

## **Statement of Recommended Practice**

### **Financial Statements of Authorised Funds**

**October 2010**

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**APPENDIX I** – Presentation for funds with units classified as equity instruments

**APPENDIX II** - Applicable laws, regulations and accounting standards

# Statement by the Accounting Standards Board

The aims of the Accounting Standards Board (ASB) are to establish and improve standards of financial accounting and reporting, for the benefit of users, preparers, and auditors of financial information. To this end, the ASB issues accounting standards that are primarily applicable to general purpose company financial statements. In particular industries or sectors, further guidance may be required in order to implement accounting standards effectively. This guidance is issued, in the form of Statements of Recommended Practice (SORPs), by bodies recognised for the purpose by the ASB.

The Investment Management Association (IMA) has confirmed that it shares the ASB's aims of advancing and maintaining standards of financial reporting in the public interest and has been recognised by the ASB for the purpose of issuing SORPs. As a condition of recognition, the Association has agreed to follow the ASB's code of practice for bodies recognised for issuing SORPs.

The code of practice sets out procedures to be followed in the development of SORPs. These procedures do not include a comprehensive review of the proposed SORP by the ASB, but a review of limited scope is performed.

The ASB believes that all the movements in revenue and capital and the total return should be considered in assessing total financial performance and so does not take a view on the basis of allocation of costs and returns between capital and revenue set out in the SORP. However, it accepts that this distinction is necessary to determine the distribution, as noted in paragraph 2.21 of the SORP.

On the basis of its review, the ASB has concluded that the SORP has been developed in accordance with the ASB's code of practice and does not appear to contain any fundamental points of principle that are unacceptable in the context of present accounting practice or to conflict with an accounting standard or the ASB's plans for future standards.

October 2010

# 1. Introduction

- 1.1 Statements of Recommended Practice (SORPs) are recommendations on accounting practices for specialised industries or sectors. They supplement accounting standards and other legal and regulatory requirements in the light of the special factors prevailing or transactions undertaken in a particular industry or sector.
- 1.2 The Accounting Standards Board (ASB) has approved the Investment Management Association (IMA) for the purposes of issuing recognised SORPs for authorised funds. This arrangement requires the IMA to follow the ASB's code of practice for the production and issuing of SORPs. The code of practice provides the framework to be followed by the IMA for the development of SORPs, but does not entail a detailed examination of the proposed SORP by the ASB. However, a review of limited scope is performed.
- 1.3 The recommendations of this SORP are not an alternative for referring to the relevant regulations and accounting standards. For convenience signposts are provided to the relevant regulations or accounting standards. The SORP should be read in conjunction with the ASB Statement "SORPs: Policy and Code of Practice", any rules and regulations relating to authorised funds that are in force, and the law relating to these matters. The recommendations of this SORP have been arrived at after consideration of all rules, regulations and accounting standards issued before 30 June 2010.
- 1.4 Financial statements prepared in accordance with this SORP should comply with all applicable Statements of Standard Accounting Practice (SSAPs), Financial Reporting Standards (FRSs) and Urgent Issues Task Force (UITF) Abstracts. The SORP does not reflect the full detail of the relevant accounting standards. The full standards should be applied in order for the financial statements to give a true and fair view of the results and financial position of an authorised fund. Where standards issued after this SORP contain requirements that conflict with this SORP, the requirements of the relevant standard shall prevail.
- 1.5 [deleted]

## Objective

- 1.6 The objective of this SORP is to provide recommendations for the preparation of the financial statements of all authorised funds. In addition to providing standard interpretations of accounting standards and other legal and regulatory requirements in so far as they relate to authorised funds, this SORP establishes principles for determining the nature of items as revenue or capital for the purposes of both distribution and taxation.

## Scope

- 1.7 This SORP applies to the annual and half-yearly reports of all authorised funds. Notwithstanding that SORPs describe 'recommended' practice; compliance with this SORP is required by the Financial Services Authority's (FSA's) Collective Investment Schemes (COLL) sourcebook.

## Date from which effective

- 1.8 This SORP was issued by the IMA in October 2010 and supersedes the previous SORP for authorised funds. The recommendations of this SORP are applicable to accounting periods beginning on or after 1 January 2010. Earlier application is permitted.

## Responsibilities

- 1.9 The directors of an open-ended investment company must prepare an annual report and a half-yearly report for each accounting period of the company. Where the company's first annual accounting period is less than 12 months, a half-yearly report need not be prepared for any part of that period. **OEICR 66 R**
- 1.10 The annual report of an open-ended investment company must contain the accounts of the company and the auditor's report in respect of the accounts. **OEICR 67 R**
- 1.11 The authorised fund manager must, for each annual and half-yearly accounting period, prepare a short report and a long report. Where the first annual accounting period is less than 12 months, a half-yearly report need not be prepared. **COLL 4.5.3 R**
- 1.12 The authorised fund manager of an authorised fund that is a qualified investor scheme must prepare a report in respect of each annual and half-yearly reporting period. Where the first annual accounting period is less than 12 months, a half-yearly report need not be prepared. **COLL 8.3.5 R**
- 1.13 The directors of an open-ended investment company must lay copies of the annual report before the company in general meeting where general meetings are held. **OEICR 66 R**
- 1.13A The annual and half-yearly long reports must be signed in accordance with paragraph 3.4.

## Definitions

- 1.14 *Amortised cost*  
The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount and the maturity amount. **FRS 26**
- 1.15 *Authorised corporate director (ACD)*  
The director of an OEIC who is the authorised corporate director of the OEIC in accordance with COLL 6.5.3 R (Appointment of an ACD). **FSA Glossary**
- 1.16 *Authorised fund*  
(a) A unit trust scheme which is authorised by an authorisation order under section 243 of FSMA.  
(b) An open-ended investment company incorporated under the OEIC Regulations and authorised by an authorisation order made by virtue of the provisions of FSMA.
- 1.17 *Authorised fund manager*  
The ACD of an authorised OEIC or the Manager of an authorised unit trust scheme. **FSA Glossary**
- 1.18 *Collective investment scheme (scheme)*  
Any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income. **FSMA 235 R**
- 1.19 *Credit risk*  
The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation. **FRS 29**
- 1.20 *Currency risk*  
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates. **FRS 29**
- 1.21 *Debt securities*  
Government and public securities, debentures, debenture stocks, loan stocks, bonds, certificates of deposit and any other instrument creating or acknowledging indebtedness. **FSA Glossary**
- 1.22 *Depositary*  
The person to whom the property subject to the scheme, which is not a unit trust scheme, is entrusted for safekeeping. **FSMA 237 R**

- 1.23 *Derivative*  
A derivative<sup>1</sup> is a financial instrument or other contract with all three of the following characteristics: **FRS 26**
- (a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying');
  - (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
  - (c) it is settled at a future date.
- 1.24 *Effective interest method*  
A method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. **FRS 26**
- 1.25 *Effective interest rate (EIR)*  
The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, where appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. Paragraphs 9 and AG5 to AG8 of FRS 26 contain guidance for calculating EIR. **FRS 26**
- 1.25A *Equity instrument*  
A contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. **FRS 25**
- 1.26 *Fair value*  
The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Paragraphs AG69 to AG82 of FRS 26 contain guidance for determining the fair value of a financial asset or financial liability. **FRS 26**
- 1.27 *Fund*  
A stand alone authorised fund or an individual sub-fund of an authorised fund that is an umbrella.
- 1.27A *Gilt-edged security*  
A UK Government sterling denominated security issued by, or on behalf of, HM Treasury.
- 1.28 *Income*  
Income is the return generated from investment activities and encompasses both revenue and capital gains/losses. Revenue includes items such as dividends, interest, fees, rent and equivalent items. Capital gains/losses arise, for example, from the revaluation of investments.

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<sup>1</sup> For the purposes of determining whether returns from derivatives are revenue or capital in nature, paragraphs 2.26 and 2.27 apply to derivatives and to instruments that would be defined as derivatives but for their high initial net investment.

