Invitation to Comment

Statement of Recommended Practice

Financial Statements of UK Authorised Funds

July 2013

Exposure Draft: SORP for UK Authorised Funds

Invitation to comment

This Exposure Draft (ED) sets out for comment a revised Statement of Recommended Practice (SORP) for the financial statements of UK authorised finds. The IMA is proposing to revise the SORP in order to take account of a number of changes to the regulatory and accounting frameworks within which authorised funds operate. The main changes that have been taken into account in the ED include:

- The publication of a new set of UK Financial Reporting Standards (FRS);
- The transposition into UK law of the Alternative Investment Fund Managers Directive (AIFMD); and
- The amendment of the Financial Services and Markets Act to allow a new type of fund, the authorised contractual scheme.

At the same time the IMA has taken the opportunity to make other improvements to the SORP and to introduce a template for presenting information about performance and charges during the reporting period.

The IMA invites comments on these proposals and the questions that follow. In answering the questions please provide explanations and, where it is appropriate please suggest alternative solutions. Please send your comments[1] by email to financialreporting@investmentuk.org to arrive no later than 31 October 2013.

Summary of the changes

The main changes to the SORP can be summarised as follows:

- New disclosures about the methods used to determine fair value
- Revised disclosures about the risks to which funds are exposed
- Simplification of the recognition of debt security interest
- Additional requirements for non-UCITS funds due to AIFMD
- A new format for presenting performance and charges in the comparative table

[1] In accordance with the FRC's code of practice on the development of SORPs, comments will be regarded as on the public record, unless confidentiality is requested. Copies of comments that are on the public record will be made available on request.

UK Financial Reporting Standards

In 2012 and 2013 the Financial Reporting Council (FRC) revised financial reporting standards for the United Kingdom and Republic of Ireland. The revision fundamentally reformed financial reporting, replacing almost all extant Financial Reporting Standards (FRS). For authorised funds the following standards are relevant:

- FRS 100 "*Application of Financial Reporting Requirements*" sets out the basis for the preparation of financial statements and the application of Statements of Recommended Practice (SORPs); and
- FRS 102 "*The Financial Reporting Standard applicable in the UK and Republic of Ireland"* sets out the detailed financial reporting requirements.

FRS 100 permits authorised funds a choice of applying EU-adopted IFRS or FRS 102 and links SORPs specifically to the application of FRS 102. Financial Conduct Authority (FCA) regulations (the Collective Investment Schemes sourcebook (COLL)) require authorised funds to apply the SORP. Compliance with the SORP might not be compatible with compliance with IFRS and for this reason it is expected that authorised funds will always apply FRS 102. The proposed SORP is drafted on this basis.

FRS 102 is based on the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs), which is itself a simplification of full IFRS. The FRC has modified the IFRS for SMEs' requirements substantially in terms of both its scope and to include accounting options in current UK GAAP and permitted by IFRS. To the extent UK GAAP has converged with IFRS in the past, previous SORPs have adopted relevant IFRS recognition and measurement principles and, as a result, the main changes now required are in relation to the disclosures required by FRS 102 in respect of financial instruments.

The FRC intends to consult later this year on amending FRS 102 in relation to hedge accounting and impairment. It is unlikely that these proposals will impact the SORP.

Accounting for financial instruments

Financial instruments are dealt with by FRS 102 in Sections 11 and 12 and the disclosure requirements for financial institutions are extended by Section 34. The proposed SORP requires debt instruments to be designated as at fair value through profit or loss because authorised funds are managed, and their performance is evaluated, on a fair value basis in accordance with a documented investment strategy. As a result, all financial instruments are carried at fair value in accordance with Sections 11 and 12 and it is not necessary to identify whether they are "basic" or "other".

