Findings of follow-up review of transition by investment funds to International Financial Reporting Standards

Objective and scope

The *Autorité des marchés financiers* (the “Authority” or “we”) has conducted an issue-oriented review of the transition to International Financial Reporting Standards (“IFRS”) by investment funds (the “funds”) that are reporting issuers whose investment fund manager’s head office is located in Québec.

The review was conducted to assist investment fund managers in understanding the nature and scope of funds’ disclosure obligations as set out in securities legislation, and to support the transition of the funds to IFRS. The review was carried out in two stages. The first stage was completed in 2014 and 2015, and the second, in summer 2016.

In the second stage, the Authority conducted a follow-up review on a sampling of funds in order to determine if improvements had been made to continuous disclosure documents since the initial review.

In this notice, the Authority would like to share the principal findings and areas for improvement that, if applicable, have already been communicated to the investment fund managers concerned as part of this follow-up review.

Principal findings and areas for improvement

I. Follow-up on annual financial statements as at December 31, 2015 (“2015 annual financial statements”)

a) Accounting policy

We noted in certain cases that the distributions received from underlying funds are now presented under “Dividend revenue,” “Interest revenue” and “Realized gains or losses” in the statement of comprehensive income, depending on their tax treatment.

However, this presentation does not consistently comply with the note on significant accounting policies, according to which, for example, the interest revenue for distribution purposes presented in the statement of comprehensive income corresponds to interest payments.

We therefore noted non-compliance with subparagraph 35(a) of IAS 18[1] *Revenue* (“IAS 18”) as well as inconsistency between the fund’s accounting policy presented in the note and the presentation adopted in the statement of comprehensive income.

Furthermore, we noted during the review that these distributions were presented under a single income item in the statement of comprehensive income of the interim financial report, since the breakdown of this income was not yet known.

However, it should be remembered that funds that include an unreserved statement of compliance with IFRS in their interim financial reports must comply with paragraph 45 of IAS 1 *Presentation of Financial Statements* (“IAS 1”) regarding presentation consistency.[2]

b) Statement of cash flows

We noted that interest and dividends received, after withholding taxes, are presented separately in the statement of cash flows, as required by paragraph 31 of IAS 7 *Statement of Cash Flows* ("IAS 7"). However, in some cases, this revenue corresponds mainly to distributions received from underlying funds that are substantially all re-invested in redeemable units of the underlying funds. The reinvestment of distributions does not usually involve any cash flows. When the indirect method was used, however, "increase or decrease in total equity from operations, or in net assets attributable to securityholders from operations" was not adjusted for this revenue in the "Cash flows from operating activities" section of the statement of cash flows. We therefore questioned the compliance of the funds with paragraph 31 of IAS 7, in reference to subparagraph 18(b) of IAS 7.[3]

c) Risks arising from financial instruments

We noted several deficiencies in the notes on financial instruments. Here are a few examples:

1) Funds holding investments in securities of underlying funds are indirectly exposed to risks arising from the financial instruments held by these underlying funds. Direct exposure to risks arising from financial instruments was often used rather than direct and indirect exposure (through the funds' investment in securities of underlying funds). In that regard, we made the following observations:

    - This information (direct exposure or direct and indirect exposure) is not indicated for all financial risks in the notes specific to the funds' financial statements. Therefore, it is our opinion that this omission causes confusion when the fund holds securities of underlying funds and the general note to the financial statements indicates that the fund is directly and indirectly exposed to certain financial risks.

    - These risks can have a significant indirect impact on funds holding securities of underlying funds. We noticed that the information required by paragraph B6 in the Application guidance to IFRS 7 *Financial Instruments: Disclosures* ("IFRS 7") to make financial statements complete is not mentioned in the financial statements.

2) In some cases, the information required under subparagraph 33(b) of IFRS 7 relating to objectives, policies and processes for managing certain financial risks is still not provided, or when it is, lacks detail.

3) Occasionally, the note on risk concentrations presents a summary of the statement of investment portfolio that does not always satisfy paragraph B8 of the Application guidance to IFRS 7.[4] For instance, the name of the underlying fund as a market segment does not meet the requirements of paragraph B8 of the Application guidance to IFRS 7, particularly when it does not convey the notion that it is a bond fund, stock fund or other fund.

    Market segments should also, if applicable, align with the information provided in the "fundamental investment objectives" of the fund prospectus.

d) Exception to consolidation

We noted that the information about significant judgements and assumptions made by the fund in determining the nature of its interests in other entities and in determining if it meets the definition of "investment entity," as required by subparagraph 2(a) of IFRS 12 *Disclosure of interests in other entities*, is not always presented in the financial statements.

This finding is all the more relevant when the funds invest primarily in underlying funds that are related parties.

II. Follow-up on compliance with regulatory provisions

a) Annual management report of fund performance as at December 31, 2015 ("2015 annual management report")

We noted that, contrary to the requirement in Item 3(9) of Part B of Form 81-106F1, *Contents of annual and interim management report of fund performance* of *Regulation 81-106 respecting Investment Fund Continuous Disclosure*, CQLR, c. V-1.1, r. 42 ("Regulation 81-106"), the notes to the "Ratios and Supplemental Data" table do not always indicate that the management expense ratio calculation excludes withholding taxes.

b) Classification of fund securities

We noted in the majority of cases that, contrary to the requirement set out in paragraph 3.6(1)(1.1) of Regulation 81-106, no explanation is provided in the notes to the financial statements regarding the classification of the investment fund's outstanding securities as either equity instruments or financial liabilities.

For example, the criteria of IAS 32 *Financial Instruments: Presentation* that are not met for classification as equity instruments could be stated in plain language.

Conclusion

The Authority expects investment fund managers to use the findings and areas for improvement in this notice to improve the quality of their funds' financial information provided to investors and the public. The Authority will follow-up on this point in subsequent reviews.

In spite of the above findings and areas for improvement, the Authority noted that the overall quality of the information presented in the 2015 annual financial statements and 2015 annual management reports had improved compared to the information presented in previous documents filed since the transition to IFRS.

Additional Information

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[1] Subparagraph 35(a) of IAS 18 states that an entity shall disclose information about the accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services.

[2] Paragraph 45 of IAS 1: "An entity shall retain the presentation and classification of items in the financial statements from one period to the next unless:

> (a) it is apparent, following a significant change in the nature of the entity's operations or a review of its financial statements, that another presentation or classification would be more appropriate having regard to the criteria for the selection and application of accounting policies in IAS 8; or
> (b) an IFRS requires a change in presentation."

[3] Paragraph 18 of IAS 7: "An entity shall report cash flows from operating activities using either:

> (a) […]
> (b) the indirect method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows."

[4] Paragraph B8 of Application guidance to IFRS 7 states that "concentrations of risk arise from financial instruments that have similar characteristics and are affected similarly by changes in economic or other conditions."