- 1.29 *Instrument constituting the scheme*  
In relation to an OEIC, the instrument of incorporation and in relation to a unit trust, the trust deed. **FSA Glossary**
- 1.30 *Interest rate risk*  
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates. **FRS 29**
- 1.31 *Liquidity risk*  
The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. **FRS 29**
- 1.32 *Manager*  
The firm that is the manager of an AUT in accordance with the trust deed. **FSA Glossary**
- 1.33 *Market risk*  
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk. **FRS 29**
- 1.34 *Open-ended investment company (OEIC)*  
A collective investment scheme which satisfies both the following conditions: **FSMA 236 R**  
(a) The property belongs beneficially to, and is managed by or on behalf of, a body corporate having as its purpose the investment of its funds with the aim of spreading the investment risk and giving its members the benefit of the results of the management of those funds by or on behalf of that body.  
(b) A reasonable investor would, if he were to participate in the scheme, expect that he would be able to realise, within a period appearing to him to be reasonable, his investment in the scheme and be satisfied that his investment would be realised on a basis calculated wholly or mainly by reference to the value of property in respect of which the scheme makes arrangements.
- 1.35 *Open market value*  
The fair value in respect of immovable property, determined in accordance with the Royal Institution of Chartered Surveyors' Valuation Standards, or in the case of overseas immovable property, on a basis consistent with International Valuation Standards as published by the International Valuation Standards Committee. **COLL 5.6.20 R**
- 1.36 *Operator*  
In relation to a unit trust scheme with a separate trustee, the manager. **FSMA 237 R**  
In relation to an OEIC, that company.
- 1.37 *Other price risk*  
The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market. **FRS 29**

- 1.37A *Puttable instrument*  
A financial instrument that gives the holder the right to put the instrument back to the issuer for cash or another financial asset. **FRS 25**
- 1.38 *Qualified investor scheme (QIS)*  
Qualified investor schemes are authorised funds which may be sold only to sophisticated investors and accordingly have a more relaxed set of rules governing their operation. **COLL 8.1.4 G**
- 1.39 *Trustee*  
The person holding the property in question on trust for the participants in a unit trust scheme. **FSMA 237 R**
- 1.40 *Unit trust scheme*  
A collective investment scheme under which the property is held on trust for the participants. **FSMA 237 R**
- 1.41 *Units*  
The rights or interests of the participants in a collective investment scheme. **FSMA 237 R**
- The term unit, and derivations thereof, have been used throughout this SORP for the sake of simplicity. This should not preclude an OEIC from using the term share or shareholder in situations where it is more appropriate.
- 1.42 *Zero dividend preference shares*  
Preference shares which carry no entitlement to dividends but the right, on a fixed date or on any earlier redemption, to the repayment of capital and a premium in priority to any capital payment to the holders of ordinary shares.

## 2. Accounting

- 2.1 Authorised funds are schemes whereby contributions from investors are pooled and managed together with the aim of spreading investment risk and generating an investment return for investors. The instrument constituting the scheme may provide for different classes of unit. However, where this is the case the assets and liabilities of the authorised fund remain as one pool and are not separately owned by any individual unit class.

### Assets and liabilities

#### Recognition

- 2.2 Transactions should be recognised when a legally binding and unconditional right to obtain, or an obligation to deliver, an asset or liability arises.
- 2.3 Amounts receivable and payable should be recorded for transactions awaiting settlement between the trade date and the settlement date. Amounts outstanding for purchases and sales with the same broker should not be offset unless so required by paragraph 2.8.
- 2.4 Transactions should be recognised at the total amount of the consideration payable or receivable, including transaction costs.
- 2.5 Where the consideration is not known for certain, for example there may be uncertainty about the final transaction costs relating to an immovable property transaction, a reasonable estimate of the consideration should be used.
- 2.6 Accrued interest purchased and sold on interest-bearing securities should be excluded from the cost of these securities and recognised in revenue.
- 2.7 Transactions denominated in a foreign currency should be translated using the exchange rate prevailing on the date of the transaction.
- 2.8 Assets and liabilities should not be offset unless offsetting is required. Offsetting is required when a right to set off is legally enforceable and there is an intention to settle the asset and liability on a net basis or simultaneously. **FRS 25**
- 2.9 Securities on loan should continue to be recognised and any collateral held in respect of such loans should not be recognised.

#### Valuation

- 2.10 Authorised fund managers perform regular valuations of authorised funds for the purpose of determining the dealing price of units. For most authorised funds this is done daily at a regular valuation point during the day. The methodology for valuing the investments and other assets and liabilities for pricing purposes is laid down in the instrument constituting the scheme<sup>1</sup>. **COLL 6.3.3 R**

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<sup>1</sup> Valuation guidance in COLL 6.3.6 G establishes the principles to be followed by authorised fund managers.

- 2.11 For the purposes of the financial statements all investments are to be valued at their fair value<sup>1</sup> as at the balance sheet date. In an active market the fair value of long positions is the quoted bid price and fair value of short positions is the quoted offer price. Where, in view of exceptional circumstances, for example the suspension of the market, the last quoted price is not used, the notes should describe clearly the basis of valuation and the reasoning behind it.
- 2.12 For derivatives, fair value is the price that would be required to close out the contract at the balance sheet date. A contract is closed out by another contract that eliminates any further exposure to market movements or market risk. The income and expenditure relating to a derivative are generally required to be offset so that the risks and rewards are properly matched.
- 2.13 Fair value is normally determined by reference to quoted prices from reputable sources; that is the market price. If the authorised fund manager believes that the quoted price is unreliable, or if no recent price exists, fair value is the authorised fund manager's best estimate of a fair and reasonable value for that investment arrived at in accordance with the instrument constituting the scheme. The notes should include adequate details about the basis of the valuation, and a statement on how the authorised fund manager reached the valuation. This statement should make it clear that the intention of the valuation was to estimate fair value. **COLL 6.3.6 G**
- 2.14 Foreign currency assets and liabilities should be translated using the exchange rate prevailing on the balance sheet date.
- 2.15 For the purposes of the financial statements it is acceptable to use the prices determined at the valuation point on the balance sheet date, rather than perform an additional valuation. The precise valuation point should be disclosed in the notes.
- 2.16 Investments are valued at their fair value and are shown on the balance sheet excluding any element of accrued interest. Accruals should be included at realisable value.
- 2.17 Where a fund invests in another collective investment scheme operated by the same authorised fund manager, holdings should be valued at cancellation price for dual priced funds and at the single price for single priced funds.
- 2.18 Where a fund invests in other operators' collective investment schemes, holdings should be valued at bid price for dual priced funds and at the single price for single priced funds. Valuation should take into account any agreed rate of redemption charge.
- 2.19 Immovable property should be valued at open market value. The name and qualifications of the valuer should be given in the notes, together with details of the basis of valuation of the properties. **SSAP 19**
- 2.20 Qualifying money market fund valuations are performed daily on an amortised cost basis. Weekly procedures must exist to ensure that these valuations do not **COLL 6.3.13 R**

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<sup>1</sup> It will often be the case that the valuation for the financial statements is different to the valuation for determining unit dealing prices.

differ significantly from a valuation performed on a mark to market basis. It is acceptable to use the amortised cost valuation provided that the fact that amortised cost is not significantly different to fair value is disclosed in the notes.

## **Income**

### **Revenue and capital**

- 2.21 Income encompasses both revenue and capital gains/losses. For authorised funds it is necessary to distinguish revenue from capital for the purpose of determining the distribution.
- 2.22 Revenue includes items such as dividends, interest, fees, rent and equivalent items. Capital is the return, positive or negative, from holding investments other than that part of the return that is revenue. This SORP provides guidance<sup>1</sup> on the items that should be recognised as revenue and those that should be recognised as capital. Where specific guidance is not given an item should be recognised as revenue or capital in accordance with its economic substance.
- 2.23 The distribution for the period is determined by taking the revenue, deducting the expenses and taxation and making such other adjustments as the authorised fund manager considers appropriate and in accordance with FSA rules.
- 2.24 Revenue should be recognised when earned.
- 2.25 If it is expected that revenue receivable at the balance sheet date will not be received, a provision should be made for the relevant amount.

### *Derivatives*

- 2.26 The treatment of the returns from derivatives<sup>2</sup> depends upon the nature of the transaction. Both motives and circumstances are used to determine whether returns should be treated as capital or revenue. In making such determinations it is expected that the authorised fund manager will consult with the investment manager, the auditors and the depository or trustee. Where positions are undertaken to protect or enhance capital, and the circumstances support this, the returns are capital. Similarly where they are for generating or protecting revenue, and the circumstances support this, the returns are revenue. Where positions generate total returns it will generally be appropriate to apportion such returns between capital and revenue to properly reflect the nature of the transaction.
- 2.27 For returns on an option or derivative with the characteristics of an option: if, when entered into, such an instrument has the immediate effect of generating a capital loss, for instance it is written "in the money", then generally it would be the case that all returns, including premiums received, would be regarded as being capital in nature. However, if there is no immediate capital loss generated, circumstances can support the treatment of the premium as revenue notwithstanding that any future losses may be treated as capital.

