Investment Management Association

ima

30 April 2012

Michelle Sansom
Accounting Standards Board
5th Floor, Aldwych House
71-91 Aldwych
London WC2B 4HN

Dear Michelle

The Future of Financial Reporting: Revised FREDs 46 - 48

The IMA represents the asset management industry operating in the UK. Our Members include independent fund managers, the investment arms of retail banks, life insurers and investment banks, and the managers of occupational pension schemes. They are responsible for the management of around £4 trillion of assets, which are invested on behalf of clients globally. These include UK-authorised investment funds, institutional funds (e.g. pensions and life funds), private client accounts and a wide range of pooled investment vehicles. In particular, our Members represent £0.6 trillion of funds under management in more than 2,400 Authorised Investment Funds (i.e. unit trusts and open-ended investment companies) and around £1.4 trillion in occupational pension schemes. IMA is the SORP-making body responsible for the SORP for Authorised Funds.

We welcome the proposals set out in the revised FREDs which we find to be a significant improvement to the superseded proposals. In particular, we applaud the ASB for abandoning the troublesome public accountability threshold that was to define Tier 1, and would have extended the reach of mandatory EU-adopted IFRS to entities for which the users of the accounts would derive little, if any, benefit. We believe the ASB's willingness to engage with IMA and other representative bodies throughout the development of the FREDs has enhanced the outcome and we look forward to this dialogue continuing as the draft FRSs are finalised.

Our substantive comments on the draft FRSs reflect the nature of investment funds. In line with the project objective and the guidelines for amending the IFRS for SMEs, we recommend that draft FRS 102 should be amended to:

- allow established SORP accounts formats to be used by entities that do not report under the Companies Act;
- allow investment funds to measure basic financial instruments at fair value with changes in fair value recognised in profit or loss; and
- amend the consolidation exemption to achieve an outcome consistent with the proposed IFRS investment entity exemption from consolidation.

65 Kingsway London WC2B 6TD
Tel:+44(0)20 7831 0898 Fax:+44(0)20 7831 9975

www.investmentuk.org

The nature of investment funds

In general, companies use capital markets to raise funds to finance their operations. Investors use capital markets to invest in such companies and by investing they become the owners of those companies. In deciding whether or not to invest, they will rely on financial statements in order to assess the resources and prospects of those companies. Information about cash flows is likely to be essential to that assessment.

In contrast, an investor in an investment fund is a customer of a fund management company. Such an investor might not have the ability, inclination or resource to make economic decisions about which companies to invest in. Instead, they contribute their capital, along with other investors, and the fund manager makes the economic decisions about how to deploy the capital raised. The fund manager will place their customers' contributions into a segregated investment fund and will invest it on a collective basis in accordance with an investment strategy with the aim of maximising benefits to those customers. The customer's decision to invest is based on their appetite for risk (defined by an investment strategy) and the fund manager's credentials (investment performance record).

In order to evaluate the performance of their investment, and ultimately to realise the benefits of their investment, customers will be interested in the fair value of their holding and how this has changed over the period. The role of the fund manager is to execute the agreed investment strategy with a view to maximising investment returns within the established risk parameters. The fund manager manages the portfolio of investments and evaluates its performance on a fair value basis in accordance with a defined investment strategy.

Accounts formats

In order to improve consistency in presentation the draft FRS extends the application of the company law formats to entities that are not incorporated under the Companies Act, or otherwise bound by its requirements. The nature of the relationship between an investor, the fund manager and the investment fund make it highly improbable that investment fund accounts would be compared to operating company accounts, and even if they were, the comparison would reveal little, if any, useful information. Therefore, in the case of investment funds, we believe this consistency in presentation has no utility.

The application of the company law formats to investment funds is a deviation from the ASB's project objective which is:

"To enable users of accounts to receive high-quality, <u>understandable financial reporting</u> proportionate to the size and complexity of the entity and <u>users' information needs</u>." (our emphasis).

