ICAEW representation

ICAEW REP 02/05

Draft Revised Statement of Recommended Practice for the Financial Statements of Authorised Funds

Memorandum of comment submitted in October 2005 by the Institute of Chartered Accountants in England and Wales to the Investment Management Association in response to its draft revised Statement of Recommended Practice for the Financial Statements of Authorised Funds, issued in June 2005.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the 'ICAEW') welcomes the opportunity to comments on the draft revised Statement of Recommended Practice for the financial statements of authorised funds, issued in June 2005 by the Investment Management Association.

2. The ICAEW is the largest accountancy body in Europe, with more than 127,000 members. It operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Financial Reporting Council. The ICAEW's primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy.

MAJOR POINTS

Total Expense Ratio

3. The draft revised SORP proposes that the total expense ratio ('TER') is disclosed in the audited section financial statements. We do not consider that the inclusion of the TER is necessary in order to provide a true and fair view of the long form accounts, and therefore its inclusion is not necessary in order to comply with GAAP. At the same time, we recognise that the inclusion of the TER would not conflict with GAAP.

4. We understand that the reason for the TER's proposed inclusion is that it will be the only financial information mandated in the new short reports of authorised funds. While it is possible for the TER to be audited, there will clearly be cost implications of doing so. We would suggest that an alternative would be to move the TER to the comparative information section, which is unaudited, although would still be subject to the less demanding test of being reviewed by the auditors for consistency with the financial statements.

5. The fact that it will be the only audited number in the short reports also risks giving undue prominence to this number and an expectation gap over the extent to which the fact that it has been "audited" when isolated from the financial statements. The auditor of general purpose financial statements reports upon the financial statements as a whole and not upon each and every element thereof. It is therefore important that, if the TER is to be included in the long form accounts, it is not referred to in the short report or elsewhere as the "audited TER".

RESPONSES TO QUESTIONS

Effective Dates

Q1: Are the proposed SORP implementation dates realistic and do you agree with the extended timetable in respect of the bond yield calculation changes?

6. The proposed implementation dates are realistic. However, if it is considered necessary to have an extended timetable for implementing the bond yield calculation changes, it might be better for the implementation for this to be deferred until 1 January 2007 to coincide with the implementation of FRS 26 and avoid an overly complex implementation timetable.

Derivatives

Q2: Do you agree with the proposal to move to a Statement of Economic Exposure rather than trying to reconcile it with the balance sheet?

7. Yes in principle, but we have concerns over the proposed methodology for estimating the economic exposure and also of the level of disclosure of that methodology given. We welcome the fact that it is proposed to provide additional explanatory disclosures which should assist users in better understanding this note, in particular the proposed sensitivity analysis showing correlation between market movements and portfolio movements. However, the proposed disclosures in Annex A remain somewhat opaque upon how the "economic exposure" is measured or what it represents. Using the numbers in Annex A, disclosing a market value of £48,958k and an economic exposure of £52,344k suggests that the fund has an approximate β value of 1.069. We are unconvinced that this would be the case in the example, except by chance.

8. It is not clear from the Note 13 as drafted whether the economic exposure is trying to reflect the true economic exposure; the value at risk; the maximum potential loss exposure; or the value of the underlying investments to which the fund is exposed. Value at risk is referred to in paragraph 2.96, but is not defined anywhere. The examples and further description in Annex C suggests that Note 13 is estimating the maximum potential loss exposure, which is quite different from the true economic exposure since it is directional. Further disclosure in Note 13 of the methodology used for calculating "economic exposure" is needed. We also have concerns over the basis of measurement of economic exposures suggested in paragraph 1.7. These concerns are set out in more detail under question 3 below.

9. We recommend that further work is put into considering what the statement is trying to achieve, how it is described and on the narrative disclosures explaining the basis of preparing and calculating the note.

Q3: Do you agree that purchased options cannot sensibly be shown on the statement of economic exposure, and the derivative disclosure requirements provide enough information relating to the impact of derivatives upon the fund? If not, what information disclosure would you suggest?

10. No. If purchased options are excluded from the statement, it will not accurately reflect the economic exposure.

11. Options purchased are no more difficult to measure than options written since the economic exposure of the two sides to the transaction is equal and opposite. The definition of economic exposure in paragraph 1.7 does not work. It differentiates between futures and options written and purchased. If the purpose of the disclosure is to reflect economic exposure, a better distinction for measurement purposes would be

between put and call options. All options share the characteristic that they each participant is mainly exposed to one side of the risk, the difference being that options written are mainly exposed to downside risk and options purchased are mainly exposed to upside risk. The upside risk of an option purchased is still an economic exposure. The counter side of the contract risk will be the market value of the contract, which would typically be nil for an option written and the current market price for one purchased.