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<sup>1</sup> Revenue and capital recognition is dealt with in paragraphs 2.26, 2.27, 2.28, 2.31, 2.32, 2.34, 2.35, 2.36 to 2.50, 2.51, 2.53, 2.57, 2.58, 2.60, 2.63, 2.66 to 2.68, 2.70 and 2.71.

<sup>2</sup> In order to maintain consistency with the definition of a derivative in the tax rules (section 576 of the Corporation Tax Act 2009), paragraphs 2.26 and 2.27 apply to derivatives and to instruments that would be defined as derivatives but for their high initial net investment.

## *Dividends*

- 2.28 In the case of quoted equity shares, and non-equity shares, dividends should be recognised as revenue when the security is quoted ex-dividend (i.e. when the price quoted falls to reflect the value of the dividend concerned). In the case of unquoted equity shares, dividends should be recognised when declared, and the amount at which the securities are shown in the balance sheet should reflect any such declared dividend.
- 2.29 Application of the accruals concept means that a return (whether in respect of dividends, in respect of redemption, or otherwise) on a non-equity share (such as a preference share) should, in principle, be recognised and accrued on a time-apportionment basis. However, because of the practical difficulties arising from the requirement to undertake daily valuations for pricing purposes (such as the lack of availability of pricing information that achieves an accurate allocation between capital and revenue for these shares), this is impractical for authorised funds. Therefore, returns from non-equity shares should be recognised on the same basis as equities.

## *Stock dividends*

- 2.30 For certain securities, the holder may receive a dividend in the form of shares rather than cash. Generally the value of the shares to be received will approximate to the amount of the cash dividend (an 'ordinary' stock dividend), any small difference being attributable to the movement of the share price between the dividend declaration and the shares being quoted ex dividend. In certain cases an enhancement may be offered such that the value of the shares significantly exceeds the cash dividend (an 'enhanced' stock dividend).
- 2.31 In the case of an ordinary stock dividend, the whole amount should be recognised as revenue, on the basis of the market price of the shares on the date they are quoted ex dividend. In the case of an enhanced stock dividend, the value of the enhancement, calculated as the amount by which the total fair value of the shares on the date they are quoted ex dividend exceeds the cash dividend, is capital.

## *Special dividends, share buy-backs and additional share issues*

- 2.32 Whether a special dividend, share buy-back or additional share issue is revenue or capital depends on the facts of each particular case. It is likely that where the receipt of a special dividend results in a significant reduction in the capital value of the holding, then the special dividend should be recognised as capital so as to ensure that the matching principle is applied to gains and losses. Otherwise, the special dividends should be recognised as revenue.

## *Distributions from collective investment schemes*

- 2.33 Distributions receivable from collective investment schemes should be recognised when the units are priced ex-distribution (i.e. when the unit price falls to reflect the value of the distribution concerned).

- 2.34 Distributions receivable from collective investment schemes, excluding any equalisation element, should be recognised as revenue. Where an amount is reported in lieu of a distribution, for example, where the units are held in an accumulation form, the amount reported should be recognised as revenue.

*Zero dividend preference shares*

- 2.35 Holders of zero dividend preference shares are preferentially entitled to a return from the capital reserves of an investment company. Accordingly, the returns should be recognised as capital.

*Interest from debt securities*

- 2.36 Interest from debt securities should be recognised as revenue using the effective interest method by reference to the purchase price.
- 2.37 Some instruments are structured such that the economic substance may be closely tied to an underlying indicator. The accounting treatment should follow the economic substance. If, for example, an instrument's returns have the characteristics of equity returns, the instrument should be treated as equity and the effective interest method should not be used.
- 2.38 For the purpose of determining recognised interest, securities with embedded derivatives, for example convertible bonds, should be separated into their component parts. The effective interest method should be applied to the host contract excluding the embedded derivative. The purchase price for the host contract should be estimated, using the best available information, for example, by comparison to similar debt securities in the market with similar risk characteristics. Where this is not possible the derivative component should be valued instead.
- 2.39 Securities denominated in a foreign currency should apply the effective interest method in the foreign currency and translate the resulting amortisation using the prevailing exchange rate on the date of recognition.
- 2.40 When calculating the effective interest rate (EIR), an entity shall estimate cash flows considering all contractual terms of the financial instrument (for example, prepayment, call and similar options) but shall not consider future credit losses. **FRS 26**

*EIR and floating rate securities*

- 2.41 The calculation for floating interest rate securities initially takes the coupon rate prevailing at the date of purchase and does not take into the calculation the future changes to interest rates as predicted by the yield curve. The EIR is then recalculated each time the coupon rate applying to the security changes. Where the purchase cost of a floating interest rate security is close to the expected maturity value, it is acceptable to recognise revenue on the basis of the revised coupon rate and the original amortisation schedule.
- 2.42 In the case of a fixed to floating rate security, where the expected maturity date includes the floating rate period, the estimate of the floating rate is normally based on the variable rate at the time of purchase.

- 2.43 Index-linked securities are a form of floating interest rate security and as such follow the requirements of paragraph 2.41. However, the amount expected to be paid at maturity will be determined by the appropriate measure of inflation<sup>1</sup>, which may make the maturity value considerably higher than the purchase cost. The recognised interest includes the amortisation of this inflation uplift.

*EIR and variable maturity securities*

- 2.44 Initially cash flows for securities with variable maturity, such as callable bonds, should be estimated on the basis of the most likely maturity date. For the holder of a security this is usually the date with the worst yield to maturity, although other factors, such as the reputation of the issuer, may also be relevant. It should be assumed that issuers and holders of securities will behave rationally.
- 2.45 Over time markets typically respond to changes in market conditions by re-pricing securities, for example, falling interest rates cause the prices of fixed interest rate securities to rise. Where the terms of a security are variable, for instance the security can be called by the issuer, such price changes may alter the expected maturity date. When the expected maturity date changes it may be appropriate to consider revising cash flow estimates. Authorised fund managers should be satisfied that any such change of circumstance is sufficiently significant and will be sustained before revising cash flow estimates so as not to trigger repetitive short term reversing recalculations.
- 2.46 When, as a result of a change to the expected maturity date, the authorised fund manager revises cash flow estimates the amortised cost of a debt security should be recalculated by applying the original EIR to the revised cash flow estimates. The resulting adjustment is a capital item.

*EIR and impairment*

- 2.47 When an existing security becomes impaired, the loss due to the fall in its fair value should be recognised as capital.
- 2.48 When a distressed security (ie a security already impaired) is purchased, the purchase cost reflects incurred credit losses. Such incurred credit losses should be taken into account when estimating cash flows so as to ensure that interest is recognised at an appropriate rate, that is, a rate that is not significantly different to reasonable commercial expectations for such a security.
- 2.49 Where an event occurs that makes the receipt of future coupon payments and maturity proceeds uncertain and it is considered prudent to both cease daily income accruals and provide against previous accruals, then the maximum provision that should be made against revenue in the current period is the coupon accrual and amortisation arising since the last ex coupon date. Where there is no ex coupon date, for instance the instrument is a zero coupon debt security, then generally the preceding distribution period end date should be substituted for the ex coupon date. Where amounts in respect of previous coupons are due but not paid then consideration should also be given to providing against these in which case any provision would be recorded as an expense in the current period.

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<sup>1</sup> A suitable method of measuring the effect of inflation for index-linked gilt-edged securities will include the methodology set out in section 400 of the Corporation Tax Act 2009.

- 2.50 When a distressed security recovers, the gain due to the rise in the fair value should be recognised as capital. Any release of provisions should be recognised as revenue or expense depending on where the provision was originally recognised.

#### *Other income*

##### *Other interest*

- 2.51 Bank and other interest should be recognised as revenue on an accruals basis.

##### *Underwriting commission*

- 2.52 Underwriting commission should be recognised when the issue takes place, except where the fund is required to take up all or some of the shares underwritten, in which case an appropriate proportion of the commission received should be deducted from the cost of those shares.
- 2.53 Underwriting commission should be recognised as revenue except for the proportion of that is deducted from the cost of shares, which is capital.

##### *Rent*

- 2.54 Rent should be recognised on a straight-line basis over the period of the lease or, if shorter, up to the first rent review date. **SSAP 21**
- 2.55 Lease incentives and rent free periods should be treated as a reduction to rent and should be amortised on a straight-line basis over the period of the lease or, if shorter, up to the first rent review date. **UITF 28**
- 2.56 Where rent is subject to negotiation, the previous rent may continue to be charged by the landlord pending the conclusion of such negotiations. In this situation the authorised fund manager should include the best estimate of the market rent that will become due over the entire new period.
- 2.57 Rent should be recognised as revenue.