Authorised investment funds apply a SORP which specifies the format of the balance sheet and the profit and loss account. These formats have been in existence with only minor amendments (made to accommodate the ASB's past convergence activities in a manner consistent with EU-adopted IAS 1) since the SORP for Authorised Unit Trust Schemes was issued by the Investment Management Regulatory Organisation ("IMRO", the FSA's predecessor) and approved by the ASB in October 1996. Successive SORP working parties have reviewed the SORP formats and found them to satisfy users' information needs. In particular, the profit and loss account is structured to enable users to understand how capital appreciation and investment income have arisen, how these have contributed to the fair value of their investments and how the amount of any distribution has been determined. Imposing the company law formats would make the financial reports of investment funds more complex and potentially less understandable.

The application of the company law formats to investment funds is not consistent with the guidelines for amending the IFRS for SMEs because the changes are not consistent with EU-adopted IFRS. The implementation of FRS 25 (IAS 32) caused the units issued by investment funds to be reclassified as liabilities by virtue of being puttable instruments and therefore investment funds commonly have no equity. This will continue to be the case under the draft FRS, and we welcome the additional certainty provided in paragraph 22.5(b) in this respect. Following the company law formats would result in these investment funds having a balance sheet total of nil. Full EU-adopted IAS 1 (and the IFRS for SMEs) has sufficient flexibility to allow a presentation[1] of the balance sheet that excludes fund units from the liabilities section such that the balance sheet ends with "net assets attributable to unitholders". This provides users with a more meaningful and understandable presentation of the financial position of an investment fund and is the approach incorporated into the SORP.

The Pension schemes' SORP specifies that the accounts should comprise a Fund Account and a Net Assets Statement. The Fund Account segregates dealings with members and returns on investments and reconciles net assets at the beginning and end of the year. The presentation of this information in the company law formats in likely to be inconsistent with the ASB's project objective.

Schedule 1 of the Charities Regulations[2] requires methods and principles set out in the SORP for Authorised Funds to be followed and specifies the formats of the accounts for common investment funds[3]. These formats are taken from the SORP for Authorised Funds and conflict with the company law formats. Their regulatory status overrides the draft FRS and would cause inconsistent presentation of the accounts of authorised investment funds and common investment funds.

We recommend eliminating these inconsistencies with both the project objective and EU-adopted IFRS by not imposing the company law formats where they do not already apply and allowing more flexibility in the formats. This could be achieved by allowing the use of established SORP formats; formats over which the ASB, through its advisory committees, will retain control.

Fair value accounting

The nature of investment funds makes it is essential that their financial results are presented on a fair value basis, regardless of whether any of their holdings are basic or more complex financial instruments, or qualify as subsidiaries, associates or joint ventures. Therefore we welcome the exemption from consolidation for portfolio investments and the ability to measure subsidiaries, associates and joint ventures at fair value with changes in fair value

[1] Example 7 of the illustrative examples accompanying IAS 32

[2] The Charities (Accounts and Reports) Regulations 2008

[3] Common investment funds are a form of investment fund available only to registered charities and operated according to the same principles as authorised investment funds

recognised in profit or loss. However, it is anomalous that basic debt instruments cannot be measured at fair value in the same way.

Basic financial instruments

The ASB concluded that it would not be logical or meaningful to force investment entities that are eligible to apply the draft FRS to apply instead full EU-adopted IFRS in order to take advantage of the IASB's investment entity exemption. We find it anomalous that fair value measurement of basic debt instruments can be achieved only by applying the recognition and measurement provisions of the full EU-adopted IAS 39/IFRS 9. IFRS 9 is incomplete, and with a number of further exposure drafts and a possible discussion paper to be published later this year, the requirements and delivery date remain impossible to predict. This, and the subsequent EU adoption process, means that there will be significant uncertainty as to the core accounting requirements for investment funds for some considerable time to come. Moreover, the ASB has not addressed the interaction with IFRS 13.

