectively re-routes the treatment of associates back to IAS 39) from the fair value through profit or loss option.

   As stated above, for ITCs such investments are currently valued at the directors' estimate of fair value and it seems to us that such a basis may fall foul of the strict terms of the verifiable test.

   We are also not clear from the wording of the definition whether investments which fail the verifiable test are prevented from being designated as fair value through profit or loss or whether they can still be so designated but simply not be fair valued. The wording of paragraph 9 ('if elected, such designation….') is confusing in this regard. If the intention is that investments which fail the verifiable test must not be designated as fair value through the profit or loss wouldn't this be made clearer by simply deleting the words 'if elected'?

We also have a concern that investments may need to be re-categorised as their values cease to meet the verifiable test having initially met it - perhaps because a quoted investment is taken private but an equity interest is retained. Paragraph 50, on the other hand, appears to prevent this. Does this mean that an unquoted holding which was quoted when originally acquired (and fair valued through profit and loss) must continue to be fair valued through profit and loss when taken private?

b) If certain assets can only be categorised as available-for-sale then any resulting gain or loss, prior to derecognition, will be recognised directly in equity i.e. such gains and losses will not be recognised through profit or loss. For private equity trusts holding substantial unquoted investments for the long-term, it is quite possible that most of the fair value gains arising in a particular year will not be reflected in the company's Income Statement, leading to a less meaningful presentation of the company's true performance for the year. Again we do not consider this is in the best interests of shareholders and other users of the financial statements of ITCs. Under UK company law, it should be noted that such gains, even if they were taken to the Income Statement, could nonetheless not be distributed, being unrealised.

c) In general we support the proposal to value financial assets or liabilities that contain one or more embedded derivatives at fair value through profit or loss. However, to do so in isolation to other financial liabilities seems to us to potentially be introducing inconsistencies into the balance sheet. We can envisage the situation where an ITC has issued a convertible unsecured loan stock in addition to its other financial liabilities – one will be valued at fair value and the others at cost. We struggle to see the logic of this approach.

Question 3

For the reasons given above, we do not consider that the proposals are appropriate for investment vehicles such as ITCs. Indeed, we are concerned by the phraseology of the question, which appears to indicate that it has already been decided that the concerns raised are sufficiently valid to warrant such major changes to the original proposals. We are not convinced that this is the case. The question also states that, if a respondent disagrees with the proposals, the respondent should suggest how the fair value option could be further limited. This suggests that the IASB has already decided that there is no possibility that the fair value option can be relaxed from the current proposals.

Rather than further limit the scope of the fair value option, as proposed, the AITC considers that IAS 39 should permit the fair value option to be applied to a wider range of financial assets and liabilities than presently envisaged, with it being left to industry practice, regulators and auditors as appropriate to give more specific guidance. This is clearly an area where national accounting bodies and SORPs can have a role to play.

Conclusion

In summary, the AITC is concerned that the ability of an entity to fair value financial instruments is being overly restricted and, as set out above, the restriction may already be such that ITCs will not be able to fair value all of their assets, let alone their liabilities. This would be a serious step backwards in terms of accounting. We therefore recommend that the IASB gives serious consideration to amending IAS 39 to permit entities such as investment trusts to elect for their portfolio investments to be designated as fair value through profit or loss. The verifiable test would not apply in such circumstances which would allow collective investment schemes to continue to value their investments at market value (or a directors' estimate of such).

Should you have any queries on this response or require any further information, please do not hesitate to contact me on 0207 282 5605 (direct) or at john@aitc.co.uk

Yours sincerely

John Stevens
Finance Director