



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

29 July 2008

Our ref: ICAEW Rep 89/08

Your ref:

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Dear Mark

**EXPOSURE DRAFT STATEMENT OF RECOMMENDED PRACTICE FINANCIAL  
STATEMENTS OF AUTHORISED FUNDS**

The Institute of Chartered Accountants in England and Wales is pleased to respond to your request for comments on the Investment Management Association (IMA) Exposure Draft Statement of Recommended Practice Financial Statements of Authorised Funds.

The ICAEW's Financial Services Faculty was established in 2007 to become a world class centre for thought leadership on issues and challenges facing the financial services industry, acting in the public interest and free from vested interests. It draws together professionals from across the financial services industry and from the 25,000 ICAEW members specialising in the sector. This includes those working for regulated firms, in professional services firms, intermediaries, and regulators.

This response has been prepared having consulted with the ICAEW's Financial Services Faculty and other interested parties.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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## **ICAEW Representation**

**ICAEW REP 89/08**

**IMA – EXPOSURE DRAFT STATEMENT OF RECOMMENDED PRACTICE  
FINANCIAL STATEMENTS OF AUTHORISED FUNDS.**

**Memorandum of comment submitted in July 2008 by the Financial Services  
Faculty of The Institute of Chartered Accountants in England and Wales in  
response to the IMA Exposure Draft published April 2008.**

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## **INTRODUCTION**

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the consultation paper *Exposure Draft - SORP for Authorised Funds* published by IMA.

## **WHO WE ARE**

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 130,000 members in more than 140 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 700,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

## **MAJOR POINTS**

### **Principles-based approach**

4. We welcome the principles-based approach of the proposed revised SORP.

### **Examples of derivatives**

5. We note that question 2 relates to the use of derivatives and the removal of the example treatment of derivatives set out in Appendix C of the current SORP. We accept that there is such a diverse use of derivatives that the examples are perceived by some to be of limited use. However, our preferred route would be for guidance to be issued separately from the SORP. We believe there is scope for the IMA to provide guidance on reporting the nature and extent of risks arising from the derivatives to which the fund is exposed. This guidance could include both qualitative and quantitative disclosures similar to those required by FRS29 *Financial Instruments: Disclosures*.

### **Disclosure of Questions and Answers on Effective Interest Rate (EIR).**

6. As with any new requirement, in the early days of application of the EIR calculation it would be helpful for examples to be provided to assist with the calculation and disclosure process. We understand that the IMA has Q & As on particular aspects of effective interest rate calculations which are available to its members. We would ask that consideration be given to making this information public.

## **Need for pro forma financial statements**

7. The Exposure Draft removes the Annexes but we continue to see the value in the Annex A Annual Report and Financial Statements.

This is for two reasons:

- while there is more diversity in funds there is still a large core of entities where financial statements would be similar and a pro forma should assist efficiency of preparation as well as comparison between financial statements; and
- the inclusion of the detailed requirements in the body of the SORP could be seen as more prescriptive and hence less flexible than an illustrative example. More unusual funds will have potentially less of a problem justifying divergence from an illustrative example.

## **RESPONSES TO SPECIFIC QUESTIONS**

### **Effective date**

#### ***Q.1 Do you agree that the proposed implementation date is realistic?***

8. At this time we have no objection to the implementation date of accounting periods commencing on or after 1 January 2009. However, there may be other commentators who raise valid reasons why this date is not practical, not the least of which are the revised SORP being issued late or information on comparatives not being readily available, for example, the credit rating disclosures for bond funds or the disclosure required by paragraph 3.48 in relation to transactions to secure or avoid a dividend.
9. In addition we would like to see the FRS 25 *Financial Instruments: Presentation amendment* relating to certain puttable instruments fully resolved by the ASB in a manner that is satisfactory for the funds industry before the revision of the SORP is finalised. Otherwise there is a risk that the SORP will need to be revisited since at the present time, pending the ASB amendment of FRS 25, it is prepared on the basis that units/shares are liabilities. Our understanding is that the IMA plans to incorporate the updated position for FRS 25 in whatever form that takes in the finalised version of the SORP.