We recommend eliminating the anomaly and uncertainty with a simple amendment (see annex 1) to section 11 to allow investment funds to measure all financial assets at fair value. This is consistent with the fair value option available in company law.

Consolidation

We agree with the ASB's conclusion that it would not be logical or meaningful to force investment entities that are eligible to apply the draft FRS to apply instead full EU-adopted IFRS in order to take advantage of the IASB's investment entity exemption. In formulating their exemption, the IASB and FASB decided that an investment exit strategy is an essential determinant of an investment entity. It is in the nature of investment funds that fund managers invest with the aim of maximising benefits to their customers in the form of capital appreciation, investment income, or both. Ultimately, realising those benefits will involve the disposal of investments. Therefore, we consider the inclusion of interests "held as part of an investment portfolio" in the definition of interests "held exclusively with a view to subsequent resale" is appropriate as this is consistent both with the IASB and FASB approach and with the nature and purpose of investment funds.

However, the draft FRS is not consistent with the guidelines for amending the IFRS for SMEs because the effect is not consistent with (future) EU-adopted IFRS. There are three scenarios in which the IASB's investment entity exemption from consolidation applies and the draft FRS should replicate these outcomes:

1. An investment fund holds a controlling interest in another entity as part of a basket of investments. The investment fund should measure the holding at fair value instead of consolidating. This is the effect of the draft FRS.

2. An investment fund is a feeder fund and invests solely in a second investment fund, the master fund, which holds a basket of investments. The feeder fund's holding represents a controlling interest in the master fund. The feeder fund should measure its interest in the master at fair value instead of consolidating. However, the draft FRS requires consolidation and is inconsistent with the IASB's investment entity exemption[4].

[4] IFRS Exposure Draft: Investment Entities (August 2011): Example 4

3. The master fund in the previous scenario holds a controlling interest in another entity as part of a basket of investments. The proposals have the effect of preserving the master fund's treatment (ie measuring the holding at fair value) in the consolidated accounts of the feeder. However, the feeder fund should not be consolidating the master fund.

We recommend eliminating the inconsistency with the IASB's exemption for master-feeder arrangements with a simple amendment (see annex 1) to the definition of an interest "held as part of an investment portfolio".

Financial institutions

The financial institution definition is broad and includes a number of distinct types of entity that carry out very different activities. Many banking and insurance activities use financial instruments to insulate the entity from the economic environment and generate wealth for their shareholders by extracting a margin from their customers. These entities hold financial instruments on their proprietary balance sheets and credit risk and cash flow are important for evaluating their financial position. In contrast, investment funds use financial instruments to expose their customers to changes in the economic environment in order to generate wealth for those customers and it is information about changes in fair value that is essential for evaluating their financial position and performance. We believe it would be helpful for the financial institution definition to group together similar types of financial institution under a number of sub-headings, for example, banks and bank-like entities, investment funds, and so on.

Most of the entities are defined by reference to various Acts or Regulations. However, part (d) defines investment funds by listing a variety of legal forms. A drawback of this approach is it cannot readily accommodate new legal forms, for example, HM Treasury will shortly introduce a new form of investment fund in the UK as detailed in the consultation on contractual schemes for collective investment.[5] The ASB might wish to consider our suggestions for some more resilient definitions in this respect (see our response to question 4).

Please do not hesitate to contact us regarding these comments or any other matters arising as you progress towards finalising the proposals.