##### *Stock lending fees*

- 2.58 Net fees receivable arising from stock lending activities should be recognised as revenue on an accruals basis.

##### *Fee rebates*

- 2.59 Where a fund invests in other collective investment schemes, fee rebates (including trail or renewal commissions) should be recognised on an accruals basis.
- 2.60 Where it is the policy of the underlying fund to charge its fees to capital in determining its distribution, the fund should generally recognise such rebates as capital. Otherwise the fund should recognise such rebates as revenue.

### *Tax on revenue*

- 2.61 Revenue should be stated net of irrecoverable tax credits. In cases where revenue is received after the deduction of withholding tax, the revenue should be shown gross of taxation, and the tax consequences should be shown within the tax charge. **FRS 16**

### *Guaranteed funds*

- 2.62 Where a premium is paid to a third party for a guarantee, the accounting treatment follows the nature of the transaction. Where the nature of the guarantee is to limit or cap the expenses of the fund, any receipt from the third party should be shown as a deduction against expenses rather than income. Any such deduction should be disclosed in the notes. The cost of the premium should be recognised in the statement of total return over the period to which the guarantee relates. The treatment of any recoveries from third parties follows the treatment of the premium. Because there will be instances where professional judgement will be required and other factors might have to be taken into account (for example the ability of third parties to honour their guarantees), there should be sufficient narrative disclosure in the notes to enable the user properly to understand the nature of the receipt.
- 2.63 Where a third party guarantees to protect investments, the income and expenditure should be dealt with in capital; where it guarantees to protect revenue, the income and expenditure should be dealt with in revenue.

## **Expenses**

- 2.64 Expenses should be recognised when incurred.

### *Transaction costs*

- 2.65 Transaction costs are generally recognised as part of the consideration for a transaction.
- 2.66 Any other charges arising as a result of effecting transactions for the scheme should be recognised on an accruals basis as deductions from capital.

### *Expenses*

- 2.67 All expenses, including performance fees and interest on borrowing (but excluding transaction costs covered by paragraphs 2.65 and 2.66), should be charged against revenue regardless of any alternative treatment that may be permitted in determining the distribution. **COLL 6.7.11 G**
- 2.68 Where an authorised fund incurs costs in pursuing a claim, but the outcome is uncertain, those costs should be charged as expenses as they are incurred. In determining the distribution, such expenses should be offset to capital until such time as an economic benefit is crystallised. The expenses should then be matched to the benefits either as deductions against revenue or as part of capital, as appropriate.

- 2.69 To the extent that a fund is able to recover VAT it should not be included in income or in expenditure. Irrecoverable VAT should be included as part of the relevant cost. SSAP 5

## Taxation

- 2.70 In general, the tax accounting treatment should follow that of the principal amount, with charges or reliefs allocated using the marginal basis. Under the marginal basis, tax charges or reliefs are allocated to capital or revenue to the extent that there remains a liability to corporation tax after relief has been made for all expenses attributed directly to revenue and capital. In calculating how much tax relief should be allocated, revenue expenses are matched first against taxable income arising in revenue, and tax deductible capital expenses are matched first against taxable income arising in capital. Tax relief should be allocated to capital only to the extent that expenses in capital (if any remain after offsetting these expenses against taxable income in capital) are required to reduce or eliminate taxable profits. Similarly, tax relief should be allocated only to revenue to the extent that expenses in revenue (if any remain after offsetting these expenses against taxable income in revenue) are required to eliminate taxable profits. The fact that a fund is not in an overall taxpaying position is not, in itself, a reason not to allocate tax relief on expenses.
- 2.71 For example, a fund with £100 of taxable income and £120 of relievable expenses, £50 of which are offset to capital, would take full relief for the £70 of expenses borne by revenue before allocating relief of £6 (being £100 less £70 = £30 at 20%) to capital.
- 2.72 Overseas withholding tax suffered net of expected recoveries under any relevant double tax treaty, to the extent that a valid claim is or is expected to be made, should be separately disclosed in the financial statements. In addition, there may be a large amount of overseas taxation recoverable under double tax treaties. There may often be a significant time lag between the receipt of the overseas dividend net of taxation and the receipt of the tax refund. Whether the distribution should assume that all tax claims would be recovered in full will depend on the circumstances and recovery experience in respect of the investments and territories involved. If provision is considered necessary, owing to significant uncertainty as to receipt, this should be deducted from the amount receivable and disclosed as part of overseas taxation. The estimated expense of recovering the taxation should also be provided for and included within expenses.
- 2.73 Where an authorised fund opts to pay an interest distribution, the amount paid out or, for accumulation units, reinvested is allowed as a deduction against the fund's taxable profit for the period. In effect, where all of the revenue is paid out or reinvested, there should be no charge to tax within the fund. However, except where an interest distribution is paid gross to unitholders, it will nevertheless be a responsibility of the fund to deduct income tax at source at the appropriate rate on payment of the interest distribution to the unitholders. Tax withheld on interest distributions should be shown within 'other creditors' and not as part of the liability to corporation tax, since it will be settled from amounts transferred to the distribution account.

## *Deferred tax*

- 2.74 Deferred tax should be recognised in respect of timing differences that have originated but not reversed by the balance sheet date. Deferred tax assets should be recognised to the extent that, on the basis of all available evidence, it is regarded as more likely than not that they will be recovered. Deferred tax should be measured at the average tax rates that are expected to apply in the periods in which the timing differences are expected to reverse based on tax rates and laws that have been enacted or substantively enacted. **FRS 19**
- 2.75 Deferred tax assets are realised only as a reduction of a tax payment, which will normally be more than 12 months into the future. Realisation is contingent on the crystallisation of future taxable profits. Credits arising from the recognition of deferred tax assets should not form part of the distribution until the period in which the tax liability is reduced. Therefore, in determining the distribution, the benefit of taxable losses should be included only to the extent that taxable profits have arisen in the period under consideration.

## **Consolidation**

- 2.76 The principles for determining when an entity is required to produce consolidated financial statements are set out in FRS 2. When required, an authorised fund's consolidated financial statements should be prepared in accordance with the requirements of FRS 2.
- 2.77 All assets and liabilities of an entity acquired should be included in the acquirer's consolidated balance sheet at their fair value at the date of acquisition. The results and cash flows of the acquired entity should be brought into the consolidated financial statements only from the date of acquisition. **FRS 6**
- 2.78 Intragroup balances, transactions, income and expenses should be eliminated in full. **FRS 2**
- 2.79 Uniform accounting policies should be used for determining the amounts to be included in the consolidated financial statements, if necessary by adjusting these amounts for consolidation purposes. **FRS 2**
- 2.80 The annual accounting period of subsidiary undertakings should, wherever practicable, be coterminous with the parent undertaking. **FRS 2**

## **Classification of units**

- 2.81 Authorised fund units are puttable instruments. Fund units are classified as equity instruments only when they meet all three of the following conditions: **FRS 25**
- the fund is a stand-alone fund or is the sole sub-fund of an umbrella;
  - the fund has only a single class of units; and
  - the fund is not obliged to distribute by way of cash (where, for example, only accumulation units are in issue) any part of the total return to unitholders.

All other fund units are classified as financial liabilities.

## 3. Reports

- 3.1 The authorised fund manager of an authorised fund that is not a qualified investor scheme (QIS) must, no more than four months after the end of each financial year, make available and publish the annual long report and, no more than two months after the end of the first six months of each financial year, make available and publish the half-yearly long report. **COLL 4.5.14 R**
- 3.2 The authorised fund manager of an authorised fund that is not a QIS must publish and send to unitholders annual and half-yearly short reports in the timescales applicable in paragraph 3.1. The contents of the short report<sup>1</sup>, which must be consistent with the long report, are not within the scope of this SORP. **COLL 4.5.13 R**
- 3.3 The authorised fund manager of a QIS must, within a reasonable time period after the end of each relevant accounting period, make available and publish the annual report and half-yearly report. **COLL 8.3.5 R**
- 3.4 Annual and half-yearly long reports, including reports prepared under paragraph 3.3, should be signed in accordance with the Financial Services Authority's Collective Investment Schemes (COLL) sourcebook. **COLL 4.5.8B R**  
**COLL 8.3.5E R**

### Annual reports

- 3.5 Annual reports on authorised funds which are umbrella funds must contain: **COLL 4.5.7 R**
- Authorised fund manager's report<sup>2</sup>
  - Statement of the authorised fund manager's responsibilities
  - Depositary's report<sup>3</sup>
  - Auditors' report<sup>4</sup>
  - Aggregated annual financial statements (audited)
  - For each sub-fund:
    - Comparative table<sup>5</sup>
    - Total expense ratio<sup>6</sup>
    - Annual financial statements, including the distribution table (audited)
- 3.6 Annual reports on authorised funds which are not umbrella funds, or are individual sub-funds of an umbrella fund, must contain the same items as umbrella funds except that they should not include aggregated financial statements. **COLL 4.5.7 R**
- 3.7 The authorised fund manager must ensure that the financial statements referred to in paragraphs 3.5 and 3.6 give a true and fair view of the net revenue, the net capital gains or losses and the financial position of the fund as at the end of the period. This is achieved by complying with this SORP and with relevant accounting standards. **COLL 4.5.7 R**

<sup>1</sup> The contents of the short report are defined in COLL 4.5.5 R.

