Investment Management Association

Feedback statement

Statement of Recommended Practice

Financial Statements of UK Authorised Funds

May 2014

Feedback Statement: SORP for UK Authorised Funds

Introduction

IMA has issued the 2014 edition of the Statement of Recommended Practice (SORP) for UK Authorised Funds. This follows a public consultation last year.

This document provides a summary of responses to the invitation to comment issued in July 2013, together with feedback explaining how these comments have been taken into account by the SORP Working Party[1] (SWP). This document is intended to explain the development of the SORP's requirements. It is not guidance and it does not carry the authority of the SORP.

Consultation

The Exposure Draft (ED) issued in July 2013 proposed revisions to the SORP designed to take account of a number of changes to the regulatory and accounting frameworks within which authorised funds operate and introduce a template for presenting information about performance, charges and costs during the reporting period. 30 responses were received from a variety of sources.

The SWP considered 23 responses in respect of the SORP as it applies to authorised funds, including 12 from authorised fund managers (AFMs) representing a third of funds under management in authorised funds, 5 from third party providers of fund accounting services (TPAs), being the preparers of the financial statements for two-thirds of authorised funds, and 5 from audit firms, being the auditors of virtually all authorised funds. A summary of these responses and the SWP's feedback is presented in part I.

The SWP also considered 7 responses, including 5 passed on by the Financial Reporting Council (FRC), in relation to the disclosure of charges and transaction costs by pension schemes. These responses originated from a variety of sources including a cross-party group of Parliamentarians and the TUC. Although the SORP does not apply to pension schemes, the SWP considered these responses in the light of the wider debate about the transparency of charges and transaction costs. A summary of these responses and the SWP's feedback is presented in part II.

Next steps

The Financial Conduct Authority's (FCA) rules currently require authorised funds to prepare their financial statements in accordance with the 2010 edition of the SORP. It is expected that the FCA will propose amendments in order to permit a choice of using either the 2010 or the 2014 edition of the SORP for a transitional period and then to require that the 2014 edition is used for accounting periods commencing on or after 1 January 2015.

However, it is not expected that the transitional provisions will apply to the comparative table requirements, which means the table will be required for from an earlier date that will be determined by the FCA.

[1] The SORP Working Party is constituted In accordance with the FRC's Code of Practice on the development of SORPs and comprises four members representing the industry, three auditors and two fund accounting service providers to ensure there is sufficient technical accounting support, two independent members representing the wider public interest and a user of financial statements.

Part I: Responses to the SORP for Authorised Funds

Fair value disclosures

Section 34 of FRS 102 requires an analysis by class of financial instrument of the methods used to estimate the fair value of each category of instrument. The ED drew attention to the misalignment of this fair value disclosure hierarchy with that required by full IFRS. It was noted that FRS 102 imposes the additional burden of identifying valuations based on recent transactions. It was proposed that additional analysis should be given splitting the lowest FRS 102 level in accordance with full IFRS levels 2 and 3.

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

There were 19 responses to this question.

Six AFMs and all five TPAs expect only a small number of funds to hold instruments that are valued using unobservable inputs and three AFMs expect a more significant number of their funds to hold such instruments, although the number of instruments is small. Four auditors observed that they would not expect their clients' funds to hold significant numbers of instruments that are valued using unobservable inputs. Two AFMs would welcome further guidance on how the fair value of a quoted security is classified when the relevant market is closed.

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

There were 18 responses to this question.

Six AFMs and all five TPAs stated that they are already able to support reporting under the IFRS fair value hierarchy (with three observing that they also support the US GAAP hierarchy) and two AFMs stated that it would require systems development. Five of those that can support the IFRS hierarchy would require systems development in order to support the equivalent reporting under FRS 102.

One AFM asked IMA to try to influence the FRC to align the hierarchy with IFRS and another asked for the SORP to require the IFRS hierarchy to be applied. One TPA pointed out that changing the level for a particular instrument is a manual process and another would like IMA to issue classification guidance.

The remaining respondents observed that they expect administrators to be able to support reporting under the IFRS fair value hierarchy.

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

There were 21 responses to this question.

All respondents agreed that the additional category for unobservable inputs is a positive addition to the FRS 102 requirements that avoids losing the utility and comparability of the resultant disclosures. Four TPAs noted that significant development will be required in order to support the FRS 102 classifications and three TPAs want IMA to explore the possibility of aligning the FRS 102 classification with the IFRS hierarchy. Five AFMs and an auditor would like IMA to issue classification guidance and one AFM called for consistency with the AIC and PRAG SORPs.

