GUIDANCE NOTE

FINANCIAL SERVICES (JERSEY) LAW 1998

INTERPRETATION AND APPLICATION OF PRINCIPLE 5 AND THE SECOND SCHEDULE OF THE FINANCIAL SERVICES (JERSEY) LAW 1998 TRUST COMPANY BUSINESS CODES OF PRACTICE

1.0 Introduction

The purpose of this Guidance Note is to provide clarification as to the expectations of the Jersey Financial Services Commission (the "**Commission**") with regard to the interpretation and application of Principle 5 and the Second Schedule of the Financial Services (Jersey) Law 1998 Trust Company Business Codes of Practice. ("**TCBCOP**") and to provide a basis that will encourage the adoption of a consistent approach across the industry.

2.0 Exemption From The Permissible Professional Indemnity Insurance Excess Amount

Principle 5.4.6 of the TCBCOP sets out the circumstances in which the Commission may approve an application from a registered person for an exemption from the excess requirements as set out in 5.4.5 of the TCBCOP.

The Commission's current policy, where granting consent, is to require that the amount of any excess above that required under 5.4.5 of the TCBCOP, be treated as an additional liability in the Adjusted Net Liquid Assets calculation ("**ANLA**"). This liability should equate to at least three times that element of the excess greater than the level permitted in 5.4.5 of the TCBCOP.

The rationale for requiring a multiple of at least three to be factored into the ANLA calculation stems from the principle that claims may arise from an endemic behavioural pattern imbedded in the systems and controls of the registered person. The outcome of such an inherent weakness is the risk that a single claim will not emerge in isolation, but will rather form part of a series of similar claims.

3.0 Illiquid Assets

The Second Schedule of the TCBCOP defines illiquid assets as "for example, land and buildings, intangibles (goodwill, intellectual property, etc) amounts receivable from shareholders and / or directors and / or related parties (unless in the ordinary course of business and outstanding balances are settled every 60 days), debtors which are more than 90 days overdue; and margins taken against bank guarantees."

3.1 Treatment of Work in Progress ("WIP") or amounts recoverable in connection with service contracts

Where a registered person chooses to include WIP (or amounts recoverable in connection with service contracts) as a liquid asset within their ANLA calculation, the Commission would expect that a consistent approach be adopted both from one period to the next and across a group where relevant. The WIP amount may fluctuate from quarter to quarter due to the registered person's position in their billing cycle. However the registered person should be able to clearly demonstrate, on request, that the WIP amounts included within each ANLA calculation can be billed and collected within 90 days so as to be consistent with the treatment of debtors set out in the definition of illiquid assets, within the Second Schedule of the TCBCOP.

3.2 Treatment of Prepayments

Only that element of prepayments which relates to goods or services to be received or performed within 90 days should be included as a liquid asset in the ANLA calculation. Therefore within the ANLA calculation any prepayment relating to a period after 90 days should be adjusted out of the ANLA calculation as an illiquid asset.

This treatment allows the portion of the prepayment treated as liquid to match against the relevant amount of expense within the Expenditure Requirement.

4.0 Deferred Income

Deferred income, specifically in terms of fees billed in advance, is not referred to in the TCBCOP and historically there has been no guidance on this matter. It is important that the approach adopted is consistent, given the materiality of the fees billed in advance.

Deferred income is an area that generates a large number of queries from the industry. The general consensus is such that where income is billed in advance and it is clearly stated in the registered person's terms and conditions/client agreement that the income is non refundable, then the relevant amount of the deferred income creditor can be added back, thereby increasing the overall adjusted liquid assets in the ANLA.

However if the terms and conditions/client agreement are silent on this matter or permit a repayment of fees collected in advance then the deferred income creditor should not be added back into the ANLA.

In addition, it is important that the registered person gives consideration to their ability to meet the ANLA requirements going forward. The annual billing of fixed fees in advance and the impact of adding back the deferred income creditor will result in an ANLA at the point of billing that will be the registered person's most favourable position of the year.

For a registered person to look at this ANLA position in isolation will reflect an unduly favourably position towards the start of the year which is not representative of the registered person's ANLA going forward. The ANLA in subsequent quarters will reflect a declining liquidity with the danger that the ANLA requirement will not be met in the later quarters.

It may be beneficial for the registered person to consider the impact that deferred income has on their ANLA position by looking at their calculation with and then without the deduction of the deferred income amount.

5.0 Relevant Annual Expenditure

The Second Schedule of the TCBCOP defines relevant annual expenditure as the total annual expenditure based on the higher of the latest annual audited results and the budget for the current year, less those items of expenditure that could be quickly reduced or eliminated if necessary. Examples of such deductible items provided within the TCBCOP are employee and directors' bonuses or profit shares, "together with any exceptional item of expenditure with the Commission's consent."

The following list sets out some items that the Commission would **not** consider as deductible in this context:

- Employee and directors' bonuses are not deductible where they are payable under an employment contract;
- Directors' salaries;
- Depreciation;
- Recruitment costs;
- Management charges (See 5.3 below) and
- Taxation.