### **Derivatives**

#### ***Q.2 Do you agree with the principles based approach and the removal of the examples?***

10. We note that this question relates to the use of derivatives and the removal of the example treatment of derivatives set out in Annex C of the current SORP. The move to a principles-based approach is sensible in an environment where derivatives and strategies are changing rapidly.
11. There are likely to be many funds where derivatives are only a small part of the funds' investments and possibly only a recent addition, in such circumstances guidance on accounting for some example derivatives may be of benefit. If, as stated in the 'invitation to comment', the examples 'have a greater propensity to confuse than to clarify' it may be that the examples themselves are at fault and should be amended rather than removed.

12. We accept that there is such a diverse use of derivatives that the examples are perceived by some to be of limited use. We also accept that there is a risk that by including examples in the SORP they effectively limit the flexibility provided by the 'motives and circumstances' tests underlying the principles based approach. However, in this respect we agree that the example included in paragraph 2.28 (accounting for total returns) provides a useful principle on which to base the accounting for these instruments. In this regard we do not agree with the different accounting that could be used in respect of the judgement call arising from the words 'unless the income property elements of the return are expected to be a not significant portion of the overall return.' We suggest that these words are deleted from the final version of the SORP.
13. Our preferred route would be for more detailed guidance to be issued separately from the SORP. We believe there is scope for the IMA and its membership to consider sponsoring such guidance on reporting the nature and extent of risks arising from the derivatives to which the fund is exposed. This guidance could include both qualitative and quantitative disclosures similar to those required by FRS29.

***Q.3 Do you agree with the proposal to report derivative disclosures using the tools established under the DRMP?***

14. We would concur with the view that disclosure requirements should be 'proportional to the volume and sophistication of the use of derivatives'. Linking this to the derivative risk management process (DRMP) established by the managers is a pragmatic solution which we would support. It is the quality of the narrative explanation of the use of derivatives and the sensitivity of the fund as a consequence that are important.
15. We would see the reference to the DRMP as the link which means that the ACD/Manager must get appropriate reporting from the Fund Manager to the fund accountants/administrator for an appropriate risk disclosure. We would suggest that this is an area which may need to be closely monitored over the first couple of years to confirm that such disclosure is 'adequate' in the circumstances and whether any additional guidance may be required.

**A new standard for disclosures**

***Q.4 Would users of the authorised fund's financial statements find additional sensitivity analysis helpful in making investment decisions?***

16. The SORP already requires information on risks relating to interest rates, exchange rates and market prices. If the information in relation to these disclosures is clearly set out we can see no need for an extension of sensitivity analysis to all financial instruments.
17. In addition we would not see the benefit of extending the risk disclosures along the lines of those required by FRS 29 in respect of interest and credit risk at this stage. This reflects the uncertainty of the value and timing of the application of FRS29 to mutual funds, the capacity to achieve this in Authorised Funds and the usefulness of such disclosures to (retail) investors when the focus of the FSA is on the Short Report which would not include this information.

## **Income property and capital property**

### ***Q.5 Do you agree with the proposal to distinguish the terminology used in the SORP in this way?***

18. We accept that each item of accounting income will need to be treated as income property or capital property for the purposes of the accounts of the fund and that an attempt to define income and capital for this purpose is appropriate. However, we believe the definitions in the exposure draft are confusing given that transfers can be made between income and capital.
19. We have some concerns of detail with the definitions and would like to avoid confusion with the FSA's defined term 'income property' which relates to the distributable income property of the Fund. Overall, as an alternative to the adoption of a three column format which we understand was considered but dismissed, we are supportive of the intention. That said the 'devil in the detail' means that the words used need to be correct and consistent throughout the SORP before it is finalised.
20. Specifically the SORP should provide more guidance on how items should be reported in financial statements. At present the differences between 'income property' and 'distributable income property' are not clearly dealt with. There are also tax implications and the tax regulations refer to 'gains and losses on investments' and 'other gains/(losses)' being exempt from taxation ie they do not refer to 'capital property'. We are concerned that the amendments/definitions and formatting changes proposed in the exposure draft should continue to be effective for tax purposes.
21. The distinction continues to be important because income property and capital property are an intrinsic part of FSA regulation and tax regulation. There can be a number of 'adjustments' between income after expenses and taxation and the amount distributed. Although this is important to investors, it is not an issue for financial reporting but is a matter for the distribution policy and the provision of adequate explanation/reconciliation as to how the distribution is determined. If one of the primary purposes of the financial statements is to determine what is distributable it may be simpler if the SORP gave separate guidance on this although we can appreciate that there may be practical obstacles to this.

