INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

INDUSTRY GUIDELINE

FOR

TAX ASSET RECOGNITION

IN

UNIT PRICING MODELS

24 February 2003

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INDUSTRY GUIDELINES FOR TAX ASSET RECOGNITION IN UNIT PRICING MODELS

Background

This Guideline has been issued by the Board of ISI to introduce industry consistency in respect of tax loss accounting policies and unit pricing models.

The issue of tax loss accounting policies and unit pricing modelling arise from periods of prolonged declines or gains in equity prices. It is during these times that attention to this matter is particularly important.

The Board of ISI consider this to be a matter of such importance that it has determined to issue an industry guideline. It is essential that consistent practice standards and appropriate disclosure exists and that common principles are applied. Adherence to these guidelines will assist the maintenance of professional standards and maintain investor confidence.

In developing this Guideline ISI has prepared the attached appendix describing the nature of the issue and in particular an outline of where unit trust pricing and tax asset recognition may diverge from application of the Statement of Standard Accounting Practice (“SSAP”) 12 as required to be applied to financial statements.

Guideline

The complexity and nature of the issue is such that it is not possible to prescribe specific ratios or methodologies for individual managers and/or funds. As a result ISI members are strongly encouraged to adopt the following principles based approach.

Principles:

- Members should disclose in their Prospectuses and Offer Documents whether they include or do not include tax assets in unit prices.

- Members should have a written policy for the treatment of tax assets in their unit pricing. It should be formulated with approval of the Trustee. This also includes those that do not include tax assets in their unit trust pricing and a rationale for why they do not.

- Where members include tax assets they should have a tax asset model that allows them to calculate a reasonable and prudent level of tax assets.

- Members are encouraged to actively monitor (as frequently as daily if the circumstances make that appropriate) the tax asset ratios on a fund-by-fund basis.

- Members should give consideration to the following issues in respect of their modelling for probability of use of tax assets:
  - The provisions of the Trust Deed.
  - Investor objectives.
  - The fund's investment objectives and expected investment timeframe for investors
  - The historical earnings and expected earnings for the funds over the same time frame.
  - The expected correlation of returns where the funds hold multiple-asset classes.
  - The historical and expected funds flows (giving consideration to environmental and industry structural conditions).
  - Inter-generational equity of investors. Policy should incorporate fiduciary responsibilities and reasonableness in the treatment of existing and future unit-holders.
  - A discounting factor on the value of future tax assets.
  - The likelihood of fund termination or restructure that would cause the assets to be written off.
  - Establishment of target ratios and the ability to cap those ratios should conditions warrant (including unit trust pricing adjustments where outflows affect this cap).
  - The Statement of Standard Accounting Practice (SSAP 12) Test for 'Virtual Certainty'.

Effective Date

Members should apply this industry guideline no later than the next roll-over date of the fund's prospectus.

24 February 2003

APPENDIX TO: INDUSTRY GUIDELINE FOR TAX ASSET RECOGNITION IN UNIT PRICING MODELS

Introduction

Concerns have arisen regarding the application of Statement of Standard Accounting Practice ("SSAP") 12 and the consequences of a possible divergence between a fund's financial statements and the aggregate unit price. This is likely to arise in any period of downturn where losses in funds create a tax asset. The issue has been raised by a number of sources. While the Board has not conducted its own research into the extent of divergence between financial statements and unit prices, it considers it worthwhile to address potential concerns, in order to promote transparency and maintain public confidence.

Justification for Divergence

Where there is a view that markets will recover and the fund will continue to exist in the future, it is reasonable to expect some divergence from time to time between the unit pricing model and the amount of tax asset recognised in the financial statements (using the virtual certainty test described in the SSAP12 Test below). Managers and Trustees may, however, be under some pressure to justify any divergence between the value of the fund in the financial statements and the aggregate unit price. **"Any provisions of the Trust Deed in respect of unit pricing will be the first reference point."** In the absence of specific provisions in the Trust Deed, the following "principles for considering levels of tax asset in unit pricing" have been identified as those which should be taken into account in making the decision on whether a write down of the tax asset in the financial statements should be reflected in the unit pricing.