The approach taken in the ED has not changed. It has been clarified that, where an otherwise active market is closed at the time of the valuation due to normal business hours, the market should continue to be regarded as active for the purpose of the fair value classification.

It is desirable for the FRC to amend FRS 102 to align with the IFRS fair value hierarchy to avoid significant systems development in order to diverge from IFRS.

IMA will consider developing guidance on the classifications.

Risk disclosures

Section 34 requires narrative and numerical disclosures about the risks arising from financial instruments. The ED included proposals to employ the documentation and methods for monitoring and measuring exposures to risk set out in European and UK regulations to fulfil the requirements of FRS 102.

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?

There were 20 responses to this question.

Responses were mixed with twelve respondents favouring the generic approach and seven preferring a greater emphasis on UCITS with non-UCITS funds being dealt with by exception. However, at least three that favoured the generic approach did so under the expectation of future regulatory alignment of the regulatory risk frameworks for UCITS and non-UCITS funds. Two respondents observed that the generic approach made the SORP more confusing.

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

There were 21 responses to this question.

All respondents agreed with the integrated approach. Five pointed out that although they agreed in this instance, they were not generally in favour of dual purpose reporting. A number of respondents pointed out that this approach facilitates investor disclosures that deliver a cohesive report on the actual risks and the processes employed for managing those risks that is consistent with the nature of an authorised fund.

Two respondents suggested clarifying the information that needs to be included within the financial statements and that which can be presented elsewhere in the annual report. Two sought additional guidance around the leverage calculation, three suggested examples of the disclosures and four were interested in additional guidance to capture ESMA's requirements.

The general approach taken in the ED has not changed but the relevant sections of the SORP have been redrafted to be more closely aligned with FRS 102 and to use the regulatory disclosures for UCITS only to the extent that they are necessary to satisfy the requirements of FRS 102. Additional guidance arising under AIFMD and applicable to non-UCITS funds has been added to Appendix D.

Alternative Investment Fund Managers Directive

Under the AIFMD, managers of non-UCITS funds must make available AIFMD-compliant annual reports for all annual accounting periods ending after the earlier of:

- the date of authorisation of the AIFM; or
- 21 July 2014.

The ED included a proposal to provide guidance on applying the AIFMD requirements to non-UCITS funds in a manner that is consistent with the requirements of FRS 102 and sought views on whether it would be helpful to define the meaning of realised and unrealised in the context of gains and losses and, if so, what the definition should be.

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

There were 21 responses to this question.

Eighteen respondents thought the SORP should define realised and unrealised gains/losses in order to ensure a consistent interpretation for all non-UCITS funds. The other three questioned the need for a definition.

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

There were 20 responses to this question.

Overall there was equal support for each of the 3 options (A, B or something else).

Amongst the AFMs, something else (being that realised gains should be sales proceeds less original book cost) was the most favoured choice and one pointed out that this is the approach taken in other Member States, in particular, Luxembourg.

The TPAs were split in their preferences although one recommended something else on the basis that this is a requirement of a European regulation and therefore all Member States and other vehicles subject to the AIFMD requirements should use a consistent approach.

Most auditors favoured, or expressed merit in, option B. However the other auditor pointed out that the AIFMD describes realised gains and losses as representing gains and losses on the disposal of investments and that this invalidates option B which includes in realised gains and losses changes in fair value where the change is readily convertible to cash.

There was strong support for a definition but mixed views on what it should be. On balance, the SWP favoured the definition of realised gains/losses as being proceeds from disposal less book cost (ie something else). This reflects the wording of the AIFM Regulation and the fact that, as a harmonising Directive, the AIFMD requirements should give outcomes consistent across Member States.

Authorised contractual schemes

The ED set out proposals to introduce new requirements for authorised funds that hold a single investment in a fiscally transparent fund, such as a UK ACS or an offshore equivalent, in order to 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 ACS's assets.

There were no specific questions on this topic but comments were received from eight respondents.

Two agreed with the approach taken and five thought that the approach taken was appropriate for feeder funds holding a UK ACS or an offshore equivalent, but for authorised funds investing in a diversified pool of assets, it is disproportionate. Some suggested it would be impossible for some authorised funds to obtain the necessary data from the managers of some funds.

The requirement has been amended to allow more flexibility in the timing of the recognition by an authorised fund of income arising from a holding in a UK ACS or an offshore equivalent.