Transaction costs

Sections 11 and 12 require transaction costs to be excluded from the initial measurement of financial instruments measured at fair value but is silent on how these costs should be presented. Industry practice is to record transactions in financial instruments at their transaction price including transaction costs. All financial instruments on which transaction costs are incurred are carried at fair value and therefore transaction costs are taken through the income statement in the period in which they are incurred.

The FCA's COLL requires transaction costs to be charged to capital and therefore they are presented in the net capital gains/losses line item in the statement of total return. The current SORP requires the amount of transaction costs to be disclosed and analysed separately. Regardless of whether the initial measurement of financial instruments includes or excludes transaction costs, they will be presented in the same line item in the financial statements in the period in which they are incurred and will be disclosed separately in the notes. Therefore, it is not necessary to amend the SORP's disclosure requirements, or for firms to amend their accounting systems, in order to comply with FRS 102.

Fair value disclosures

Section 34 requires an analysis by class of financial instrument of the methods used to estimate the fair value of each category of instrument, but it does not use the 3-level fair value hierarchy analysis required by full IFRS:

IFRS level	*IFRS category*	*FRS 102 category*
1	Quoted prices for identical instruments in active markets	Quoted prices for identical instruments in active markets
		Recent transactions for identical instruments
2	Valuation techniques using observable inputs	Other valuation techniques
3	Valuation techniques using unobservable inputs	

Anecdotal evidence suggests that a number of firms already have systems that support the full IFRS reporting levels. This would mean an additional step is required to achieve compliance with FRS 102 whereby valuations based on recent transactions would have to be stripped out of the IFRS levels 2 and 3. It also means that considerably more instruments would be reported in the lowest level under FRS 102 than under IFRS.

Section 11 requires disclosures to be made about the assumptions applied in determining fair value when a valuation technique is used. The proposed SORP extends the FRS 102 requirements by:

- Sub-analysing the inputs to valuation techniques in accordance with IFRS[2] levels 2 and 3;
- Placing the emphasis on the disclosures in respect of instruments where significant judgement has been exercised (level 3) in quantifying the inputs to the valuation technique; and
- Anticipating lighter touch disclosures where the inputs are observable (level 2).

[2] IFRS 13 paragraphs 81 to 90

Q1. How many funds do you expect to have significant numbers of instruments that are valued using unobservable inputs?

Q2. Do you have systems or processes in place to support the IFRS reporting levels?

Q3. Do you agree that the SORP's emphasis justifies the additional disclosure category for unobservable inputs? If not, please explain why.

Risk disclosures

Section 34 requires narrative and numerical disclosures about the risks arising from financial instruments. European and UK regulations for funds require a risk management framework to be established and documented and include detailed rules specifying the policies and procedures to be followed for monitoring and measuring exposures to risk. The European Securities and Markets Authority (ESMA) has issued supplementary guidance on the calculation methods and disclosures required in fund documents and annual reports.

The proposed SORP aims to employ the documentation and methods in the regulations and guidance to fulfil the requirements of FRS 102. We believe this most closely represents the way authorised funds are managed and the risk profile to which investors are exposed. It also maximises the use of existing systems and processes for preparing the disclosures. The terminology used in the proposed SORP is designed to be sufficiently generic so as to represent the similar, but not identical, requirements for UCITS and non-UCITS funds.

As with the current SORP, the emphasis is on the narrative disclosures explaining the nature of risks and how they are managed. It is expected that this narrative will be derived from funds' regulatory documentation.

Sensitivity analysis in respect of market risk focusses on the regulatory measures that reflect the interdependencies between risk variables and that are used to define funds' risk limits. Where value-at-risk is used, the disclosures required by FRS 102 are extended in order to comply with ESMA's 2010 guidelines[3].

Authorised funds carry all financial instruments at fair value, so the credit worthiness of an issuer is a part of market risk. In order to disclose credit quality the credit analysis accompanying the portfolio statement in the current SORP has been retained. To the extent that credit risk is not a part of market risk it is reported as counterparty risk. Authorised funds are required to mitigate substantially all exposure to counterparty risk by diversification in the use of pre-approved counterparties and the use of high quality collateral. Disclosures detailing the exposures to counterparty risk and the collateral held are given in accordance with ESMA's 2012 guidelines[4].