Yours sincerely

Mark Sherwin
Senior Adviser, Financial Reporting

[5] Consultation on contractual schemes for collective investment (January 2012) issued by HM Treasury

Annex 1: FRS 102 drafting comments

Accounts formats

In order to afford investment funds the flexibility to present their accounts in the most appropriate format, we recommend reinstating paragraph 4.9 of the IFRS for SMEs and amending paragraphs 4.1 and 5.1 of the draft FRS as follows:

> *"Entities that do not report under the Act should comply with the requirements of this section, and with the Regulations where referred to in this section, except to the extent that these requirements are not permitted by any statutory framework under which such entities report<u>, or an alternative presentation is more appropriate due to the specialised nature of a particular industry or sector</u>."*

For completeness we recommend adding authorised investment funds to the table in paragraph A3.30 of the draft FRS, as follows:

Legislation	Overview of requirements
"Financial Services and Markets Act 2000 and regulations made thereunder	*The regulations require that the annual accounts give a true and fair view of the net revenue and the net capital gains or losses for the annual accounting period in question and the financial position as at the end of that period and that they must be prepared in accordance with the requirements of the SORP for Authorised Funds."*

Fair value accounting

In order to allow investment funds to measure basic financial instruments at fair value, we recommend adding the following to paragraph 11.7:

> *"(h) financial instruments held as part of an investment portfolio."*

The definition "held as part of an investment portfolio" is used in paragraph 9.9A to replicate the IFRS investment entity exemption from consolidation. We recommend amending the definition in order to align it with the IFRS investment entity exemption from consolidation in respect of master-feeder arrangements.

The definition is also used in paragraphs 14.4B and 15.9B to ensure the measurement requirements for associates and jointly controlled entities are consistent with subsidiaries measured at fair value with changes in fair value recognised in profit or loss. We recommend deleting all but the first sentence in paragraphs 9.9A, 14.4B and 15.9B and instead creating a glossary definition as follows:

"held as part of an investment portfolio	*~~A subsidiary~~ <u>An interest</u> is held as part of an investment portfolio if its value to the investor is <u>directly or indirectly</u> through <u>the</u> fair value ~~as part~~ of a ~~directly or indirectly held~~ basket of investments rather than as media through which the investor carries out business. ~~A basket of investments~~ <u>The value of an investment portfolio</u> is indirectly ~~held~~ <u>through the fair value of a basket of investments</u> if an investment fund holds a single investment in a second investment fund which, in turn, holds ~~a~~ <u>the</u> basket of investments."*

Annex 1: FRS 102 drafting comments

Statement of cash flows

Paragraph 3.17 (d) requires a statement of cash flows to be presented. Section 7 sets out the information to be presented in a statement of cash flows. Paragraph 7.1A excludes certain types of entity from the scope of section 7, but does not deliver the intended exemption from the need to present a statement of cash flows.

In order to provide the intended exemption we recommend moving paragraph 7.1A to paragraph 3.17A, and amending it as follows:

> *"3.17A A complete set of financial statements of the following entities does not include a statement of cash flows: ..."*

Financial instruments disclosures

Paragraph 11.48
This paragraph corresponds to paragraph 20 of IFRS 7. However, it is unclear how certain items should be reported. IFRS 7 requires disclosure of net gains or net losses on financial assets or financial liabilities measured at fair value through profit or loss. However, the draft FRS requires amounts to be separately disclosed for financial assets and for financial liabilities. For an instrument with no initial outlay, this disclosure produces some meaningless results in the income statement. A derivative with no initial outlay is defined as an asset or liability by whether it stands at a gain or a loss. Moving from gain to loss, or vice versa, changes the balance sheet classification in a meaningful way. However, in the income statement, it is of no consequence whether a gain or loss for the year arises on a derivative standing at an overall gain or loss over its life.

Paragraph 20 of IFRS 7 requires separate disclosure of net gains or net losses on financial instruments measured at amortised cost and total interest income and total interest expense calculated using the effective interest method. However, the draft FRS requires disclosure of income, expense, gains or losses on instruments measured at amortised cost and total interest income and total interest expense calculated using the effective interest method. This appears to result in a duplication of the disclosure requirements for income and expenses.

We recommend redrafting paragraph 11.48 to clarify the requirements.