The SSAP12 Test

Financial statements are required to reflect the value of tax assets in accordance with SSAP12, which applies a "virtual certainty" test for realisation of income tax benefits in the financial statements. "Virtual certainty" is generally interpreted by auditors as requiring writing down the tax asset unless realisation of the income tax benefits will take place beyond reasonable doubt.

Writing down the tax asset in the financial statements creates an issue for Managers and Trustees when addressing unit pricing models. Determining the appropriate level of recognition of tax assets in the unit price is a complex process as there are a number of factors to be considered, some of which are discussed in more detail below.

There are currently no New Zealand accounting standards that explicitly support any limit or cap on the level of tax assets maintained.

Principles for Considering Levels of Tax Asset in Unit Pricing

Recognition of the Arbitrary Nature of Models

While as much care as possible is applied to the models used for determining the value of tax assets in unit pricing, the number and complexity of the variables that apply to this issue for any particular fund means that the process will always be subjective.

This needs to be recognised when addressing this issue.

Unitholder Objectives

It is imperative that due consideration is given to unitholder objectives when addressing this issue. Unitholders, especially those in growth assets, may have a longer term view than that implied by the SSAP12 “virtual certainty” test. They are likely to have accepted the inherent volatility of the assets they are investing in and generally have a view that markets will recover after a downturn. The view is that with the diversification they achieve in a fund, the default risk is minimal and they will only lose money by pulling out in a downturn. This view is obviously at odds with the "virtual certainty" test required by SSAP12.

Unitholders would probably accept the logic of some discounting on the “time value of money” basis given that in a severe downturn it may take more than one accounting period to realise the tax asset. If adopted this would need to be applied both up and down.

Care must be taken when introducing additional volatility by moving the unit price as this will influence perception of performance and this may change the way unitholders behave.

Unitholder interests and the provisions of trust deeds must be the primary driver of the development of policy in this area.

Equitable Treatment of Unitholders

There are inter-generational issues for unitholders to be considered when valuing tax assets for pricing purposes, as one group of unitholders may be disadvantaged relative to other groups. This is a major issue for Managers and Trustees and means any process for valuing tax assets in the unit pricing process must be carefully considered. Given this, the Manager must take full account of the issues outlined in this Guidance Note. Adjustments to the valuation of tax assets need to have appropriate supporting documentation and the agreement of all parties.

Factors to Consider

Having made the decision that it is appropriate to recognise a deferred tax asset (arising out of losses carried forward and/or unrealised losses – most commonly on equities but however, by no means limited only to equities) for unit pricing purposes, the extent of recognition should take into account the following factors:

* The history of the fund. If the fund is a long running fund with a pattern of consistent positive growth, with the occasional tax loss etc being regularly absorbed by future better-performing years, then there will be a greater likelihood of recognising the asset. In the case of a new fund which has not been in existence for a sufficient period to develop a pattern or history, it may be appropriate to refer to the histories of established funds with the same characteristics.
* The market that the fund is investing in to. Is the market going through a technical correction or is it in long term decline? Influence of world markets. Expert advice is usually taken.
* The track record of the fund manager.
* The provisions of the trust deed.

* Relevant accounting standards.
* The investment time horizon of the fund and whether (and to what extent) the tax asset is expected to be realised over the lifetime of the fund.
* The size of the tax asset versus size of the fund and the expected income of the fund over time.
* Stability of the unitholder base of the fund (including the investment time horizon of unitholders) and whether the funds under management are expected to decline, remain stable, or grow in size.

Disclosure

Note: The following comments reflect ISI's understanding of disclosure legislation – these are provided for general guidance. They are not intended to be extensive and members should seek their own advice regarding required disclosure for their particular circumstances.

Under the Securities Act there is a requirement to disclose in the prospectus (not the investment statement) any material matter that might affect a unitholder's decision to invest. There are no specific rules on what constitutes a matter that is "material", and issues such as historical volatility of a fund, movement of unitholders and the degree of difference between the non-recognition of tax assets in financial statements compared with their recognition in unit pricing, must all be weighed up.
The minimum legal requirement is for general rather than specific disclosure. For instance, disclosure might simply state that the unit price reflects the value of losses which the manager reasonably expects over time will be recovered by the fund. Specific disclosure will vary from fund to fund and does not need to specifically mention that those losses are not regarded as a tax asset in the financial statements and that there is consequentially a difference between the financial statements and the unit pricing treatment of the losses.