FRS 102 requires a maturity profile of an entity's financial liabilities as a measure of liquidity risk. Substantially all a fund's liabilities are its units, which are puttable on

[3] Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS (CESR/10-788).
[4] Guidelines on ETFs and other UCITS issues (ESMA/2012/832).

demand. For most authorised funds substantially all the investments are highly liquid, but where this is not the case, for example property funds, it will normally be sufficient to deal with liquidity risk by narrative disclosure about the liquidity transformation and the policies and procedures employed for managing liquidity.

Q4. Do you agree with the generic approach for all authorised funds or should it be more focussed on UCITS with non-UCITS funds being dealt with by exception in Appendix III?

Q5. Do you agree with the integrated approach of using a single set of disclosures to satisfy the regulatory and accounting requirements?

Accounts formats

Sections 3 to 8 of FRS 102 set out the requirements for the presentation of the financial statements.

Sections 4 and 5 use the formats prescribed by regulations[5] made under the Companies Act for the balance sheet and profit and loss account. These formats specify the level of granularity required on the primary financial statements. The proposed SORP has an extended format for the balance sheet to reflect the mandatory headings and line items. For the statement of total return it has been necessary to make only minor amendments to some of the line item descriptions and it is no longer necessary to present the distribution as a finance cost. A new requirement for a reconciliation of the number of units in issue has been introduced.

Cash flow statements

Section 7 retains the FRS 1 exemption from presenting a cash flow statement and the proposed SORP is unaltered in this respect. However, funds that do not qualify for the exemption, such as directly invested property funds, will find the requirements for the layout and content of the cash flow statement in Section 7 are different to those in FRS 1.

Income tax

The requirements for accounting for income tax set out in Section 29 do not give rise to significant changes, but do cause the proposed SORP to change the presentation of tax withheld on interest distributions in the balance sheet. The proposed SORP clarifies that the notes should include an analysis of the fund's total tax charge for the period.

Consolidation

Section 9 of FRS 102 does not require authorised funds to present consolidated financial statements because they do not report under the Companies Act and the statutory framework does not require consolidated financial statements. This will allow feeder funds to treat their holding in their master fund in the same way as would be the case under full IFRS; the master will not be consolidated and will be carried at fair value in the same way as any other investment. However, the

[5] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

proposed SORP requires authorised funds that hold immovable property through intermediate holding vehicles to prepare consolidated financial statements. This treatment is consistent with the existing requirements of the SORP.

Investment property disclosures

Section 16 of FRS 102 introduces additional disclosures for property funds including a reconciliation of the carrying value of investment property and the proposed SORP reflects these requirements.

Lease incentives

Section 20 of FRS 102 introduces a new accounting treatment for lease incentives that will be relevant to property funds whereby a rent-free period will be recognised as a reduction to the rent over the full term of the lease rather than until the next rent review. The proposed SORP reflects this change and the optional transitional provision for leases commencing before the date of transition to FRS 102.

Alternative Investment Fund Managers Directive

The Alternative Investment Fund Managers Directive (AIFMD) and European Regulations made thereunder came into force in July and will apply to the authorised managers of all non-UCITS funds. Managers of non-UCITS funds must apply for authorisation by 22 July 2014 and, once authorised, must comply with the relevant requirements. The regulations specify a layout for the primary financial statements, although they do not override national accounting standards. Compared to current SORP-based reporting, the most significant effect will be to require gains and losses that are realised to be disclosed separately to those that are unrealised.

Appendix III of the proposed SORP provides guidance on applying the regulatory requirements to non-UCITS funds in a manner that is consistent with the requirements of FRS 102. This requires a single net capital gains/losses line item on the face of the statement of total return and additional analysis in the notes splitting the realised and unrealised components. The SORP working party considered whether it would be helpful to define the meaning of realised and unrealised, and what the definition should be, but reached no firm conclusions.