## **Consolidated financial statements**

### ***Q.6 Do you agree that the proposed new material on consolidation is helpful and sufficient?***

22. Our understanding from the analysis in the invitation to comment, is that this only relates to intermediate holding vehicles (IHV) and investments in overseas real estate. The wording in the body of the revised SORP does not discuss this specific situation but rather deals in general with the need to produce consolidated financial statements that include all subsidiaries. If the IHV scenario is the only situation considered to arise at present, we believe it should be described in the relevant sections of the body of the SORP.
23. There may be merit in giving an overview of the expected content of consolidated financial statements - in terms of the various group and parent company primary statements and notes. It would be useful if the additional features/reports were scheduled, in particular explaining that there would be a statement of total return

for the 'Group' and the 'parent Company' ('the Fund') and that the distribution is by/from the 'Fund' and its statement of total return. Clarification of the need for such statements and notes, including a cash flow statement, for the group and the Fund would be useful.

## **Effective interest rate calculation**

### ***Q.7 Do you agree that the proposed new material on effective interest rate is helpful and sufficient?***

24. The discussions on effective interest rates (EIR) in paragraph 2.39 to 2.56 provide guidance on the principles to be followed. However, as with any new requirement it is helpful in the early stages of application for examples to be provided to assist with the calculation and disclosure process. We believe that some supporting examples would be of assistance to funds in meeting the requirements of the SORP in this area. We understand that the IMA has Q & As on particular aspects of effective interest rate calculations which are available to its members. We would ask that consideration be given to making this information public.
25. However, we recognise that there are many complex bonds in existence and new instruments will be created and, as a consequence, any Q & As or 'examples' can never be comprehensive. For this reason it is important that the SORP establishes principles for reporting in this area.

## **Contents of financial statements**

### ***Q.8 Do you agree that these changes are appropriate, and in particular that paragraph 3.23 satisfies the requirement to show changes in the composition of the portfolio?***

26. This proposal means that the summary of material portfolio changes will be replaced by a description of material changes in portfolio composition within the review of investment activities. In principle we would have no objections to the removal of the current requirement provided the Fund Manager's review gives a resumé of the most important purchases and disposals of investments in the period.
27. It is unclear that current Fund Manager's report consistently addresses the material portfolio changes and hence does not act as a substitute for the twenty largest purchases and sales but equally we do not see the ongoing benefit of disclosing the twenty largest purchases and sales. Rather the Fund Manager's report should include an appropriate description of the changes in the portfolio and its disposition over the period. We agree the benefit is modest as systems have been developed to generate the information required by the current disclosure requirements but that is hardly a sufficient reason to maintain the information preparation and disclosure when it is perceived to be of little benefit.

## **Half-yearly reports**

### **Q. 9 Do you agree that these changes are appropriate and helpful?**

28. We agree that the reduction of interim financial reporting that has been achieved for other entities is justified for Authorised Funds. We presume that the FSA has agreed that the format is appropriate in terms of meeting the COLL requirements for half yearly long reports.

## **SORP document**

### **Q.10 Do you agree with the removal of these appendices?**

29. By including illustrative financial statements and certain FSA rules the current SORP has tried to pull together requirements and rules in the area of accounting for funds into one source document. We believe the illustrative financial statements in particular provide a useful base for those less familiar with the requirements. We recognise the difficulty of preparing an illustrative set of financial statements with detailed derivative disclosures including sensitivity analysis. However, we can see benefits in the inclusion of a 'simple' set of illustrative financial statements.

30. We agree with the removal of Annexes B to E but see continued value in the Annex A.

This is for two reasons:

- while there is more diversity in funds there is still a large core of entities where financial statements would be similar and a pro forma should assist efficiency of preparation as well as comparison between financial statements; and
- the inclusion of the detailed requirements in the body of the SORP could be seen as more prescriptive and hence less flexible than an illustrative example. More unusual funds will have potentially less of a problem justifying divergence from an illustrative example.

## **FRS25 amendment/Accounting framework**

### **Q.11 IMA is interested to hear your views on the future direction of developments in the accounting information provided to investors in funds.**

31. Following the introduction of short reports some years ago, increasingly the main user of fund financial statements appears to be HMRC. However, it is essential that full financial statements of a fund are available to those who wish to receive them and we believe that the SORP has an important role to play in helping the funds industry make this information available in a clear, concise and consistent manner.

### **Q.12 Please provide any other comments on the proposals or about the SORP generally.**

32. We have no further comment.



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