12. Put options, whether purchased or written, have a finite maximum potential exposure of the contract price less any guaranteed minimum value of the underlying investment (usually nil). It is no more difficult or easy to measure this for options written as for those purchased.

13. Call options, by contrast, have a potentially infinite maximum exposure, which is dependant upon the performance of the underlying stock. While the contract price is a factor in determining the economic exposure, it is not good proxy for its value. In fact, for a call option the contract price should work as a deduction from the potential value of the underlying assets to arrive at the economic exposure. Therefore, the basis of measurement of call options written, as set out in paragraph 1.7, appears to be wrong.

14. Furthermore, the level of economic exposure of a fund will be affected by the extent to which various individual exposures are positively or negatively correlated to other exposures. A short position, for example, could reduce the economic exposure if it hedges another investment or series of investments. On the other hand, it would increase the economic exposure if not.

15. Given the complexity of estimating the true economic exposure, it may not be possible to provide meaningful numeric disclosures of this figure. An alternative and possibly more meaningful disclosure might be the net exposure to underlying investments. It would also require some degree of netting of well matched exposures. Again, this is different to the economic exposure and should not be described as such, but might be easier for users to understand without significant additional disclosures.

Additional Disclosures

Q4: Do you agree that beyond what is proposed in the draft SORP, there should be no further disclosures until after the FSA consultation process has concluded? Or would you prefer to have further disclosures from 1 January 2006? If so, on what basis?

16. Yes. Financial reporting should be driven by developments in accounting standards and accounting theory. Regulatory requirements should not drive financial reporting.

IFRS

Q5: Would you prefer us to accelerate the move to IFRS? If so, on what basis and to what timetable?

17. No. Funds should have the option of adopting IFRS but adoption should not be mandated. Implementing aspects of FRS 26 and IAS 39 will require significant work

for authorised funds and funds should be given a sufficient time to implement these in an orderly fashion.

Q6: Do you agree with the proposal to move to bid pricing in January 2006 or should it wait until FRS 26 is implemented? What are your reasons?

18. Yes. This will improve comparability across the market. However, we note that some fund managers might have to amend their current systems to implement this change.

Bond yields to reflect amortisation to maturity

Q7: Do you agree with the proposal to defer the implementation of this until 1 July 2006? Is there any reason why you would not be able to meet this implementation date?

19. See our response to question 1 above.

Q8: Do you agree with the credit rating disclosure proposals in paragraph 2.64? In particular, are there cost implications that should be disclosed?

20. The disclosure seems helpful. We have no comments upon any cost implications.

Gains and Losses, note 2 to the accounts

Q9: Do you agree with the proposed simpler note or would you prefer to have an analysis between realised and unrealised gains?

21. We note that this will create differences with the AITC SORP. However, we recognise that a full analysis between realised and unrealised gains would create a significant amount of work for administrators and we do not consider its removal would be significantly detrimental to investors. On balance we support the proposed simplification.

OTHER COMMENTS

22. The SORP currently allows funds an exemption from the preparation of a cash flow statement on the grounds that the investments are highly liquid. We note that the increasing use of derivatives might impact upon the liquidity of the investments and the availability of the cash flow exemption in certain funds.

23. It is unclear in paragraph 2.68 what is the distinction between aggregation and netting.

24. Paragraph 2.70 uses the terms cancellation prices and bid prices, which are similar terms. Clarification of the difference between the two terms and when it is appropriate to use each basis would be helpful.

25. We noted a number of points which we consider to be minor drafting matters. These are set out below.

- On page 4, para 1.7, part a) of the definition of a derivative appears to have been incompletely extracted from FRS 26. It should read "….or other variable**, provided in the case of a non-financial variable** that the variable…." (words in bold underlined text omitted from draft SORP).
- On page 5, para 1.7, the words "This aims to identify" at the start of the definition of economic exposure appear reduntant and misleading. We suggest they are deleted.
- On page 9, para 2.7 refers in two places to Chapter 10 of the CIS Sourcebook **and** Chapter 4 of the COLL Sourcebook. We suggest that "and" is replaced with "or", as a fund will fall under either CIS or COLL, not both.

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