One particular area that is commonly raised is depreciation. The Commission's rationale for not allowing depreciation as a deductible expense is on the basis that a registered person will normally maintain a level of tangible fixed assets appropriate to the ongoing operation of their business. Purchasing tangible fixed assets will have a cash impact on the business. Depreciation is the spreading of the cost of the asset over its useful economic life. It is therefore an effective mechanism for ensuring on an ongoing basis that the cash flow impact of tangible fixed asset purchases is appropriately included on a consistent basis in the ANLA calculation.

A bad debt expense may be deducted on the basis that the corresponding debtor will have already been eliminated from the ANLA calculation as a debtor aged more than three months.

5.1 Exceptional Items

The definitions used in the Second Schedule provide that total annual expenditure may be adjusted for any exceptional items providing the Commission has given its consent. In determining whether an exceptional item may be eliminated in this way, the Commission would consider the definition set out in paragraph 5 of UK Financial Reporting Standard 3, Reporting Financial Performance which defines exceptional items as,

"Material items which derive from events or transactions that fall within the ordinary activities of the entity and which individually or, if of a similar type, in aggregate, need to be disclosed by virtue of their size or incidence if the financial statements are to give a true and fair view."

This definition should be compared to guidance given under International Financial Reporting Standards. The definition set out in IAS 1, Presentation of Financial Statements is broader than the UK equivalent and requires separate disclosure, "*When items of income and expense are material."* The examples given in IAS 1 are not dissimilar to those that might be considered exceptional under current UK GAAP.

Accordingly, examples that the Commission would consider include:

- Asset write downs;
- Restructuring costs;
- Profit or Loss on disposal of assets and investments;
- Discontinuing operations and
- Reversal of provisions.

Amounts payable in respect of litigation have been excluded from the above list as the Commission would not be in favour of granting consent to exclude litigation costs from the relevant annual expenditure amount until the litigation has been concluded and related legal fees and settlement amounts due, have been physically paid.

However, to ensure a fair and appropriate treatment where litigation is ongoing, it is recommended that the relevant annual expenditure amount should be reviewed on a quarterly basis and that all amounts that are due to be paid, (both billed and provided for) be included as an expense and those amounts that have been actually paid and are therefore not expected to recur, be excluded from the calculation.

The Commission favours seeing the impact that litigation may have on a registered person. In the event that amounts payable in respect of litigation result in a breach of the registered person's ANLA calculation, the Commission will then consider any corrective action plan that the registered person has put in place to address the deficit.

5.3 Management Charges

The TCBCOP make no reference to the use of management charges between related parties and how they should be treated within the ANLA calculation.

Frequently, the Commission comes across instances where a management charge is made between the registered person and a related party. In these instances the management charge often comprises an element of expenditure that has been borne by the related party. This approach is particularly common place for those registered persons that have service related companies which recharge an element of shared costs back to the registered person for which they have incurred the full amount. Examples of these shared costs would be professional indemnity insurance, staff and accommodation costs.

The Commission's expectation is that within the ANLA, the expenditure requirement of the registered person should include that element of costs, which is reflected within the management charge or borne by a related party in respect of the registered person. This is because the registered person would have to incur these costs in their own right if they were not part of a larger group.

Where expenses are borne by a related party and there is no management charge, the Commission's policy is that an appropriate apportionment of the costs is included within the registered person's ANLA.

In addition, the management charge expense often includes an element of profit that is being stripped out to the parent company or other related party. From the perspective of the ANLA calculation any profit element within a management charge, which is not on a contractual basis, must not be incorporated into the expenditure requirement when performing the ANLA calculation. The inclusion of a profit element generated within a group could distort the expenditure requirement, having an adverse effect on the overall ANLA.

6.0 Allowable undrawn credit facilities

The Second Schedule of the TCBCOP sets out that the Commission may allow the inclusion of an undrawn credit facility as an asset within the ANLA calculation.

The Commission considers such requests on a case by case basis.

The Commission foresee that a registered person may wish to request consent in certain exceptional circumstances if they anticipate a short term liquidity problem. Such an example may be where the registered person is faced with an unforeseen cash outflow, which would result in a breach of the ANLA requirements.

Undrawn credit facilities will not be permitted as a general mechanism for bolstering a registered person's ANLA. To benefit from such a consent the registered person must be able to demonstrate that either:

a) They have, as part of the budgeting process, anticipated a future liquidity shortfall and are using the undrawn credit facility to tide them over in the short term. Furthermore they have a plan in place to come back into compliance with the ANLA requirement without the use of the undrawn credit facility.

Or

b) They have, in the immediate term, encountered an unforeseen cash outflow that has resulted in a deficit in their ANLA and are currently putting plans in place to address such deficit. As a short term measure however, the undrawn credit facility is required.

In considering whether to give consent to such arrangements, the Commission will consider:

- The extent of any deficit (actual or foreseen);
- Track record of compliance with ANLA;
- The purpose of the facility;
- Terms of facility;
- Any guarantees in place in relation to the facility and
- Stature of the lender.

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