<sup>2</sup> The authorised fund manager's report must contain the items set out in COLL 4.5.9 R (or COLL 8.3.5C R for a QIS). This information must be given for each sub-fund if it would vary from that given in respect of the umbrella as a whole.

<sup>3</sup> The depositary's report must contain the items set out in COLL 4.5.11 R (or COLL 8.3.5D R for a QIS).

<sup>4</sup> The authorised fund manager must ensure that the auditors' report includes the all the matters set out in COLL 4.5.12 R.

<sup>5</sup> Information required in the comparative table is defined in COLL 4.5.10 R (a comparative table is not required for a QIS).

<sup>6</sup> The TER calculated in accordance with COLL 4 Annex 1 R together with the corresponding figure for the preceding financial year (TER is not required for a QIS).

- 3.8 In addition to complying with the requirements for umbrella funds, the authorised fund manager may prepare further annual long reports for any one or more individual sub-funds of an umbrella fund. **COLL 4.5.7 R**

## Half-yearly reports

- 3.9 Half-yearly reports on authorised funds which are umbrella funds must, subject to paragraph 3.12, contain: **COLL 4.5.8 R**
- Authorised fund manager's report<sup>1</sup>
  - Aggregated interim financial statements
  - For each sub-fund:
    - Number of units in circulation and net asset value per unit<sup>2</sup>
    - Total expense ratio<sup>3</sup>
    - Interim financial statements
- 3.10 Half-yearly reports on authorised funds which are not umbrella funds, or are individual sub-funds of an umbrella fund, must contain the same items as umbrella funds except that they should not include aggregated financial statements. **COLL 4.5.8 R**
- 3.11 In addition to complying with the requirements for umbrella funds, the authorised fund manager may prepare further half-yearly long reports for any one or more individual sub-funds of an umbrella fund. **COLL 4.5.8 R**
- 3.12 The authorised fund manager of an authorised fund that is a QIS may choose whether the half-yearly report is prepared for the umbrella as a whole, or for each individual sub-fund, or both. **COLL 8.3.5B R**

## Portfolio statement

- 3.13 A list of all a fund's investments is required as part of the authorised fund manager's report in both the annual and half-yearly reports. **COLL 4.5.9 R**
- 3.14 The total net assets in the portfolio statement should agree to the balance sheet total.
- 3.15 The portfolio statement is a list of all the investment assets and liabilities in a fund's portfolio. For each investment<sup>4,5</sup> it should show the following information:
- Security name
  - Amount held
  - Value determined in accordance with paragraphs 2.10 to 2.20

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<sup>1</sup> The authorised fund manager's report must contain the items set out in COLL 4.5.9 R (or in COLL 8.3.5C R for a QIS). This information must be given for each sub-fund if it would vary from that given in respect of the umbrella as a whole.

<sup>2</sup> UCITS Directive, Article 28.6. For annual reports this requirement is satisfied by the comparative table (not required for a QIS).

<sup>3</sup> The TER calculated in accordance with COLL 4 Annex 1 R together with the corresponding figure for the preceding financial year (TER is not required for a QIS).

<sup>4</sup> Notwithstanding paragraph 2.38, securities with embedded derivatives should not be separated into their component parts for the purposes of presentation in the portfolio statement.

<sup>5</sup> This information is not required for immovable property investments which should be shown in accordance with paragraph 3.22.

- Percentage of the net assets
- 3.16 The investments should be analysed by category using the most appropriate criteria in the light of the investment policy of the fund, for example economic, geographical or currency. The percentage that each category represents of the total net assets should be shown. **UCITS Sch B**
- 3.17 For funds where a significant proportion of the portfolio is invested in debt securities, where credit rating is not a category used in presenting the portfolio statement, there should be additional analysis indicating the credit quality of the portfolio. This analysis should show the proportion of the portfolio that is invested in unrated securities and the proportion in securities that are below investment grade. Where the authorised fund manager believes such analysis would be misleading, for instance due to substantial use of credit default swaps, the reasons for this belief should be disclosed and an appropriate alternative analysis should be presented.
- 3.18 Comparative percentages for each category (but not for each security) should be given for the end of the preceding financial year in order to indicate changes in the composition of the portfolio during the period.
- 3.19 If a fund invests in more than one class of asset (for example, bonds and equities) and asset class is not a category used in presenting the portfolio statement, the split between each asset class should be made clear at the foot of the portfolio statement. Such an analysis is not recommended if a single asset class represents more than 95% of the total value of the net assets.
- 3.20 The portfolio statement should distinguish<sup>1</sup> between those securities admitted to official stock exchange listing, securities traded on another regulated market, recently issued securities and other securities. **UCITS Sch B**
- 3.21 The net value of each derivative position should be shown in the portfolio statement.
- 3.22 The value and percentage of each individual immovable property need not be shown in the portfolio statement. Properties may be aggregated in bands, each band representing not more than 5% of the total value of immovable properties. Where this presentation is adopted, details of individual properties should be given within each band and the percentage of the total net assets that each band represents should be shown.
- 3.23 UCITS schemes are required to show changes in the composition of the portfolio during the period. For authorised funds this requirement is satisfied by the inclusion of all of the following:
- Portfolio statement comparatives (paragraph 3.18)
  - Total purchases and sales (paragraph 3.35)
  - Description of the material changes in portfolio composition as part of the review of investment activities

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<sup>1</sup> The categories required in this paragraph are defined by article 19 of the UCITS Directive, but for the purpose of this SORP apply to all types of authorised fund.

## Financial statements

- 3.24 The requirements for the contents of financial statements where the fund units are all classified as financial liabilities are set out in paragraphs 3.26 to 3.83 inclusive. Where fund units are classified as equity instruments in accordance with paragraph 2.81, paragraphs 3.33, 3.46, 3.48 and 3.49 should be replaced with paragraphs 3.33A, 3.46A, 3.48A and 3.49A in Appendix I. Where these paragraphs provide a format for the layout the items identified are required where applicable. Where a particular line item given in the format is nil for both the current and preceding period, that line item need not be shown.
- 3.25 Where an authorised fund is required to produce consolidated financial statements, both the consolidated and the individual primary statements required in paragraphs 3.26 or 3.29 should be presented. Where appropriate consolidated and individual notes should be presented to support the figures in the primary statements.

## Annual financial statements

3.26 A complete set of annual financial statements should contain:

- Statement of total return
- Statement of change in net assets attributable to unitholders
- Balance sheet
- Statement of cash flows<sup>1</sup>
- Notes to the financial statements

3.27 The statements above should be presented with equal prominence. There is no prescribed order in which these statements should be presented; however, the statement of total return and the statement of change in net assets attributable to unitholders should be presented on the same page, thereby providing unitholders with a summary of the principal features of the fund's results for the period.

3.28 Comparative information should be shown for all items in the annual financial statements, unless the exceptions defined in FRS 28 apply. The corresponding amounts should be the amounts for the preceding financial year. **FRS 28**

## Interim financial statements

3.29 Interim financial statements are a condensed version of annual financial statements and should contain:

- Statement of total return
- Statement of change in net assets attributable to unitholders
- Balance sheet
- Statement of cash flows<sup>1</sup>

3.30 Comparative information should be shown for all items in the interim financial statements. The corresponding amounts for the balance sheet should be the amounts as at the end of the preceding financial year and the equivalent amounts

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<sup>1</sup> A statement of cash flows is not required where the conditions in FRS 1 "Cash Flow Statements" are met (paragraph 3.50).

for the same half-yearly period in the preceding financial year for all other statements.