Performance and charges

The FCA's COLL requires the annual report to contain a comparative table. The ED sets out a mandatory format for the presentation of the table such that there is a single table for each unit class, which enables investors to focus on the numbers relevant to their holding. The table is laid out to show the progress of a unit held throughout the year including the investment return, the operating charges and an indication of the direct transaction costs incurred.

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

There were 22 responses to this question.

Overall, 13 respondents thought the proposals, or parts of the proposals (the parts not including the further breakdown of operating charges and transaction costs), will help investors and four supported the initiative to improve transparency. Five respondents do not consider the disclosures are merited.

Six respondents thought the long report is the wrong delivery mechanism to carry these disclosures and three suggested that the disclosures should be made in the short report as well or instead. One provided a suggestion for an alternative, simpler presentation. Nine thought there is too much information, mostly because the information is required for every unit class and four of these suggested including only a representative unit class. One was concerned about the sizeable initial set up overhead.

One respondent thought the focus on costs has overshadowed consideration of the quality of information about how performance has been achieved and suggested disclosure of detailed attribution analysis in the manager's report.

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

There were 21 responses to this question.

Many respondents commented on the difficulty in splitting commissions between research and execution. The other recurring themes were the determination of the dilution mechanism offset and the comparative data, especially in the context of the proposed early implementation date.

Overall, the SWP was in favour of a financial summary presented for each unit class, but agreed with the respondents who thought there was too much detail. As a result, the SWP has limited the comparative table to prescribing a layout for the information required by the FCA rules, subject to those rules being amended to accommodate the recommendations, and additional information calculated from the required information or information given elsewhere in the financial statements.

The SWP removed the detailed breakdown of expenses and transaction costs. This detail is available elsewhere in the notes to the financial statements that breakdown expenses and transaction costs. In particular, this removes the requirement to split dealing commissions into their research and execution components. It was noted that the dilution mechanism offset is not compulsory.

Other matters

Income recognition

The ED included proposals 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?

There were 20 responses to this question.

Seventeen respondents agreed with the simplification, although four AFMs noted that they are likely to continue with their existing EIR methodology now that it is bedded in. One TPA was concerned about the complexity involved in transitioning from the existing approach to a new, simpler approach. Two auditors suggested that it should be made clear that the simplification is an accounting policy option and Managers will be able to continue with their existing approach.

One AFM highlighted a concern about inconsistency if different approaches are available. One TPA perceived the proposal as a reversal of many years trying to converge standards and suggested it would lead to less consistency with other funds and other types of investment vehicle. However, another supported the proposal because it breaks the link to the machinations of the IASB as part of their long running IAS 39 replacement project and that it is more consistent with the treatment of funds domiciled in other jurisdictions.

Six respondents were interested in additional guidance in respect of the more complex technical aspects such as convertible bonds, bonds denominated in foreign currencies, index-linked securities and bonds with embedded derivatives.

It has been clarified that the proposed SORP permits a choice of methodologies and there is no need to move from the existing approach. It was also clarified the policy chosen will be expected to apply to the entire bond portfolio but that bonds with certain characteristics, such as index-linked bonds, may apply a different methodology.

IMA will consider reviewing its effective yield guidance outside of the SORP.

Other income related matters

One AFM sought clarification about how paragraph 2.33 of the ED (income from collective investment schemes) interacts with the reporting obligations for offshore funds and whether or not equalisation received can form part of the distribution. Another suggested that paragraph 2.33 compelled rather than permitted the acceleration of revenue recognition and sought clarification about the application of equalisation in the master of a master-feeder arrangement. A TPA also raised the compulsion or permission point. An auditor suggested that additional clarification was required that paragraph 2.33 amounts to a policy choice.

An auditor also suggested that it should be clarified that lease incentives should be deducted from the property valuation and should be shown separately on the balance sheet in order to mitigate the risk of double counting.

One AFM asked that the SORP should provide guidance on paragraph 2.32 of the ED (special dividends, share buy-backs and additional share issues), in particular the meaning of significant in respect of special dividends and some examples of the practical application of paragraph 2.32.

It has been clarified that the intention of the SORP is to permit rather than require the acceleration of income recognition. The SWP considered the application of equalisation in a master fund. It was noted that it appeared a strange policy for a master to operate equalisation in a dedicated class held only by a single feeder because equalisation is a mechanism for equalising the rights to income where there is more than one investor. Nevertheless, clarification has been provided in respect of a master operating such a policy.

Clarification has been provided in respect of the treatment of lease incentives on the balance sheet.

The SWP noted that paragraph 2.32 of the ED provided sufficient guidance for managers in respect of special dividends.