The SORP working party considered two definitions:

A Realised gains/losses are proceeds less opening value, or cost if acquired during the period; and

Unrealised gains/losses are closing value less opening value, or cost if acquired during the period.

B Realised gains/losses are proceeds less opening value, or cost if acquired during the period, plus changes in fair value where the change is readily convertible to cash. For this purpose, changes in fair value are readily convertible to cash unless they are based on valuations determined using unobservable inputs; and

Unrealised gains/losses are closing value determined using unobservable inputs less opening value, or cost if acquired during the period.

Option B is based on guidance[6] for determining realised profits and losses in the context of distributions under the Companies Act. The SORP working party considered that option B has merit because it shows the amount of the investment return that is subject to significant judgement by the manager.

Q6. Do you think the SORP should define realised and unrealised gains/losses for non-UCITS funds?

Q7. If so, should it use definition A, B or something else?

Authorised contractual schemes

In June the Government introduced a new type of fund, the authorised contractual scheme (ACS) as part of its initiative to support the UK asset management industry. These schemes are designed to be attractive to managers looking to pool assets from funds across Europe, and potentially more widely, using arrangements permitted by the UCITS IV Directive. In such a structure, a UK ACS would form a master fund into which other UCITS funds could combine their assets. ACSs may also be suited to certain tax-exempt institutional investors, such as pensions companies, which may be able to take advantage of their transparent nature to secure more appropriate rates of foreign withholding tax than might be the case when investing in an opaque fund.

The proposed SORP has no specific amendments relating to the financial statements of ACS but introduces new requirements for an authorised fund that holds a fiscally transparent fund such as a UK ACS or an offshore equivalent. The requirements ensure that the authorised fund recognises revenue and expenses as they arise in the ACS and distributes income to its investors as if it was directly invested in the master's assets.

Performance and charges

The FCA's COLL requires the annual report to contain a comparative table showing, for the last five years, the performance record in the form of the highest and lowest prices and the distribution history, and, for the last 3 years, the net asset value, net asset value per unit and the number of units. The performance record is often supplemented with figures representing the returns generated expressed on a variety of bases. The result, especially where a number of unit classes exist, is a series of large tables in which investors will be interested in only a small number of the figures presented. Moreover, the presentation of multiple different return figures is likely to be confusing.

The proposed SORP specifies a format for the presentation of this data such that there will be a single table for each unit class which enables investors to focus on the numbers relevant to their holding. Furthermore the table is laid out to show the progress of a unit held throughout the year including the investment return expressed on a consistent basis, the operating charges expressed on a basis consistent with the ongoing charges figure and an indication of the transaction costs incurred. Operating charges are further analysed between amounts paid to the

[6] ICAEW Guidance on the determination of realised profits and losses in the context of distributions under the Companies Act 2006 (TECH 02/10).

authorised fund manager and other parties involved in operating the fund. Transaction costs are broken down into tax and dealing costs, with the dealing costs further sub-divided into their execution and research components.

An estimate of the average spread across the markets in which the fund is invested is required. Although this is not a cost charged to the fund, it is important as an indicator of the performance hurdle that needs to be overcome in order to generate positive returns.

In order for the proposed format to work it will be necessary for the FCA to consult and make minor amendments to COLL. The SORP working party has discussed with the FCA the options in this respect and we understand that, subject to the feedback on these proposals, the FCA will consult on this matter in due course.

Most of the figures in the table are readily available or are believed to be reasonably accessible. However, we would be interested to hear about aspects of the proposals that might be particularly troublesome to produce.

These developments are designed to contribute towards the IMA's core values and principles for engendering the public's trust and confidence in the industry. Taken together, the figures presented will provide investors with a statement of performance and costs that will start to help them be better informed in understanding the value they have received from their investments in funds.