- 3.31 Interim financial statements should include a statement that they are prepared on the basis of the accounting policies set out in the most recent set of annual financial statements. Where it is known that an accounting policy change will be made in the annual financial statements, the change should be implemented in the interim financial statements rather than deferred to year end. The nature of each change and the reasons for it should be disclosed.
- 3.32 There are no specific requirements for notes in the interim financial statements.

## Contents of financial statements

### Statement of total return

- 3.33 The statement of total return summarises the results of the management of the fund and should show the following amounts:

|  |     |     |
|--|-----|-----|
| Income   |     |     |
| Net capital gains/(losses)   |     | X   |
| Revenue  | X   |     |
| Expenses   | (X) |     |
| Finance costs: Interest  | (X) |     |
| Net revenue/(expense) before taxation  | XX  |     |
| Taxation   | (X) |     |
| Net revenue/(expense) after taxation   |     | XX  |
| Total return before distributions  |     | XX  |
| Finance costs: Distributions   |     | (X) |
| Change in net assets attributable to unitholders<br>from investment activities |     | XX  |

#### *Net capital gains/(losses)*

- 3.34 Net capital gains/(losses) include all items that are recognised as capital. The notes should include an appropriate analysis of this figure and should distinguish amounts relating to derivatives and non-derivatives.

#### *Transaction costs*

- 3.35 Transaction costs treated as capital (paragraph 2.65 and 2.66) form part of net capital gains/losses. For purchases and for sales the total before and after transaction costs should be disclosed in the notes. The notes should also show the amount of each type of transaction cost making up the total. CIS Gov

#### *Revenue*

- 3.36 Revenue includes all items that are recognised as revenue. The notes should include an appropriate analysis of this figure and should distinguish amounts relating to derivatives and non-derivatives.

### *Stock lending*

- 3.37 Fees earned from stock lending are included in revenue on a net basis. The notes should disclose the gross fees and related expenses. **CIS Gov**
- 3.38 Disclosure should be given in the notes of the aggregate value of securities on loan at the balance sheet date, and the nature and value of collateral held in respect thereof analysed by asset class.

### *Expenses*

- 3.39 Each type of expense (excluding interest on borrowing and transaction costs) should be shown in the notes with an analysis that shows the expenses payable to each of the authorised fund manager, the depositary or trustee, other related parties and third parties.
- 3.40 Where there is directly or indirectly any fee sharing between the authorised fund manager, the depositary or an affiliate of either, this must be disclosed with the relevant details. **CIS Gov**
- 3.41 Where performance fees are charged, the basis of the charge should be disclosed. Where there are known circumstances that may affect future performance fees, this information should be disclosed in the notes.

### *Taxation*

- 3.42 The notes should include an analysis of the tax charge for the period distinguishing between current and deferred tax. The current tax charge should show separately the domestic and foreign tax, any adjustments relating to prior periods and any relief under double taxation treaties. **FRS 16**
- 3.43 The notes should disclose the amount of corporation tax that would arise on the net revenue before taxation at the standard rate for UK corporation tax for authorised funds. This amount should be reconciled to the actual current tax charge for the period.
- 3.44 The deferred tax provision at the start and the end of the period and the movement in the year should be stated in the notes.
- 3.45 The amount of any deferred tax asset that has not been recognised should be disclosed in the notes together with the circumstances in which the asset would be recovered. **FRS 19**

### *Finance costs*

- 3.46 The notes should detail the total finance costs showing distributions, interest payable and any other finance costs to give a single total. The amount and type of each distribution payable in respect of the period should be disclosed.

- 3.47 Where there is a material difference between net revenue after taxation shown in the statement of total return and the total amount of the distributions, a reconciliation of the difference should be included in the notes. It is expected that the authorised fund manager's report should explain the investment strategy, the result of which has led to this material difference.

### Statement of change in net assets attributable to unitholders

- 3.48 The statement of change in net assets attributable to unitholders reconciles the opening and closing net assets attributable to unitholders. It presents the impact of transactions with unitholders in addition to the results of the management of the fund and should show the following amounts:

|  |     |           |
|--|-----|-----------|
| Opening net assets attributable to unitholders   |     | X         |
| Amounts receivable on issue of units             | X   |           |
| Amounts payable on cancellation of units         | (X) |           |
|  |     | <u>XX</u> |
| Dilution levy                                    |     | X         |
| Stamp duty reserve tax                           |     | X         |
| Change in net assets attributable to unitholders |     |           |
| from investment activities                       |     | X         |
| Retained distributions on accumulation units     |     | X         |
| Unclaimed distributions                          |     | X         |
| Closing net assets attributable to unitholders   |     | <u>XX</u> |

Additional line items should be presented for other significant amounts.

### Balance sheet

- 3.49 The balance sheet presents the financial position and should show the following amounts:

|  |   |           |
|--|---|-----------|
| Assets:                                |   |           |
| Investment assets                      |   | X         |
| Debtors *                              | X |           |
| Cash and bank balances *               | X |           |
| Total other assets                     |   | <u>XX</u> |
| Total assets                           |   | <u>XX</u> |
| Liabilities:                           |   |           |
| Investment liabilities                 |   | X         |
| Creditors *                            | X |           |
| Bank overdrafts                        | X |           |
| Distribution payable on income units   | X |           |
| Total other liabilities                |   | <u>XX</u> |
| Total liabilities                      |   | <u>XX</u> |
| Net assets attributable to unitholders |   | <u>XX</u> |

\* For annual financial statements these items should be analysed further and items relating to derivatives should be shown separately, either in the notes or on the face of the balance sheet.

## Statement of cash flows

- 3.50 Authorised funds qualify for exemption from the need to prepare a statement of cash flows if they meet all the following conditions: **FRS 1**
- substantially all of the entity's investments are highly liquid;
  - substantially all of the entity's investments are carried at fair value; and
  - the entity provides a statement of change in net assets.
- 3.51 When assessing the criteria for exemption from the need to prepare a statement of cash flows the authorised fund manager should consider both the nature of the investments and the prevailing market conditions.
- 3.52 The statement of cash flows should deal with cash flows under the following headings: **FRS 1**
- Operating activities
  - Servicing of finance
  - Taxation
  - Financial investment
  - Financing
- 3.53 The notes to the annual financial statements should include a reconciliation between the cash flow from operating activities and the total return before distributions reported in the statement of total return. **FRS 1**
- 3.54 The notes to the annual financial statements should also include a reconciliation between the movement of cash for the period and the movement of net debt. **FRS 1**

## Notes to the financial statements

### *Accounting policies*

- 3.55 The financial statements should state the title of this SORP and whether the financial statements have been prepared in accordance with it. In the event of a departure from the SORP, the authorised fund should give a brief description of how the financial statements depart from the recommended practice set out in the SORP, which should include: **FRS 18**
- the reasons why the treatment adopted is judged more appropriate to the particular circumstances of the authorised fund; and
  - details of any disclosures recommended by the SORP that have not been provided, and the reasons why they have not been provided.
- 3.56 A description of each of the accounting policies that are material in the context of the financial statements should be given, together with a description of significant estimation techniques. Details of any changes from the previous period should also be disclosed. **FRS 18**

### *Distribution policies*

- 3.57 A description of the distribution policies that are material in the context of the distribution should be given detailing, in particular, policies relating to adjustments to net revenue after taxation in determining the distribution together with a statement explaining the consequential impact on the value of capital. Details of any changes from the previous period should also be disclosed.
- 3.58 Ordinary stock dividends are recognised as revenue in the first instance. The policy for ordinary stock dividends should state whether or not they form part of the distribution.
- 3.59 Interest from debt securities is recognised using the effective interest method in the first instance. The distribution policy<sup>1</sup> should be stated and where the policy is to increase the distribution by disregarding the effect of amortisation a statement explaining the consequential impact on the value of capital should be included.
- 3.59A The distribution policy<sup>2</sup> should be stated where that policy is designed to contribute to the preservation of the unit value in real terms.
- 3.60 Expenses, including performance fees, are charged against revenue in the first instance. Where the policy is to partially or fully offset expenses against capital in order to determine the distribution, the distribution policy should be disclosed together with a statement explaining the consequential impact on the value of capital.
- 3.61 Where an authorised fund receives distributions from other collective investment schemes the policy for recognising any equalisation included in the distribution should be stated in the accounting policies. The distribution policy of the fund in respect of this equalisation should also be stated.
- 3.62 The distribution policy for qualifying money market funds should be stated and should explain the impact that maintaining the value of such a fund has on the distribution.
- 3.63 Where consolidated financial statements are produced, the distribution policy should state whether the distribution is determined based on the authorised fund's individual net revenue after taxation or on that of the consolidated group.