Aggregation

The FCA's COLL requires an aggregation of the sub-funds' financial statements to be included in the annual and half-yearly reports. The SWP discussed with the FCA the utility of the aggregation and suggested the requirement should be removed from COLL.

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

There were 20 responses to this question.

All respondents agreed with the removal of the aggregation. Eight linked their comments to the introduction of the protected cell regime and eight believed the aggregation has no utility. Three noted the need for COLL to be amended to effect this change. One expressed concerns about the wording in the OEIC Regulations and hoped for clarification in respect of a series of unit trusts set up under a single trust deed.

In the light of the feedback, the SWP recommends that the FCA should consult on removing from COLL the requirement for an aggregation.

Effective date

FRS 102 applies for accounting periods beginning on or after 1 January 2015 with earlier application permitted. The ED included proposals for the SORP to become applicable at the same time as FRS 102, with mandatory earlier application of the comparative table requirements.

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?

There were 20 responses to these questions.

Fourteen respondents agreed with the effective date of 1 January 2015 and nine of these agreed with optional earlier application. Five suggested earlier mandatory start dates. Seven expressed a preference for a single commencement date for the entire SORP and six found the earlier application of the comparative table requirements to be too soon.

A number of respondents observed that the SORP deals with both regulatory and accounting matters and pointed out that the regulatory commencement dates cannot be deferred by the SORP. Several respondents suggested that IMA should produce implementation guidance to cover the period of transition to the new SORP. Some respondents also pointed out that the SORP cannot be used until the FCA has amended the regulatory rulebook.

The effective date of the SORP is aligned with the effective date of FRS 102. Earlier application of the SORP and FRS 102 together is permitted, but the 2014 edition of the SORP cannot be applied until the FCA has amended the rulebook. It is expected that FCA will provide transitional relief such that use of either the 2010 or the 2014 editions is permissible. However, it is not expected that the transitional provisions will apply to the comparative table requirements.

FRS 102 compliance

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?

There were 18 responses to this question.

Thirteen respondents confirmed they thought the SORP satisfies the requirements of FRS 102 or observed that they had not observed any non-compliance issues. One AFM noted that the ED proposed to satisfy some disclosure requirements using the portfolio statement, which is outside the financial statements, and that there is no guidance on using a presentation currency that is different to the functional currency.

Two auditors made specific comments in relation to the following matters: the absence of a requirement to make an explicit accounting policy choice to apply sections 11 and 12 in full; the absence of a requirement to make an explicit designation to carry debt instruments at fair value; whether the liquidity risk disclosures are sufficient; the criteria for classifying puttable instruments as equity; the identification of related parties; the risk of prejudice in the contingent liabilities disclosures; and the general approach to risk disclosures.

The SWP made amendments to require the application of sections 11 and 12 in full, to enhance the liquidity risk disclosures and to remove the material that dis-applied contingent liability disclosure in the event of prejudice. The general approach to risk disclosures has not changed but the wording has been enhanced to reflect more closely the FRS 102 requirements.

The SWP took the view that paragraph 2.11 of the ED (valuation) is sufficient to cause debt instruments to be carried at fair value and that the ED criteria for classifying puttable instruments and for identifying related parties are adequate.

Part II: The wider debate about the transparency of charges and transaction costs in pension schemes

Seven responses were received in relation to the disclosure of charges and transaction costs by pension schemes. Although the SORP does not apply to pension schemes, the SWP considered these responses in the light of the wider debate about the transparency of charges and transaction costs.

These responses were variations on a theme and, in particular, five responses were critical of the proposals in the ED. Four of these provided the same list of items they believed to be absent from the proposals:

- Bid-offer spreads
- Foreign exchange spreads
- Transaction costs of underlying funds when a fund invests in a fund
- Profits from stock lending retained by fund managers
- Interest on cash balances retained by fund managers

One respondent highlighted the importance of the impact of the market on poorly-managed trades and observed that funds with high costs per transaction will be less efficient than those which execute at a low price. This respondent alluded to statistical evidence in support of an argument that high transactional costs almost always create consumer detriment. Another respondent observed that bid-offer spreads and other costs due to market impact effects and inefficient market timing are of material significance.

One respondent went further and suggested that spreads should be converted into a fund cost using a portfolio turnover ratio and, together with dealing commissions and taxes, aggregated with the operating costs of the fund. This respondent suggested that such aggregation would help investors to understand the value they receive and provided a template demonstrating how such an aggregated figure might be calculated.