Q8. Do you think the proposals will help investors better understand the performance and costs? If not, please suggest how it might be improved.

Q9. Are there any aspects of the proposals that you think will be particularly troublesome to produce?

Other matters

Income recognition

The current SORP contains extensive material linking the recognition of debt security interest as revenue to the effective interest method as documented in FRS 26. The effective interest method is a method of calculating the amortised cost of a debt instrument in order to determine its carrying value. However, authorised funds carry debt securities at fair value through profit or loss because they are managed, and their performance is evaluated, on a fair value basis in accordance with a documented investment strategy. The SORP working party identified that, for the purpose of recognising revenue, other methods of spreading the premium or discount on the purchase of a debt security over its remaining life will give a reasonably comparable result. For this reason, the proposed SORP has been amended to simplify the guidance (but not to prohibit the use of the effective interest method) for recognising debt security interest.

Q10. Do you agree with the simplification of the principles for recognising revenue from debt securities?

Aggregation

The FCA's COLL requires that, in the case of an umbrella fund, the individual sub-funds' financial statements are prepared so as to give a true and fair view of those sub-funds' affairs. COLL requires an aggregation of the sub-funds' financial statements to be included in the annual and half-yearly reports, and the SORP reiterates this requirement. Investors in funds have a discrete interest in one or more sub-funds and the aggregation is relevant only in the context of the risk of contagion where another sub-fund is unable to meet its liabilities.

In 2011, new rules were introduced requiring the assets of each sub-fund to be segregated such that they cannot be used to discharge the liabilities of another sub-fund. The rules have a two-year transitional period ending in December 2013, by which time all authorised funds must have introduced the segregated liability provisions. This removes the risk of contagion and the SORP working party has discussed with the FCA the utility of the aggregation. The requirement for an aggregation has been removed from the SORP. However, until such time as the FCA consults and amends COLL, the aggregation will continue to be required. We understand that, subject to the feedback on these proposals, the FCA will consult on this matter in due course.

Q11. Do you agree with the removal of the aggregation?

Distribution policies

The proposed SORP introduces additional disclosure requirements in respect of the distribution policies. It should be noted that these do not permit or prohibit certain policies; they simply clarify the disclosures that will be required should certain policies be deemed appropriate.

Portfolio statement

The proposed SORP clarifies the intention of the banding for the portfolio statement in respect of property funds. For example, for a fund worth £100m the maximum band width is £5m. Any number of properties can be listed in a particular band and the total percentage of the net assets that the properties in a single band represent can exceed 5%.

Transition

Section 35 requires entities applying FRS 102 for the first time to adjust items in the balance sheet as at the date of transition (being the beginning of the comparative period), to reflect the recognition and measurement requirements of FRS 102 and to explain and reconcile the effect of the transition. To the extent UK GAAP has converged with IFRS in the past, previous SORPs have adopted relevant IFRS recognition and measurement principles and, as a result, it is not expected that adjustments will be required on transition.

Managers of property funds will need to consider the optional transitional exemption in relation to lease incentives.

Effective date

It is expected that the final SORP will be published around the end of March 2014. It has been assumed that it will be applicable for accounting periods commencing on or after 1 January 2015 in order to be consistent with the effective date of FRS 102. However, there are a number of provisions that relate to matters not connected with FRS 102, for which earlier application may be desirable. One option under consideration is to set an earlier effective date and to defer to 1 January 2015 the commencement of specific requirements needing a longer implementation period.

Q12. What do you think would be the earliest feasible effective date?

Q13. Which requirements need an earlier effective date?

Q14. Which requirements should be deferred?

The proposed SORP is intended to provide sufficient disclosures to satisfy the requirements of FRS 102.

Q15. Do you think the proposed SORP satisfies the requirements of FRS 102?

Q16. Do you have any other comments on the proposed SORP?