### *Risk management policies*

- 3.64 Disclosures are required to enable users of financial statements to assess and understand the risks that arise in connection with financial instruments and how those risks are managed. For authorised funds, these risks will typically include market risk (currency risk, interest rate risk and other price risk), liquidity risk and credit risk. The authorised fund manager should ensure that suitable narrative and numerical risk disclosures are provided by those who are responsible for the management of those risks.

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<sup>1</sup> COLL 6.8.3 R permits transfers to be made such that distributions are determined disregarding the effect of amortisation, provided that the resultant distribution is not less than if those transfers had not been made.

<sup>2</sup> COLL 6.8.3 R permits funds whose policy is to invest predominantly in index-linked securities to make transfers in respect of index-linked gilt-edged securities in order to exclude from the distribution the amount attributable to the change in the Retail Prices Index during the period.

- 3.65 For each type of risk that arises the disclosures should include:
- an explanation of the risk, how it arises and its significance in the context of the fund;
  - a description of the objectives, policies and procedures used to manage that risk; and
  - if any of these disclosures reflect a significant change from the explanations provided for the previous period the reasons for that change should be explained.
- 3.66 In the case of an umbrella scheme the narrative risk disclosures (paragraph 3.65) may be presented in the aggregated financial statements together with a cross-reference to the numerical disclosures (paragraph 3.67) that are required to be presented in each sub-fund's financial statements.
- 3.67 Where the exposure to a particular type of risk is significant a numerical analysis of that risk is also required. When assessing the significance of a particular risk the authorised fund manager should consider both the nature of the investments and the prevailing market conditions. Market risk should be disclosed in accordance with paragraphs 3.78 to 3.82. Where disclosure is not given on the grounds of significance, it should be stated that this is the case.

*Other information in the notes*

*Commitments, contingent liabilities and contingent assets*

- 3.68 A provision should be recognised when the entity has a present obligation (legal or constructive) as a result of a past event, it is probable that a transfer of economic benefits will be required to settle the obligation, and a reliable estimation can be made of the amount of the obligation. **FRS 12**
- 3.69 Where an authorised fund has a commitment, for example, where it may be called upon to subscribe for shares pursuant to an underwriting, placing or similar agreement, and the existence of an obligation will be confirmed only by the occurrence of one or more future events not wholly within the authorised fund's control, the aggregate commitments should be disclosed. Such future events could include the passing of certain resolutions by the issuing company.
- 3.70 A contingent liability should not be recognised but, unless the possibility of a transfer of economic benefits is remote, should be disclosed with a brief description of the nature of the contingent liability and, where practicable, an estimate of its financial effect and an indication of the uncertainties relating to the amount or timing of any outflow. **FRS 12**
- 3.71 A fund may have a contingent liability with respect to partly paid and nil paid shares. Even though it may be intended to sell these shares before the calls become due, a possible obligation exists, and the aggregate commitment should be disclosed as a contingent liability for partly paid and nil paid shares.

3.72 A contingent asset should not be recognised in the financial statements unless it becomes virtually certain that an inflow of economic benefits will arise. If an inflow is probable, the contingent asset should be disclosed with a brief description of its nature and, where practicable, an estimate of its financial effect. **FRS 12**

3.73 Contingent assets usually arise from unplanned or other unexpected events that give rise to economic benefits. An example is a claim that an entity is pursuing through legal processes, where the outcome is uncertain. **FRS 12**

3.74 Whilst contingent assets should not be recognised in the financial statements they may be recognised, on a proportional or otherwise appropriate basis, for the purposes of determining the dealing prices of units. Where the bases of recognition are different, disclosure should be given in the notes explaining the reasons for the differences.

#### *Related party transactions*

3.75 Transactions and balances with related parties should be disclosed. The authorised fund manager should identify the related parties. Related parties will include, in the case of an OEIC, the ACD, and in the case of a unit trust scheme, the manager and the trustee, and may include parties by reason of their relationship with the ACD, manager or trustee. Material unitholders will be related parties to the extent that they are in a position to control the company, and the required disclosure should be given. Disclosure of other material unitholders may also be desirable. Material dealing in the units and investments of the fund carried out with or through related parties should also be disclosed. **FRS 8**

#### *Unitholders' funds*

3.76 The price of a unit is determined by reference to the proportional share of the net asset value attributable to each unit class. Where there are different unit classes, the price of units will reflect the terms and conditions of each class, but it is not necessary to analyse each class in the financial statements. The different rights and terms attaching to each unit class, including the rights on winding-up and the policy for allocating taxation and distributable income, should be summarised in the notes to the financial statements, unless they are disclosed elsewhere in the report.

#### *Distribution table*

3.77 A table showing the distribution rate per unit for each distribution relating to the period for every class of unit is required. The table should distinguish between group 1 and group 2 units, and should be analysed to show:

- Gross revenue \*
- Income tax \*
- Net revenue
- Equalisation
- Distribution

\* These items are not required for funds making dividend distributions.

### *Risk disclosures<sup>1</sup>*

- 3.78 Funds with a significant exposure to interest rate risk should include the numerical interest rate disclosures in paragraphs 3.79 and 3.80.
- 3.79 The aggregate value of assets and of liabilities should be analysed, by principal currency, to show, separately, assets and liabilities at fixed interest rates, those at floating interest rates and those that are non-interest bearing. **FRS 13**
- 3.80 The following should also be disclosed by reference to principal currencies: **FRS 13**
- the weighted average interest rate of fixed rate instruments;
  - the weighted average period for which fixed rates are fixed;
  - the weighted average period to maturity for non-interest bearing instruments;
  - the benchmark rates for determining interest payments for floating rate instruments.
- 3.81 For funds with a significant exposure to currency risk the net exposure to the principal foreign currencies should be shown after taking into account any instruments used to hedge against the foreign currencies. **FRS 13**
- 3.82 For sophisticated<sup>2</sup> funds the impact of market changes arising from the use of derivatives should be determined by using a value at risk technique or another appropriately robust model. It is recommended that disclosures should be made using the tools being used as part of the derivative risk management process. The methods and assumptions used should be described in order to aid understanding of these disclosures.

### *Events after the balance sheet date*

- 3.83 The nature and financial effect of each significant category of non-adjusting events should be disclosed. An example of such an event is an abnormally large change in the fair value of investments between the balance sheet date and the date the accounts are signed. **FRS 21**

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<sup>1</sup> The recommendations of paragraphs 3.78 to 3.82 may be overridden if a fund elects to apply FRS 29.

<sup>2</sup> There is no formal definition of what constitutes sophisticated in this context. However, a fund will be determined to be sophisticated as part of its regulatory approval. The authorised fund manager of a sophisticated fund must establish, as part of its derivative risk management process, appropriate tools to enable it to monitor and measure the risk of the fund's positions and their contribution to the overall risk profile of the fund.

## APPENDIX I – Presentation for funds with units classified as equity instruments

This appendix forms an integral part of the SORP and shows the variations to the text embedded in the body of the SORP that should be followed where a fund's units are assessed as equity instruments, having regard to the conditions in paragraph 2.81, rather than financial liabilities.

### Statement of total return

3.33A The statement of total return summarises the results of the management of the fund and should show the following amounts:

|  |     |     |
|--|-----|-----|
| Income   |     |     |
| Net capital gains/(losses)                                 |     | X   |
| Revenue  | X   |     |
| Expenses   | (X) |     |
| Finance costs: Interest                                    | (X) |     |
| Net revenue/(expense) before taxation                      | XX  |     |
| Taxation   | (X) |     |
| Net revenue/(expense) after taxation                       |     | XX  |
| Total return before distributions                          |     | XX  |
| Distributions  |     | (X) |
| Change in unitholders' funds<br>from investment activities |     | XX  |

### *Distributions*

3.46A The notes should show the distributions for the period. The amount and type of each distribution payable in respect of the period should be disclosed.

### Statement of change in unitholders' funds

3.48A The statement of change in unitholders' funds reconciles the opening and closing net assets. It presents the impact of transactions with unitholders in addition to the results of the management of the fund and should show the following amounts:

|  |     |    |
|--|-----|----|
| Opening net assets   |     | X  |
| Amounts receivable on issue of units                       | X   |    |
| Amounts payable on cancellation of units                   | (X) |    |
|  |     | XX |
| Dilution levy  |     | X  |
| Stamp duty reserve tax                                     |     | X  |
| Change in unitholders' funds<br>from investment activities |     | X  |
| Retained distributions on accumulation units               |     | X  |
| Unclaimed distributions                                    |     | X  |
| Closing net assets   |     | XX |

Additional line items should be presented for other significant amounts.

