

## **New rules for accounting for and distributing bond income in authorised investment funds**

There have been changes to the way in which bond income is accounted for and distributed from authorised funds (unit trusts and OEICs). For most funds, there will be little difference in what investors receive over time; however, at the next distribution point information will be provided for investors on the accounting change and any consequent change in the fund's distribution basis, and managers will likely make that information available more widely (eg on their websites).

Specifically, funds will need to decide whether to distribute on the new accounting basis ("effective yield" – explained below) or to continue to distribute coupon income, as previously. In practice, only those funds whose investment objective is to provide high income are expected to continue to distribute on a coupon basis. Advisers and other intermediaries, who wish to know of the impact on a particular fund ahead of its distribution date, may wish to contact the relevant management company direct.

### *The changes*

For authorised funds, bond income used to be accounted for, and distributed, on the basis of coupon income receivable for most bonds. However, following changes in accounting rules, for periods beginning on or after 1 January 2007 funds are required to account for income from bonds on an "effective yield" basis. Effective yield takes account of all expected cash flows from a bond over its lifetime. This differs from the coupon basis because expected cash flows include, in addition to coupons, any differences which exist between the purchase cost of a bond and its final redemption amount (as shown below).

In light of this change in accounting rules, and in order to allow high income funds to continue to distribute coupon income notwithstanding the change in accounting, the Financial Services Authority has clarified its rules. From 23 March 2007, the rules allow managers of authorised funds to choose to distribute income from bonds on the newly introduced effective yield basis (as shown in the fund's accounts) or on a coupon basis. Coupon distributions are permitted only where these are at least equal to the amount of the income calculated on an effective yield basis.

Funds will have to declare whether they are distributing on a coupon or effective yield basis. Many funds will choose to keep distributions in line with accounting income, and will distribute effective yield income. Some funds, particularly those whose objective is to produce regular income for investors (such as high income bond funds), will continue to distribute coupons. Funds that distribute on a coupon basis may have a higher risk of capital erosion or constrained future growth. However, it is important to note that other factors, such as changes in interest rates, may impact the value of bonds held by a fund, no matter what its distribution policy.

### *Effective yield and coupon bases compared*

In order to illustrate the differences between effective yield and coupon based accounting and distribution, two simple examples are set out below.

In reality a fund will hold a portfolio of investments and may not hold them to maturity. The distribution which an investor receives will depend on the net income from the entire portfolio. For the purpose of the examples, however, the impact of a fund's distribution policy is illustrated on the assumption that the fund holds only one bond and that it holds it to maturity. In example A, a fund purchases a bond at a premium to its redemption value. In example B, a bond is purchased at a discount.

#### *Example A*

A fund buys a bond for £102. The bond is due to redeem in one year's time for £100 and pays an annual coupon of £8. The total return on holding this bond over the year is, therefore, £6 (that is, £8 of coupon minus the £2 loss when the bond is redeemed). The coupon and effective yield bases of calculating income (ignoring any investor tax) can be compared as follows:

1. The fund's income on a coupon basis for the coming year is £8; if income is accounted for on a coupon basis, the fund in this example will make a capital loss of £2 as the amount receivable on redemption is less than the purchase cost.
2. The fund's income on an effective yield basis is £6; if income is accounted for on an effective yield basis, the fund in this example will make no capital loss or gain as the £2 premium paid on purchase of the bond is brought into the income calculation.

In this example, an investor in the fund would in the past typically have received a distribution of £8, being the amount of the coupon income. In future the fund may choose either to continue to distribute on a coupon basis or to distribute on an effective yield basis:

1. Distribution on a **coupon** basis will enable investors to continue to receive distributions as they have done in the past, with potential impact on the capital value of their investment: in this case, £8.
2. Where a fund distributes on an **effective yield** basis, investors may notice a change in the amount of distributions compared with previous years. In this case, the investor would receive a distribution of £6 compared with the £8 received in the past, but the capital value of their investment is not reduced as it is taken into account when the income is calculated.

#### *Example B*

A fund buys a bond for £98. The bond is due to redeem in one year's time for £100 and pays an annual coupon of £4. The total return on holding this bond over the year is, therefore, £6 (that is, £4 of coupon plus the £2 gain when the bond is redeemed).

In this example, the fund's income on a coupon basis for the coming year is £4 and the accounting income on an effective yield basis is £6. The fund is not permitted to

distribute on a coupon basis as this is less than the amount of the fund's income calculated on an effective yield basis

An investor in this fund would, in the past, typically have received a distribution of £4, being the amount of the coupon income.

When the fund changes to distribute on an effective yield basis, investors may notice a change in the amount of distributions compared with previous years. In this case, the investor would receive a distribution of £6 compared with the £4 received in the past as the redemption amount is taken into account when the income is calculated.

Examples A and B above are summarised in the following table:

|                              | Example A<br>£ | Example B<br>£ |
|------------------------------|----------------|----------------|
| <b>Bond details</b>          |                |                |
| Cost of bond                 | 102            | 98             |
| Redemption amount            | 100            | 100            |
| Annual coupon                | 8              | 4              |
| Total return                 | 6              | 6              |
| <b>Coupon basis</b>          |                |                |
| Coupon income                | 8              | 4              |
| Capital gain/( loss)         | ( 2)           | 2              |
| <b>Effective yield basis</b> |                |                |
| Effective yield income       | 6              | 6              |
| Capital gain/(loss)          | 0              | 0              |

It is important to note that these examples relate to only one bond; funds will have a mix of bonds in their portfolio all of which, taken together, will determine an investor's net income. In practice, therefore, for a number of funds effective yield income will be little different from coupon income for the portfolio as a whole. It is only those funds whose portfolios predominantly contain either high coupon bonds or low coupon bonds where the difference may be material. Typically, high income bond funds will be heavily invested in bonds bought at a premium and/or with high coupons. For these funds, coupon income will generally be above effective yield, so are more likely to choose to distribute on a coupon basis.

*Technical footnote*

The examples above are simplistic in that they consider a portfolio of one bond, they are also simplistic in that they consider bonds with only one year to maturity, so do not reveal the full complexity of effective yield accounting. The effective yield basis recognises income over the life of a bond using its effective interest rate ("EIR"). The EIR is similar to a redemption yield calculated when the bond is acquired or to an internal rate of return. It is the rate that exactly discounts expected future cash receipts back to the net carrying amount of the bond. This methodology is more precise than simple methods of amortising discounts or premiums, such as, for example, "the straight line method".