Paragraph 11.48A
The fair value option in paragraph 36 of Schedule 1 to the Companies Act Regulations applies to all financial assets and to financial liabilities that: are held as part of a trading portfolio; are derivatives; or, provided the appropriate disclosures are made, are permitted by EU-adopted IFRS to be included at fair value. Paragraph A3.7 recognises that the disclosures introduced by paragraph 11.48A are not required for financial assets or for financial liabilities that are held as part of a trading portfolio or are derivatives.

Paragraphs 9-11 of IFRS 7 require credit risk disclosures <u>solely</u> for financial assets and liabilities that have been <u>designated</u> as measured at fair value and would otherwise have been measured at amortised cost. In implementing these requirements, paragraphs 11.48A (a)-(c) have extended the scope of these disclosures to <u>all</u> financial assets in addition to the intended financial liabilities. Investment funds mandatorily measure all financial instruments at fair value and the ASB has developed specific disclosures for financial institutions in section 34. The fair value nature of investment funds make credit risk a form of market risk and disclosures should be made in that context. Therefore the extended scope of paragraph 11.48A, and in particular clauses (a)-(c), will cause extensive additional disclosure which has no utility.

In order to align the scope of paragraph 11.48A with company law and the intention expressed in paragraph A3.7, we recommend restricting the requirements to financial liabilities.

Annex 2: IMA's responses to the specific questions

<u>QUESTION 1</u>

The ASB is setting out the proposals in this revised FRED following a prolonged period of consultation. The ASB considers that the proposals in FREDs 46 to FRED 48 achieve its project objective:

> To enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs.

Do you agree?

No. We have identified an important aspect of the proposals that do not meet the project objective. This is the extension of the company law formats to entities that do not report under the Companies Act. Investors in investment funds hold units or shares that represent their proportionate participation in the fund. These units or shares are generally classified as liabilities because the holder has the right to put them back to the issuer (the fund). As a result, investment funds often have no equity and reporting under the company law formats would result in a balance sheet total of nil.

Authorised investment funds currently use accounts formats specified in the SORP which is based on illustrative example 7: entities with no equity that accompanies IAS 32. The gives a balance sheet total representing the "net assets attributable to unitholders"; a figure that is highly significant because it is the figure in which investors have a proportional participation.

The SORP formats require a layout for the profit and loss account that shows clearly the capital growth and investment income components of the total return. This format does not comply with the company law formats.

The SORP formats are widely accepted as being readily understandable and the best way to satisfy users' information needs. Imposing the company law formats will therefore be detrimental to the terms of the project objective and we have made alternative suggestions elsewhere in this response.

<u>QUESTION 4</u>

Do you agree with the definition of a financial institution? If not, please provide your reasons and suggest how the definition might be improved.

Yes, but we do have suggestions as to how the definition might be improved in order that it is more resilient. Part (d) of the definition relies on a list of common legal forms of investment fund (although it should be noted that custodian banks and stockbrokers are different in nature to investment funds). A new form, such as the contractual schemes currently being introduced in the UK, might require the existing definition to be modified. An alternative approach might be to use regulatory references, such as "investment companies as defined in the Companies Act" and "Collective Investment Schemes as defined in the Financial Services and Markets Act", together with the equivalent Irish references.

Another alternative might be a qualitative test, such as the EU definition[6] of investment funds, which is:

"collective investment undertakings which raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors".

QUESTION 8

Do you agree with the effective date? If not, what alternative date would you prefer and why?

We tentatively agree with the effective date, but are concerned about the impact that the evolution of, and the ASB's response to, IFRS 9 might have. We have suggested in our covering letter that a fair value option for investment funds should be introduced in section 11 and this would alleviate our concerns.

QUESTION 9

Do you support the alternative view, or any individual aspect of it?

No, we do not support the alternative view, which appears to be focussed on the nature of small and medium-sized businesses where "cash is king". UK GAAP applies far more widely than such entities and, as explained in our covering letter, the nature of investment funds is such that "fair value is king" and cash is of such little relevance that it is normally appropriate to dispense with the cash flow statement.

[6] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011