Two respondents made reference to the Office of Fair Trading (OFT) Report "Defined contribution workplace pension market study" (September 2013). One claimed that the proposals in the ED fail to comply with the OFT recommendations.

One respondent provided a detailed list of items that should be disclosed by all funds, which includes the monetary amounts of management fees, performance fees, custody fees, dealing commissions and transfer taxes. It also includes bid-offer spreads and foreign exchange spreads, expressed in basis points.

Two respondents were interested in seeing disclosure of a figure for portfolio turnover.

The SWP noted that most of the items some respondents believed to be absent were already required under the 2010 edition of the SORP or were included in the proposals in the ED.

In particular, the 2010 SORP requires authorised funds to disclose the gross fees earned from stock lending, the related expenses and the net revenue retained by the fund. The ED preserved these disclosures and introduced an additional requirement to identify the recipients of any deductions from the gross fees.

The ED introduced a requirement to disclose the average portfolio dealing spread (which includes both the bid-offer spread and the foreign exchange spread).

Authorised fund regulations prohibit the retention of cash balances by fund managers and therefore it is not possible for fund managers to earn interest on client's money.

The proposals do not include transaction costs incurred in underlying funds when a fund invests in another fund. The SWP noted that the proposals in the ED were based on the assumption of a unit held throughout the year and, except in the case of a master-feeder arrangement, took the view that this assumption is not sufficiently reliable to facilitate a meaningful aggregation of the underlying funds' transaction costs. Moreover, distortions would arise because transaction cost data is not available in the case of non-UK underlying funds. However, a requirement to explain the existence of transaction costs in underlying funds has been introduced.

The SWP agreed with the comments about the importance of market impact effects on performance and agreed that funds with high costs per transaction will be less efficient. As a result, the SORP's existing transaction cost disclosures have been expanded to require the costs per transaction to be displayed, together with the average portfolio dealing spread, in the audited financial statements. A requirement to explain transaction costs and spreads in order to aid consumer understanding has also been introduced.

The SWP observed that the respondent that claimed the proposals in the ED did not comply with the OFT's recommendations was wrong. That respondent argued that transaction costs and operating charges should be aggregated. However, the OFT recommended the opposite, stating in paragraph 1.37 of its report[2]:

"The only type of costs that the OFT suggests is omitted from this single charge would be investment management transaction costs because in the OFT's view their inclusion could potentially create incentives for investment managers to avoid carrying out transactions in order to keep costs down, even where this is contrary to the member's interest. However, these costs should be transparently reported and made available to Independent Governance Committees (see paragraph 1.32) who will be best placed to make an informed decision about whether transaction costs represent value for money. To this end, regulators should agree a consistent methodology for reporting comparable information on investment management transaction costs and portfolio turnover rate. We recommend that the Financial Conduct Authority (FCA) undertake this work as part of its planned competition review of wholesale markets."

[2] Defined contribution workplace pension market study (September 2013)

The SWP noted that, even though the ED was published before the OFT Report, its proposed approach is consistent with the views expressed by the OFT (paragraphs 6.28 to 6.33) in respect of transaction costs.

Furthermore, the SWP was concerned that aggregating charges and costs should be limited to similar items. They noted that paragraph 3.15 of FRS 102 is clear in this respect: *"An entity shall present separately items of a dissimilar nature or function unless they are immaterial."*

The SWP is strongly of the view that comparing funds on the basis of transaction costs expressed relative to the fund value, or attempting to convert spreads into a cost figure using a measure of portfolio turnover, risks misleading consumers. Aggregating such a figure with operating charges compounds this risk. To imply that high aggregate transaction costs are a bad thing risks encouraging consumers to make miss-informed decisions. Whether high or low transaction costs are good or bad can be judged only in the context of the performance that results from the decisions to transact. High transaction costs resulting from lots of good decisions are better for consumers than low transaction costs resulting from a few poor decisions.

The SWP has enhanced the portfolio transaction cost note within the financial statements to improve the transparency of the cost per transaction, and therefore dealing efficiency, in a way that is meaningful, informative and fair.

In preparing the ED the SWP did not reconsider the removal in 2010 of the portfolio turnover ratio disclosure requirement. The removal in 2010 had been proposed, and strongly backed, given that experience had suggested that including this measure did not help users of the financial statements better to understand the significance of changes in the portfolio composition. It is also worth reiterating that this removal occurred in the context of the EU moving away from a quantitative PTR measure, widely regarded as flawed, and its replacement in the UCITS KIID with a qualitative statement where relevant. However, this does not signify the end of the debate.