## Balance sheet

3.49A The balance sheet presents the financial position and should show the following amounts:

|                          |   |    |
|--------------------------|---|----|
| Assets:                  |   |    |
| Investment assets        |   | X  |
| Debtors *                | X |    |
| Cash and bank balances * | X |    |
| Total other assets       |   | XX |
| Total assets             |   | XX |
| Liabilities:             |   |    |
| Investment liabilities   |   | X  |
| Creditors *              | X |    |
| Bank overdrafts          | X |    |
| Total other liabilities  |   | XX |
| Total liabilities        |   | XX |
| Net assets               |   | XX |
| Unitholders' funds       |   | XX |

\* For annual financial statements these items should be analysed further and items relating to derivatives should be shown separately, either in the notes or on the face of the balance sheet.

## APPENDIX II – Laws, regulations and accounting standards

At the time the SORP was issued the following laws, regulations and accounting standards were relevant to the financial statements of authorised funds.

### Laws and regulations

#### **UCITS Directive 85/611/EEC (UCITS)**

The European Council Directive of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), as amended.

Section VI deals with the requirements for publishing periodical reports. Schedule B of annex I deals with the information to be included in the periodic reports. Articles 19 and 21 provide background information to some of the requirements of Schedule B.

#### **Financial Services and Markets Act 2000 (FSMA)**

An Act to make provision about the regulation of financial services and markets.

Part XVII deals with powers of incorporation and authorisation and defines the types of entity that are authorised funds and the parties involved their operation.

#### **Open-Ended Investment Companies Regulations 2001 (OEICR)**

Regulations governing the establishment, carrying on, and regulation of open-ended investment companies (OEICs).

Part II deals with powers of incorporation and authorisation. Part III deals with the responsibilities of the directors of an OEIC, including in respect of reports.

#### **Collective Investment Schemes Sourcebook (COLL)**

Part of the FSA's regulatory handbook, this specialist sourcebook provides the detailed framework within which authorised funds operate.

Section 4.5 deals with an authorised fund manager's responsibilities in relation to reports and accounts. Chapter 6 deals with operating duties and responsibilities of the parties involved in operating an authorised fund.

#### **Collective investment schemes governance review (CIS Gov)**

A set of recommendations regarding the governance arrangements of UK authorised collective investment schemes and issued by the IMA in February 2005.

### Accounting standards

#### **FRS 28 - Corresponding Amounts**

The standard sets out the requirements for the disclosure of corresponding amounts for items shown in an entity's primary financial statements and the notes to the financial statements.

#### **FRS 25 (IAS 32) - Financial Instruments: Presentation**

This standard establishes principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. It applies to the classification of financial instruments, from the perspective of the issuer, into financial assets, financial liabilities and equity

instruments; the classification of related interest, dividends, losses and gains; and the circumstances in which financial assets and financial liabilities should be offset.

### **FRS 21 (IAS 10) - Events after the Balance Sheet Date**

This standard specifies the accounting treatment to be adopted (including the disclosures to be provided) by entities for events occurring between the balance sheet date and the date when the financial statements are authorised for issue.

### **FRS 19 - Deferred Tax**

This standard requires full provision to be made for deferred tax assets and liabilities arising from timing differences between the recognition of income and expenditure in the financial statements and their recognition in a tax computation.

### **FRS 18 - Accounting Policies**

This standard ensures that the most appropriate accounting policies are adopted and communicated to users, that they remain appropriate and are changed when a new policy becomes more appropriate.

### **FRS 16 - Current Tax**

This standard prescribes the recognition and disclosure of current taxes.

### **FRS 13 - Derivatives and other Financial Instruments: Disclosures**

This standard requires disclosures that enable users to assess the entity's objectives, policies and strategies for holding or issuing financial instruments, in particular, the risk profile of the main financial risks that may arise and the significance of such instruments.

This standard has been superseded for entities that apply FRS 29. This SORP has been developed on the basis that authorised funds will not elect to apply FRS 29 voluntarily so the requirements of FRS 13 continue to be applicable.

### **FRS 12 - Provisions, Contingent Liabilities and Contingent Assets**

This standard ensures that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets, and that sufficient information is disclosed about their nature, timing and amount.

### **FRS 9 - Associates and Joint Ventures**

This standard sets out the definitions and accounting treatments for associates and joint ventures. It makes special provisions for investment funds.

### **FRS 8 - Related Party Disclosures**

This standard ensures that financial statements contain the disclosures necessary to draw attention to the possibility that the reported financial position and results may have been affected by the existence of related parties and by material transactions with them.

### **FRS 7 - Fair Values in Acquisition Accounting**

This standard ensures that the assets and liabilities are recorded at fair value at the date of an acquisition.

### **FRS 6 - Acquisitions and Mergers**

This standard ensures that financial statements show consistent and relevant information about a combination. The acquisition method of accounting for a combination is to be used unless a set of criteria defining a merger is met.

### **FRS 5 - Reporting the Substance of Transactions**

This standard requires that the substance of a transaction, that is the economic effect, is reported and not merely the legal form.

### **FRS 4 (as amended by FRS 25) - Capital Instruments**

This standard ensures that costs associated with capital instruments that are classified as liabilities are allocated to accounting periods on a fair basis over the period the instrument is in issue.

### **FRS 3 - Reporting Financial Performance**

This standard provides for the information required for users to form an understanding of the performance achieved in the period.

### **FRS 2 - Accounting for Subsidiary Undertakings**

This standard requires consolidated financial statements to be prepared that show a group as if it were a single economic entity.

### **FRS 1 - Cash Flow Statements**

This standard prescribes the reporting of cash flows, so as to facilitate comparison and provide information to assist in the assessment of liquidity, solvency and financial adaptability.

### **SSAP 21 - Accounting for leases and hire purchase contracts**

This standard prescribes the accounting treatment in respect of leases to be adopted by lessors. It is applicable to leasehold properties in immovable property funds.

### **SSAP 20 - Foreign currency translation**

This standard prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity.

### **SSAP 19 - Accounting for investment properties**

This standard requires investment properties to be carried at current value and the results to reflect changes in current value instead of systematic depreciation charges.

This SORP anticipates amendment of this standard to accommodate the change to IAS 40 proposed in the IASB's annual improvements project. This allows development properties to be valued on the same basis as investment properties.

### **SSAP 5 - Accounting for value added tax**

This standard defines the treatment of recoverable and irrecoverable VAT amounts.

### **UITF abstract 28 – Operating lease incentives**

Supplements SSAP 21 by defining the recognition of lease incentives.

### **ASB Statement: SORPs: Policy and code of practice**

This statement provides guidance on the policy for recognition of a SORP-making body and the process of developing and issuing a SORP.

The following standards do not currently apply to authorised funds. However, if they were to apply, they would be relevant to authorised funds.

**FRS 29 (IFRS 7) - Financial Instruments: Disclosures**

This standard requires disclosures that enable users to evaluate the significance of financial instruments on financial position and performance, the nature and extent of risks from financial instruments, and how the entity manages those risks. This standard, which supersedes the disclosure requirements of FRS 25, is not mandatory because it forms part of the FRS 26 package of standards.

**FRS 26 (IAS 39) - Financial Instruments: Measurement**

This standard establishes principles for measuring financial assets and financial liabilities. It does not apply to authorised funds although the SORP has been aligned with FRS 26 in respect of the determination of 'fair value'. The SORP utilises FRS 26 definitions in so far as they are required by FRS 25.

**FRS 23 (IAS 21) - The Effects of Changes in Foreign Exchange Rates**

This standard prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency. This standard, which supersedes SSAP 20, does not apply because it forms part of the FRS 26 package of standards.

The following standards are applicable but are not likely to be relevant to authorised funds.

FRS 27 - Life Assurance

FRS 24 (IAS 29) - Financial Reporting in Hyperinflationary Economies

FRS 22 (IAS 33) - Earnings per share

FRS 20 (IFRS 2) - Share-based Payment

FRS 17 - Retirement Benefits

FRS 15 - Tangible Fixed Assets

FRS 14 - Earnings per Share

FRS 11 - Impairment of Fixed Assets and Goodwill

FRS 10 - Goodwill and Intangible Assets

SSAP 25 - Segmental reporting

SSAP 13 - Accounting for research and development

SSAP 9 - Stocks and long-term contracts

SSAP 4 - Accounting for government grants